

Goodbye & Good Riddance

Part 2 of 2

**FINANCIAL
COMPANIES
BLOATED
ESTIMATES
OF FUTURE
COLLECTIONS**



In the late 1990s and the early part of the last decade, several large financial service companies recognized bogus “gains on sale” from bloated estimates of future collections upon which those gains were based. These were portents of the impending economic meltdown and fraud.

Estimates of future accounting events can be the stuff of potential manipulation. Take the example of Creditrust, a Baltimore, Md., company that raised approximately \$80 million in equity capital based upon gains on sale in connection with its securitizations of delinquent credit card receivables.

In 1997 Creditrust reported net income for the year of approximately \$456,000. In the first quarter of 1998, the company reported that earnings had increased substantially, but the improved results weren't sufficient to drive Creditrust's market capitalization to \$124 million, a massive multiple of 272 times trailing year earnings. The catalyst for that leap was the Creditrust disclosure in its initial offering documents that the company had recently realized a \$6.1 million gain as a result of the securitization of its defaulted credit card receivables. A second equity offering in 1999 following the report of a second securitization upon which a \$7.4 million gain on sale was reported, valued the company at \$190 million.

The gains were illusory. Creditrust filed for bankruptcy in 2000, and after more than five years of litigation, class-action plaintiffs settled fraud charges for \$7.5 million, a recovery that represented less than 10 percent of the equity Creditrust had raised in the capital markets. (See “Judge Gives Preliminary OK for Settlement in Creditrust Lawsuit,” by Rachel Sams in the May 6, 2005, *Baltimore Business Journal*.) While the losses were by no means remarkable, the fact that Creditrust could raise \$80 million of equity was preposterous.

In early 1999 Commercial Financial Services (CFS), the nation's largest purchaser of delinquent credit card receivables and the pioneer of the securitization of those financial assets—collapsed, throwing 3,900 people out of work and leaving behind some \$2 billion of securitization wreckage.

In both the Creditrust and CFS cases, the gains on sale were calculated from bloated estimates of future collections upon which bogus gains on sale were based. The CFS fraud was discovered only because a whistle-blower disclosed the scheme to several ratings agencies. (See “Tulsa, Okla. Debt Collection Agency's Secret Dealing Led to Failure,” Knight-Ridder Tribune Business News in the March 18, 2000, *Tulsa World* via Dow Jones & Company.)

Nor were the restatements—public admissions of errors—of financial results related to gain on sale accounting limited to securitizations of delinquent credit card receivables. Others, including First Plus Financial Group, an auto lender, and Green Tree Financial, a manufactured housing lender, were compelled to write down or restate residual interest values from their securitizations as well.

In the third quarter of 1997 Green Tree reported approximately \$348.3 million in income, some \$200 million of which were gains on sales in connection with the securitization of Green Tree's manufactured housing loans. (See the Oct. 17 1997 *Motley Fool*.) Such gains had helped propel Green Tree's CEO to become the most highly compensated executive in the United States in 1996. But within weeks of the earnings announcement, Green Tree acknowledged that it would write off \$125 million to \$150 million

By Gordon Yale, CFE, CPA, CFF

The views expressed here aren't necessarily those of the ACFE, its executives, or employees. — ed.

of its residual interests. (See “Green Tree Has a Record Year” in the Jan. 27 1997 issue of the *Minneapolis-St. Paul Business Journal*.) Consecro Inc., the Carmel, Ind., financial services giant, acquired Green Tree in 1998 for more than \$6 billion. The high-risk, high-reward lender was the acquisitive Consecro’s largest purchase as well as one of its last.

In July 1998, Consecro reported \$498 million of charges relating to the Green Tree acquisition, some \$300 million of which was related to the write-down of Green Tree’s residual interests in securitizations. In September 1999 Consecro announced it would no longer recognize gains on sales in connection with its securitizations, largely because of chronic, material write-downs and partly because analysts no longer believed such income would ever materialize. The accounting change compelled Consecro to reduce its estimate of profits for the last six months of the year by a staggering 48 percent. (See “Consecro Halts Gain-on-Sale Accounting,” from the Sept. 9, 1999 issue of *The Wall Street Journal*.)

By 1999 year end, Consecro recorded after-tax charges of approximately \$349 million on its residual interests, including write-downs on servicing rights, an amount that reduced net income by approximately 37 percent. In 2000, the write-downs increased to \$370 million, contributing to Consecro’s net loss of more than \$1.2 billion. (See the Consecro Inc. Form 10-K for the year ended Dec. 31, 2001.)

By 2002, the dismal performance in manufactured housing and Consecro’s massive borrowings eliminated the company’s access to the securitization markets on any terms, and in December the company filed for bankruptcy.

There’s a further irony. Had Consecro never recorded gains on sale from its securitizations, there was some likelihood that its auditors would have been required to take exception to Consecro’s judgment and that the Securities and Exchange Commission (SEC) would have scrutinized its accounting. In March 1998, as Consecro was digesting the Green Tree acquisition, the FASB’s Emerging Issues Task Force released EITF D-69 that provided the recognition of gains or losses on the sale of financial assets weren’t elective, thus compelling fair market value estimates of the ultimate results of the transactions even by the most reluctant companies.

Consecro’s write-down of residual interests wasn’t proof that a fraud had occurred, but it should have and did raise suspicions. GAAP provides for these write-downs if conditions impacting the future cash flows change for the worse. In effect, the standards provide a mechanism to reverse, in whole or in part, the gains on sales previously recorded so there’s always the issue of timing. But more importantly, the larger question of whether the gains should have ever been recorded is one that hasn’t been asked often enough.

Through 1999 the formula for quantifying the amount of these write-downs was all too forgiving. Under the old rules, as conditions changed the residual interest owner was required to revise its estimate of future cash flows and discount them by a risk-free rate – typically the yield on a U.S. Treasury security of a similar maturity. In late 2000, the FASB’s Emerging Issues Task

Force released new guidance that provided that the discount must be at the rate that was expected on the residual interest when the gain on sale was initially recognized – a clearly higher discount that would produce a significantly smaller present value and a substantially greater charge to earnings.

PERPETUAL PROFIT MACHINES

Gain-on-sale accounting also turned New Century Financial, a subprime lender, into a powerhouse. From Dec. 31, 1996, through Dec. 31, 1999 New Century earnings grew from \$1.35 million to \$39.5 million largely as a result of gains on sale from its off-balance-sheet securitizations. During that same period, the company raised some \$76 million of equity. The non-cash gains on sale from its securitizations were nearly all the company’s revenue (approximately 95 percent) in 1998 and the preponderance of its (73 percent) total revenue in 1999. The company’s \$304 million of residual interests in its securitizations were approximately twice the company’s net worth in 1999.

By 2001, New Century changed its business model and as a result, was making more money selling whole loans to others, who in turn, were able to securitize their interests. Money was rolling in so fast that in the two years ended Dec. 31, 2003, New Century reported a total of more than \$424 million in net income, repurchased nearly \$96 million of its own stock, and held for investment some \$4.75 billion of subprime mortgages against which it had borrowed \$4.69 billion. Without the equity capital created by the earlier securitizations, New Century would never have been able to borrow as heavily as it did.

In the fall of 2006, when home prices peaked, New Century was massively leveraged, with more than \$14 billion of subprime mortgages held for investment that it funded with nearly \$13.9 billion of borrowed money. (See New Century Financial Corporation 10-K Form for the years ended Dec. 31, 2000 and 2002 and “Final Report of Michael Missal, Bankruptcy Court Examiner Re: New Century TRS Holdings, Inc.”)

Six months later, in March 2007 New Century announced that its warehouse lenders – the banks that provided short-term loans that permitted New Century to aggregate mortgages it would ultimately sell – required an additional \$150 million in equity, a margin call that New Century couldn’t satisfy. Moreover, within a week, both the state of California and the SEC notified what had been the nation’s second-largest subprime lender that they had commenced investigations of the company. By April 2007 New Century’s lawyers were filing for Chapter 11 reorganization in bankruptcy court.

QUANTITATIVE ANALYSTS MAKE THE LEAP

How could the New Century downfall have happened? Aside from the permissive accounting, there’s also a pervasive Wall Street conceit that its analysts can identify the smallest arbitrage, accurately measure and price most risk, and protect themselves with a largely foolproof hedge. The mega banks, investment banks, and hedge funds, in the eternal search for even a minute edge, have been paying physicists and mathematicians millions to

search for a financial grail because even a fraction of advantage can, with leverage, be turned into vast fortunes.

Further, at the highest levels in finance, there has also been a disregard of historical financial statements partly because of a long and sordid history of managements' gaming financial results and the feckless, if not complicit, auditing that has repeatedly failed to detect the manipulations. And finally, because financial statements are largely a snapshot of the past, historical financial information is secondary to the smart money operatives who look more forward than back. With the power of spreadsheets, statistical software, and the cheap computing muscle to drive them, the new paradigm of financial decision-making is increasingly based upon intricate modeling that endeavors to forecast the future despite its increasing complexity.

This phenomenon isn't without paradox. The models that drove the securitization sellers, the underwriters, the ratings agencies, and the investors to underestimate the inherent risks of subprime mortgages essentially looked forward by looking back. The typical models ran scenarios based upon mortgage pool histories of 10 years or so, clearly ignoring the savings and loan bust of the 1980s, much less the Great Depression. (See "Recipe for Disaster: The Formula That Killed Wall Street," by Felix Salmon, in the Feb. 23 issue of *Wired Magazine*.)

By 2005, performance forecasts of newly invented products sold to credit-challenged customers with unprecedented recklessness meant that the quantitative estimates that determined securitization structures and their credit ratings were made in a statistical vacuum—a space largely empty of relevant data.

At the same time, financial statements—the representations of the financial condition of an enterprise at some past point in time—were for securitization-driven businesses based not on the reality of what had actually happened, but were more the product of elaborate guesses about the future that also came from databases bereft of observable fact. The impact of bad, sometimes cynical, financial modeling has been catastrophic.

Which brings us back to Countrywide—by 2005 the nation's largest home mortgage lender and a major player in subprime and second-lien home equity mortgage products, particularly in California. In 2005 Countrywide originated nearly \$500 billion of mortgage loans and nearly \$90 billion in more risky home-equity and non-

Earn CPE anywhere.

Now available in a convenient online format, expand your anti-fraud knowledge with our comprehensive self-study CPE courses. These self-paced courses allow you the flexibility to study at anytime from anywhere you have internet access.

Combining informative text, video clips, unique examples, exhibits, and interactive review questions, ACFE Online Courses offer a quick and convenient way to earn quality CPE.

- 24/7 access to courses through your Internet browser.
- Save time and quickly earn CPE credits with instant access, grading and printable certificate.
- The flexibility to start or stop a course and pick up right where you left off.
- No additional shipping or customs fees.

Featured courses include:

- Interviewing Prospective Witnesses
- Introduction to Financial Statement Fraud
- Introduction to Fraud Schemes
- Understanding the Basics of Fraud Examination
- Fundamentals of Fraud: Legal Elements
- Fraud Prevention and Detection

“The course was user-friendly. It was easy to navigate and the information was presented in a format that made it easy to digest.”

Visit

to order today!

ACFE
Bookstore

In 2006, Countrywide originated \$468.2 billion of new loans including \$87 billion of subprime and second-lien, home-equity loans, which in total, were down approximately 6 percent from 2005.

prime products and securitized \$365 billion of mortgages. As a result, Countrywide earned more than \$2.5 billion of net income and its shares traded at a respectable multiple of nearly nine times trailing earnings of \$4.11 per share.

Fat profits brought fat recompense to Angelo Mozilo, Countrywide's long-time chief executive officer, who earned total compensation of nearly \$57 million that year, ranking him ninth among U.S. executives, according to *Forbes* magazine. (See Countrywide Financial Corporation's Form 10-K for the year ended Dec. 31, 2005 and executive pay at Forbes.com.)

Though 2005 seemed like a good year, it wasn't without ominous portents. First, Countrywide recognized \$4 billion from the gains on sales of its securitizations. Without the upfront recognition of this income, a fraction of which would have been recognized had the abusive accounting not been permitted, Countrywide would have earned pre-tax income of approximately \$147 million – an anemic return of roughly 1 percent on equity.

Clearly, some interest and servicing income would have been realized from older securitization transactions if the securitizations performed. Disclosure rules, however, didn't require sufficient detail to permit a reasonable estimate of those earnings impacts.)

And because Countrywide profits were inflated by gains on sale from securitizations, Mozilo's massive, performance-based compensation wasn't based on what the company earned, but upon guesses about what the ultimate economic result was likely to be.

In addition to gains on sale, the company also recognized approximately \$5.8 billion of mortgage servicing rights (MSRs) from its securitizations. (As mentioned in part 1 of this article, MSRs are a GAAP concoction that permit the recognition of the present value of the future income streams expected from the retained servicing rights to the mortgages that were transferred in a securitization.)

The recognition of MSRs is a clear departure from the fundamental accounting axiom that income shall be recognized only when earned. MSRs figure into the gain-on-sale equation and, as a result, are part of the gift of income that gain-on-sale accounting allows.

The great economist John Maynard Keynes once shrewdly observed that "markets can remain irrational longer than you can remain solvent," and Countrywide proved the obverse of the rule. Moody's Economy.com, in a housing report released in late 2005 provided substantial evidence that home prices were close to a peak. (See "The Single-Family Housing Market Monitor," October 2005 at Moody's Economy.com.)

In January 2006, the Standard & Poors (S&P)/Case Shiller

Index provided a compelling argument of just how irrational the housing market had become. In 2005, according to Case Shiller, home prices in Phoenix increased nearly 42 percent, and in Miami and Tampa, both more than 30 percent. In the two-year period ended in December 2005, home prices in Las Vegas increased 61 percent, and in San Diego the two-year increase was almost 35 percent. Over the same period, the 20-city index increased more than 34 percent. (See the December 2004 and December 2005 S & P/Case Shiller Index for these cities.) According to Primary Mortgage Market Survey data provided by Freddie Mac at www.federalreserve.gov during the same period, conventional mortgage rates climbed from 5.71 percent at the beginning of 2005 to 6.27 percent at year end, making home purchases even less affordable.

RATINGS AGENCIES ROLL OVER

In 2006, Countrywide originated \$468.2 billion of new loans including \$87 billion of subprime and second-lien, home-equity loans, which in total, were down approximately 6 percent from 2005. Countrywide securitized some \$362 billion of its new loans, recognizing a gain on sale of \$4.7 billion without which the company would have recognized pre-tax losses of approximately \$350 million. Mozilo fared better. His compensation for the year totaled more than \$48.1 million, an amount apparently tied to reported net income of nearly \$2.7 billion that included the gains on sale from securitizations. (See Countrywide Financial Corporation 10-K Form for the year ended Dec. 31, 2007.)

There was mounting evidence, however, that the housing boom was over. The Case Shiller Index reported a substantial sluggishness in residential markets. Between December 2005 and 2006, home prices in Phoenix increased less than 1 percent, while in Tampa values grew by 2 percent. In the major California markets, which comprised nearly 45 percent of Countrywide's portfolio, home values in Los Angeles were up approximately 2 percent, but in San Francisco values were down 1 percent, and prices in San Diego declined more than 6 percent. Overall, the S & P/Case Shiller 20-city Index (for December 2005 and December 2006) was up less than 1 percent for the year.

The exhaustion of most home markets by the end of 2006 should have alerted investors and ratings agencies that Countrywide's massive gains on sale in connection with its securitizations were in substantial jeopardy. Constant or deflating home prices increased the risks of Countrywide's exposure to second-lien home equity loans and subprime mortgages, a significant component of both Countrywide's securitizations as well as its investment portfolios. Because home equity loans and piggy-backed subprime loans (that is, loans in which the down payments were

also borrowed) were often based upon combined loan-to-values of up to 100 percent, the relative strength of the single family market was an obvious and key indicator of Countrywide's financial health in which home price deflation was a major risk.

There was additional evidence as well. The Joint Center for Housing Studies of Harvard, in its 2006 study, "The State of the Nation's Housing," concluded that the housing correction was underway in 2006. While failing to predict the housing catastrophe that wasn't fully manifest until 2007 the study noted that in 2006 home sales declined 10 percent, housing starts declined 13 percent and excess housing stock inventory had increased by 500,000 units – a figure that the analysts believed understated the inventory overhang because some units might have pulled from the market in anticipation of its future improvement.

The Harvard study also documented that \$1.43 trillion of home loans in 2006 were subprime, Alt-A, or home equity loans – an amount nearly equal to the prime mortgage loans that were funded in 2006 and the largest market share of higher-risk loans on record.

Countrywide's exploitation of permissive accounting coupled with an adversely dynamic marketplace and stagnant earnings should have alerted investors to Countrywide's peril. Yet, Countrywide's stock price broke the \$40 barrier on Nov. 13, 2006, and investors were apparently little concerned when Countrywide, buoyed by its gains on sale, announced marginally improved 2006 earnings of \$4.30 per share (versus \$4.11 per share in 2005) on Jan. 30, 2007. Common shares broke the \$45 barrier briefly on Feb. 2, a healthy multiple of trailing earnings of over 10 times.

The analysts not only should have known better, they did. Moody's Investors Service recognized as early as 1987 that while "... the practices developed by the accounting and regulatory world are useful starting points for the credit analyst ... these guidelines do not fully capture the true economic risks of a securitized asset sale to the originator's credit quality." (See Joseph R. Mason's testimony before the Senate Committee on Banking, Housing, Urban Affairs, Subcommittee on Securities, Insurance, and Investment, Sept. 18, 2008. Mason is finance professor at Louisiana State University and a senior fellow at the Wharton School at the University of Pennsylvania.) Moody's was even more explicit in a 1997 report that described how its analysts adjusted for off-balance-sheet and gain-on-sale accounting.

Similarly, S & P in a 2005 report, stated: "To the extent that the securitization establishes true risk transference, the transaction is interpreted as resembling an asset sale, whereas in the much more common case, where the issuer retains the bulk of the risks related to the asset, the transaction is akin to a secured financing." In the report, S & P acknowledged that frequently only the risks of "catastrophic loss" are passed to the purchasers of securitizations and that even if the first loss tranches are sold to third parties, companies that relied on securitizations as a primary funding source faced the all too ugly consequence of "moral recourse" regardless of what the contracts with investors provided.

In short, if investors in securitizations faced grievous loss, the seller was expected, and often acknowledged, that it would make

good because angry market participants would unfailingly retaliate with a paralyzing indifference to their future offerings.

Both Moody's and S & P rated Countrywide's unsecured debt. From 2001 forward, the long-term ratings were "A" from S & P and "A3" from Moody's, both mid-range investment grade ratings despite misgivings about Countrywide's "significant investment in MSR's (mortgage servicing rights) and other retained interests," its involvement in nonprime lending, as well as its liquidity and capital structure, according to the Countrywide Financial Corporation 10-K Form for the year ended Dec. 31, 2005.

Despite their misgivings about Countrywide's accounting, their qualms about its capital structure, and the continued unraveling of the housing markets in California and across the country, both Moody's and S & P maintained their ratings through Aug. 15, 2007 when the market for Countrywide's commercial paper disintegrated, which compelled the company to exhaust its \$11.5 billion credit line from a consortium of banks.

By mid-2007 the mortgage finance industry was in stress and while the evidence might not have been wholly definitive, it was omnipresent. Countrywide's financial deterioration was clearly visible, the ominous outlook for residential real estate was well known and the beginning of a serious decline in non-prime securitization prices was underway.

In June 2007 two hedge funds managed by Bear Stearns, once the fourth-largest investment bank in the country, collapsed under the weight of margin calls as the collateralized debt obligations (CDOs) they held lost substantial value. The CDOs, comprised in good part by subprime mortgages and other risk-laden loans, were leveraged by up to \$60 of debt for each \$1 of equity, yet another example of how debt can magnify losses in investments gone bad. (See "Bear Stearns' Bad Bet," by Matthew Goldstein and David Henry on BusinessWeek.com, Oct. 11, 2007.)

Within a month of the first announcement, Bear Stearns unwound the funds sufficiently to inform investors of the nearly total devastation in the more "conservatively" managed fund and the complete annihilation of value in the aggressively managed portfolio.

During this same period, delinquency rates on home loans continued to increase, further exacerbating the descent of home values at alarming rates. Six of the top 10 communities suffering the highest rates of mortgage delinquencies were in California and Florida, Countrywide's two largest markets. By July 2007 home values in Los Angeles had declined 3.4 percent from December 2006, while values in San Diego and San Francisco fell 3.7 percent and 1.6 percent, respectively. (See "Mortgage Delinquencies" at WSJ.com, July 19 2007.) In Florida, conditions were worse. Miami home values dropped 7.3 percent for the period, while the Tampa decline was 5.96 percent. (See the S & P/Case Shiller Index for respective cities for December 2006 and July 2007.)

Even modest declines in home prices were catastrophic to the value of many subprime securitizations. Describing a March 2007 conference call with Fitch Ratings, the nation's third-largest ratings agency, Robert L. Rodriguez, a fund manager for First Pacific

By August 15, Countrywide was compelled to draw nearly \$11.5 billion on its unsecured bank lines to take out approximately \$12 billion of short-term, asset-backed, and unsecured commercial paper for which there were no new takers.

Advisors, said Fitch analysts acknowledged that their subprime models would begin to break down should home prices remain flat for an extended period, and that a modest 2 percent price decline would impact the highest investment grades – that is, the AA- and AAA-rated tranches – of newly issued subprime securitizations. Given estimates that nearly 26 percent of all subprime and 41 percent of Alt-A mortgages were originated in California where Countrywide had its largest presence and was a major non-prime player, the hazards should have been clear. (See “Absence of Fear,” a speech given by Rodriguez to the Certified Financial Analysts Society of Chicago on June 28, 2007 found at fpafunds.com.)

Some of these developments were manifest in Countrywide's second quarter results announced on July 24, 2007. While the company realized earnings of \$919 million for the six months then ended, the results represented a decline of approximately 35 percent from the comparable period in 2006. Without gains on sale of more than \$2.7 billion – the pernicious future earnings recognized currently – Countrywide would have suffered a pretax loss of nearly \$1.4 billion.

Operating cash flow deficits were some \$6.8 billion, partly as a result of Countrywide's inability to sell off newly securitized assets. Between Dec. 31, 2006, and June 30, 2007, Countrywide accumulated an additional \$12 billion of mortgage-backed securities that it held available for sale but didn't disclose the proportion that were securitizations of troubled non-prime assets. The buildup of mortgage inventory was another troubling indication that Countrywide's securitizations were losing favor – and hence value – in an increasingly brutal marketplace. Delinquencies on Countrywide's subprime loans rose to more than 20 percent, up from 13.7 percent in the prior year, and home equity loan delinquencies more than doubled to 5.4 percent.

In all, Countrywide announced that it recorded nearly \$445 million of loan losses and took an additional \$697 million impairment charge on its retained interests from securitizations – a tenfold increase over the comparable period in the prior year. Countrywide's reports drove a broader market sell-off that resulted in a 2 percent decline in the S & P 500, its largest drop in five months, and Countrywide's shares declined by 11 percent that day. (See “Home Lenders' Woes Fuel Market's Decline,” by Vikas Bajaj in the July 24, 2007 issue of *The New York Times* and Countrywide Financial Corporation Form 10 Q for the six months ended June 30, 2007.)

Despite bad results and worse data, the ratings agencies were unmoved. On Aug. 2, with more than a week to digest Countrywide's earnings announcement, Moody's reaffirmed its mid-in-

vestment grade rating of A3 and designated it as stable. S & P and Fitch were silent, but investors in Countrywide's commercial paper weren't so passive.

By Aug. 15, Countrywide was compelled to draw nearly \$11.5 billion on its unsecured bank lines to take out approximately \$12 billion of short-term, asset-backed, and unsecured commercial paper for which there were no new takers.

As has often been the norm, only after credit markets had spoken did the ratings agencies follow with downgrades: On Aug. 16, Moody's dropped its Countrywide rating from A3 to Baa3 (its lowest investment grade rating) S & P from A to A- (an embarrassingly tentative move), and Fitch from A to BBB+ – a two-notch downgrade that split the difference with its larger brethren. The ratings agencies were highly conflicted because they had also rated the abundance of Countrywide securitizations that had come to market during the explosive growth of mortgage loan volumes that began in 2001, and the securitizations were a far more lucrative book of business.

For the full year ended Dec. 31, 2007, Countrywide reported \$2 billion in gains on sale from its securitizations, but the company suffered a net loss of nearly \$704 million, largely a result of a \$2.4 billion provision for loan losses and a \$2.38 billion impairment charge on residual interests from prior securitizations.

Despite the red ink and increasing prospects of additional losses, Countrywide repurchased more than \$863 million of its shares in 2007 which raised the two-year total of stock repurchases to nearly \$2.4 billion. (See Countrywide Financial Corporation 10-K Form for the year ended Dec. 31, 2007.)

Meanwhile, Mozilo continued the systematic disposal of his ownership interests, which totaled more than \$400 million, according to press reports. (See “Inside the Countrywide Lending Spree,” by Gretchen Morgenson in the Aug. 26, 2007 issue of *The New York Times*). On Jan. 11, 2008, the company announced its merger with Bank of America.

By the end of the second quarter of 2008, the last quarter it would ever report as an independent entity, Countrywide suffered net losses of an additional \$3.2 billion as a result of \$3.8 billion of loan losses, a \$705 million impairment on MSR's, and a \$497 million write-down on securities available for sale. One day later, Bank of America would complete the merger, writing Countrywide loans down by another \$10 billion and MSR's by an additional \$1.5 billion. Within six months, Bank of America would write MSR's down by an additional \$7.1 billion, but by Bank of America's accounting, Countrywide was insolvent on the day it

GOODBYE & GOOD RIDDANCE continued on page 50

continued from page 34

merged. (See Bank of America Corporation 10-K Form for the year ended Dec. 31, 2008.)

THERE YOU GO AGAIN

With the discovery and playing out of every financial scandal, the press invariably runs postmortems about lessons learned which, invariably, never are. So it goes with the accounting standards for securitizations that have been changed or amended many times since 1974

Prior to the release of Statement of Position (SOP) 74-6 from the American Institute of Certified Public Accountants (AICPA) in 1974, the accounting for transfers of receivables with recourse varied. Some enterprises recognized gain or loss on sale regardless of the recourse, while others deferred the recognition until the collections were assured.

The promulgation of SOP 74-6 ended the controversy for a time by requiring the deferral of the gain or loss. Because the standard spoke only to income recognition and not balance sheet treatment, the issue was revisited in 1980 in an AICPA issues paper that provided guidance concerning off-balance-sheet treatment. Despite reasonably clear guidance, the FASB concluded that, in practice, the accounting still varied among enterprises, particularly in the thrift industry, in which mortgage pass-through certificates—the precursor to mortgage-backed securities—were treated as sales. (See FASB Statement No. 77 and SOP 74-6, both now superseded by FASB Statement Nos. 166 and 167.)

In response, the FASB issued an exposure draft of FASB Statement No. 77 in 1981 that largely got the issue right. The draft standard prohibited the immediate recognition of gain or loss on the transfer of receivables with recourse and required that both the asset (that is, the receivables) and the debt that was secured by them be recognized on the balance sheet if the economic substance of the transaction was as a secured loan. And then all hell broke loose.

The FASB received 120 comment letters, some from financial institutions that had previous success influencing other standards that impacted their financial interests, particularly financial institutions that successfully lobbied the FASB to attenuate procedures that determined the magnitude of losses when a lender restructured a troubled borrower's loan. (See "The Not So Strange Cases of Equity Participation and Troubled Loan Accounting," by Gordon Yale, *Professional Officers' and Directors' Liability Law Committee's Newsletter* Winter of 1995.)

Under pressure, the FASB capitulated on three key issues. First, the FASB dropped a requirement that the accounting should reflect the economic substance of the transaction. In the accounting of the time, that meant that a gain on sale couldn't be immediately recognized if the sale was to a "paper" enterprise, that is, an entity that had few or no physical facilities or employees and which was created by the transferor for the purpose of recognizing sales. In other words, an entity much like today's typical securitization trust. Secondly, because of criticism from the thrift industry, the FASB dropped a provision that would

have excluded mortgage participation certificates from gain on sale accounting. And finally, the FASB refused to take a position on whether transfers to wholly owned finance subsidiaries would require consolidation with the transferor, providing an unlocked back door to the off-balance-sheet treatment that the financial services industry has been slithering through ever since. (See FASB Statement No. 77.)

The capitulation was a "critically flawed decision ... just a scam to kept things away from investors (that) has had a very devastating impact," according to Lynn Turner, the former chief accountant of the SEC under Chairman Arthur Levitt and a vocal critic of the accounting profession. (See "Plunge: How Banks Aim to Obscure Their Losses, An Interview with Lynn Turner" in the November/December 2008 issue of *Multinational Monitor*.)

The gain-on-sale treatment was revisited again in 1996 when the FASB considered, but rejected, an approach taken in the United Kingdom, in which pledged assets remained on the balance sheet and the debt was reported as a reduction of the pledged assets. As importantly, no gain or loss on sale was permitted. (See "Weaning Off Gain on Sale Accounting," by Martin Rosenblatt, at www.vinodkothari.com/martiart.htm.)

When FASB Statement No. 125 was promulgated in 1996, it broadened the application of the fundamental principles of FASB Statement No. 77 that permitted off-balance-sheet treatment and gain-on-sale accounting to newly created securitization vehicles and removed the ambiguities of conflicting treatments in the professional literature.

The promulgation of FASB Statement No. 125 wasn't the last word. In 2000, the FASB replaced it with No. 140. The new standard largely reinforced existing rules while attempting to define some limitations. Still, some pushback continued.

Federal and state regulators have the authority to make their own accounting rules or accept the primacy of GAAP. In 2001, the Federal Deposit Insurance Corporation (FDIC) rejected some of FASB No. 140 and required banks to maintain risk-based capital equal to the "face value" of the residual interest that remained on bank balance sheets. The regulators defined residual interests as any retained beneficial interest from a securitization that exposed the bank to any credit risk directly or indirectly with the asset transferred in a securitization treated as a sale. The impact of this rule was to reverse much of the gain-on-sale treatment from bank financial statements for regulatory purposes. That bank regulators and FASB standards were working at cross-purposes should have been a concern.

The 2001 failure of Enron, partly the result of its abuse of off-balance-sheet accounting, was the impetus of some reform relating to rules regarding the consolidation of special purpose entities that occurred in late 2003. (See "Enron: An Accounting Analysis of How SPEs Were Used to Conceal Debt and Understate Losses," by Gordon Yale, in the March 20, 2002, issue of the *Financial Executives International Executive Report*.)

While these changes could have ended the off-balance-sheet

treatment of the securitization of financial assets, securitization transactions were specifically exempted and off-balance-sheet and gain-on-sale accounting thrived. [See FASB Interpretation (FIN) No. 46R.]

Further attempts were made to amend FASB Statement No. 140 in 2003 and again, in 2005, when the FASB released an exposure draft that provided some limitations to the accounting but didn't provide a profound change from the status quo. Action then would have been timely because banks were doing nearly as much non-prime lending as prime.

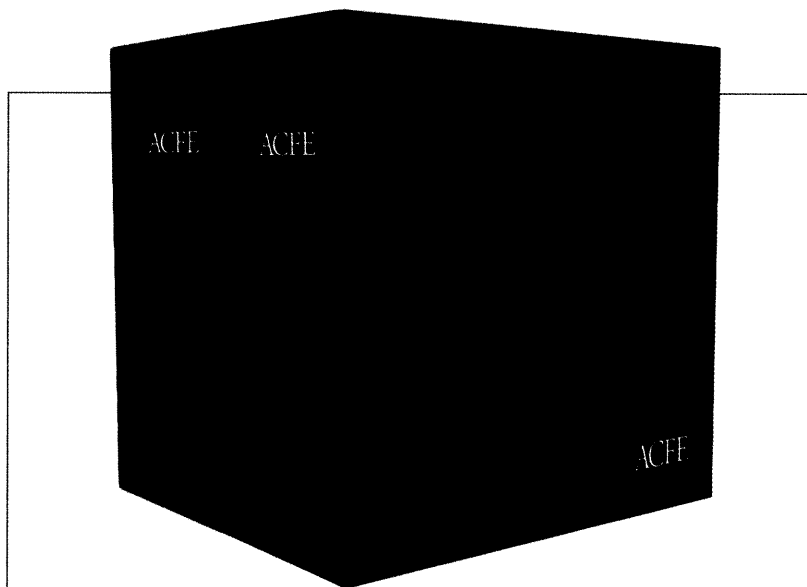
In 2006, the FASB, in discussions with the International Accounting Standards Board (IASB) about standardizing accounting principles worldwide, acknowledged that FASB Statement No. 140 was "irretrievably broken and still is despite ongoing repair and maintenance work." (See the "Information for Observers" on the IASB/FASB April 21, 2008 meeting.)

"There is no question that the FASB knew it had a serious problem in the financial reporting of securitizations," said Donald M. Young, an FASB board member from 2005 through mid-2008, during his testimony at a Securities, Insurance and Investment Subcommittee of the Committee on Banking, Housing, and Urban Affairs hearing on Sept. 18, 2008.

"The question is why was it not addressed until after this crisis was evident?" Young testified. "When I asked the staff the reasons for the delay, I was informed that there were concerns over the standard-setting actions we were considering, which would more accurately reflect the underlying economics, (and) would, in turn undermine companies' ability to execute securitization(s) worth many billions of dollars. It would be bad for business to provide transparency ... at least in the short term."

"FASB was under intense pressure from industry," said Alan Blinder, a former Federal Reserve Board vice chairman and now a professor at Princeton University. "It is fair to say that the industry and the regulatory community alike failed to look through the off-balance sheet entities with a skeptical eye and see the extent of what they might be on

Update your anti-fraud arsenal!



2010 Fraud Examiners Manual, U.S. Edition*

The essential resource for anti-fraud professionals has been updated with even more valuable to fraud fighters worldwide. Stay up to date with recent updates in laws, statistics, fraud examination techniques, methodology and procedures with the *2010 Fraud Examiners Manual*.

Important updates for 2010 include:

- Newly revised Fraud Prevention and Deterrence section (formerly Criminology and Ethics)
- New chapter on Fraud Risk Assessment, including frameworks for conducting assessments and sample questionnaires
- Discussion of the new Fraud Enforcement and Recovery Act, including its impact on:

False statements	Money laundering
Sarbanes-Oxley	Whistleblower protection
Mortgage fraud	
- New identity theft provisions
- New data analysis software tools
- Profiles of Bernard Madoff and Allen Stanford and their investment swindles

*2010 edition currently available in U.S. Edition only. International versions coming soon.

Order your copy today at ACFE.com/Shop

the hook for in a bad case scenario,” said Blinder. (See the Oct. 30, 2008, Bloomberg.com article, “Greenspan Slept as Off-Books Debt Escaped Scrutiny,” by Allan Katz and Ian Katz).

Prior to Young’s Congressional testimony, he wrote in a letter to Sen. Jack Reed, D-R.I.: “We lacked the ability to overcome the lobbying efforts that effectively argued that if we made substantive changes we would hamper the credit markets and hurt business. Our inaction did not hamper credit markets—it helped to destroy them.”

On Sept. 15, 2008, the same day Lehman Brothers filed for bankruptcy, the FASB released yet another revision to its 2005 exposure draft on FASB Statement No. 140. The proposed standard, which was effective after Nov. 15 2009 eliminates the concept of qualifying special purpose entities and requires that securitizations meet the more stringent standards that were promulgated in Enron’s aftermath.

The changes are expected to force the consolidation of securitization trusts with transferor financial statements, effectively putting an end to the off-balance-sheet treatment of what, in substance, has been limited recourse lending as well as the gain-on-sale accounting that has been distorting financial reporting for more than a generation.

In a contemplative interview, FASB Chairman Robert Herz told Reuters that banks bent and stretched accounting rules from “day one” to keep risky securitized assets, such as subprime mortgages, off their books. “(FASB Statement No. 140) ... didn’t work, it was stretched, and not complied with,” said Herz in “Subprime Accounting Stretched from Day One: Herz,” by Emily Chasan on Reuters.com of Feb. 7 2008. “The original rules made sense, it’s just the market practice didn’t comply with that. ... Things were written into the (securitization trust) agreements and in some cases the auditors didn’t see them and even the companies didn’t see that they violated these rules,” Herz contended.

Everybody was wrong, it seems, but the standard setters. 🔍

Gordon Yale, CFE, CPA, CFF is the principal of Yale & Company, a forensic accounting firm and a former securities analyst. He has served as a special investigative consultant to the Securities and Exchange Commission and has testified on audit negligence and securities fraud issues in civil matters. His e-mail address is gyale@gyale.com.



Time is
Money

Save 5% on your ACFE annual dues with the Automatic Dues Renewal Service:

1. Go to ACFE.com/autodues
2. Log in to your account
3. Enter credit card billing information on our secure site

Or call (800) 245-3321 or +1 (512) 478-9000 and a Member Services Representative will enroll you.

Save time and money. Enroll in the ACFE’s Automatic Dues Renewal Service

- **Receive a 5% discount** on your dues upon enrollment for each year you are enrolled in the service
- Your membership **dues are paid automatically each year**—no need to write a check or pay online
- Update your automatic billing profile anytime
- Eliminate paper statements and postage



*Together, Reducing
Fraud Worldwide*