The Saga of Restating Financials

Much drama can accompany a restatement of financials. In the mortgage industry it is no different. And it has been a surprisingly common occurrence due to overly complex accounting rules.

BY MICHELE HOFFMAN

"Change" is a word with which the mortgage industry has become very familiar. As economic shifts again send mortgage rates upward, the demand for new flexible loan products rises ever higher. The imperative to stay competitive is keeping mortgage leaders awake at night as they see the pendulum begin to swing toward a shrinking business landscape. Both primary and secondary industry players are forced to rethink their long-term strategies as efficiency and consolidation take the place of fast-paced growth and unbridled profit opportunity. Yet there is another worrisome factor affecting the future competitive composition within the mortgage arena—the heightening scrutiny and compliance demands of regulators. Three years after the implementation of the Sarbanes-Oxley Act, chief financial officers and controllers still lack the clarity and consistency of expectations. This is the case because the rules and guidelines established by the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB), along with the auditor interpretations, are continually being challenged, questioned and rethought. The stark reality is that the feared "financial restatement" is not only a major preoccupation for the large, complex members of the mortgage business, but also for the smaller, younger firms that have not had the luxury of time and money to build solid controls and well-documented processes.

Recent eye-opening research shows that companies with U.S.-listed securities filed 1,295 financial restatements in 2005—nearly double the previous year's mark, according to Mark Grothe, research analyst, and Jonathan Weil, managing director of San Francisco–based research firm Glass Lewis & Co. LLC in their March 2, 2006, Restatements Trend Alert, *Getting It Wrong the First Time.* That's about one restatement for every 12 public companies—up from one for every 23 in 2004, according to the report by Grothe and Weil.

With the growing number of restatements over the past five years (2003 was the only year in which the level of restatements appeared to have leveled off) and the in-depth introspection mandated by Congress and the SEC, many key mortgage stakeholders such as banks and the government-sponsored entities (GSEs) have found themselves immersed in the large effort of restating past filings (see sidebar, "It Could Happen to You").

As a company discovers it has an accounting issue and the details become public, often other companies find they, too, have the same issue, and it results in a cascading effect of financial restatements. The new numbers resulting from a different interpretation of relevant accounting rulings often detailed in the media highlight the fact that this quickly becomes an all-encompassing effort for firms going through a restatement.

Change and interruption become unwelcome features of daily work life for organizations pursuing a demand to "get current." But how did the company get in this situation in the first place? And what happens when the organization completes its restatement efforts? This article explores the specific regulations that most frequently lead mortgage firms down a restatement path, and offers insights into some red flags and outcomes to prepare for once the restatement is complete.

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Key reasons for financial restatements in the mortgage industry

Despite the deluge of publicity surrounding financial restatements born of fraudulent activities and a lack of executive-level transparency, most companies going through restatements are well-meaning and ethical firms. The simple fact is that interpreting accounting standards is an art, not a science. It requires careful judgments when the literature is not clear about how to deal with a particular issue or transaction.

These judgments are made both internally (by finance departments within a company) and externally (by documented auditor opinions). Given the complexity of accounting standards, it is not unusual for the Big-Four audit firms to reach different accounting conclusions regarding the same transaction.

To understand the key reasons for restatements within the mortgage industry in recent years, let's start by considering the regulations that have led to discovered accounting errors

Key regulations that have caused confusion and led to restatements within the mortgage industry include the following.

▯ Statement of Financial Accounting Standards (SFAS) 133, *Accounting for Derivative Instruments and Hedging Activities.* This is one of the most complex and lengthy FASB standards ever issued. Multiple mortgage firms including Glen Allen, Virginia–based Saxon Capital Inc. and Charlotte, North Carolina–based Bank of America have had to adjust their accounting of certain derivative transactions used in their hedging strategies. That resulted in a fourth-quarter 2005 net income of $17.8 million, or $0.35 per share diluted and a year-ended Dec. 31, 2005, net income of $110.7 million, or $2.18 per share diluted for Saxon Mortgage. It produced a cumulative increase of $345 million in net income for Bank of America.

Alvaro de Molina, chief financial officer for Bank of America, noted in the company's Feb. 22, 2006, financial release that, "The interpretations of how to apply SFAS 133, a quite complex standard, continue to evolve. We monitor interpretations of accounting standards by regulators and accounting professionals as well as recent industry practices to evaluate our accounting practices." FASB 133's complexities continue to be deciphered by the accounting standards setters, leaving room for future interpretations to introduce additional policy change.

▯ SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* This standard has been a sticking point for the GSEs as their accounting practices determined what transactions met requirements to be considered qualifying special-purpose entities (QSPE) allowing for special off-balance-sheet treatments.

The May 17, 2006, edition of *Inside the GSEs* published by Inside Mortgage Finance Publications Inc. reported, "Fannie Mae said it has now 'substantially completed' its review of accounting practices, including two new problems related to MBS [mortgage-backed securities] transactions. First, the GSE has determined that some of the third-party securitization vehicles in which it invested do not meet the qualifying special-purpose entity requirements of current accounting rules. As a result, Fannie will have to consolidate an estimated $28.5 billion of additional assets and liabilities of these trusts on its balance sheets."

This example demonstrates that implementation issues around SFAS 140 are far-reaching and can prove taxing to a firm's bottom line. The FASB has again listened to the accounting public on this issue, and is reviewing SFAS 140 policy definitions and interpretations. A decision is expected to be published in early 2007.

▯ SFAS 91, *Accounting for Premium or Discount and Other Deferred Fees from Lending Arrangements.* This accounting standard "[a]ffects substantially all lending institutions; it requires that virtually all fees be treated as a yield adjustment over the life of the loan, using the interest method, instead of the industry practice of counting fees immediately in income," according to Gerald H. Lander's review of the standard in his January 1991 *CPA Journal* article.

Fannie Mae's $400 million civil penalty is the most well-publicized example of a noncompliance finding, due in large part to

SFAS 91's misapplication. However, Fannie Mae is not alone in this. One partner at a Big-Four accounting firm suggested, "As determined by the Public Accounting Oversight Board [the independent body put in place by Sarbanes-Oxley to review auditors' work papers], over 100 restatements have occurred because of the complexity and changing interpretations of this regulation alone."

Since the adoption of SFAS 91 more than a decade ago, many small and medium-sized banks and mortgage companies used a straight-line amortization method as a proxy for the level yield method of accounting, assuming the difference in methods would be immaterial. When challenged in the past year or two on this assumption, many of these companies were required to restate their financial statements.

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Red flags signaling a potential restatement

There are often leading indicators that a company tends to exhibit before a determination is reached that a financial restatement is required. These can include the following.

- ***Continued difficult close:*** If a firm is plagued by continual difficulties with each monthly and quarterly close cycle, this could be a red flag that internal controls are not working as they should. This is probably caused by an underinvestment in resources within the finance department, which inhibits the establishment of an effective close process. There is a tendency for this to snowball as "reactionary" firms focus on the immediate close problems. This then leads them to overlook the more damaging long-term effect, failing to build proper controls and processes that can mitigate the issues in future monthly and quarterly closes.
- ***Multiplying of end-user computing:*** An additional manifestation is a company's willingness to "Band-Aid" a problem generated by a change in accounting standard, policy or business practice by allowing the finance department to build a spreadsheet-based solution to quickly resolve the issue and close the books. This is known as end-user computing (EUC).

When this response is allowed to develop without measures and internal guidance, the result can be hundreds of EUCs that cannot be managed at a controlled level. The firm is then left with a conglomeration of independent personal-computer-based EUCs (often Microsoft® Excel® spreadsheets), which lack the embedded controls necessary to achieve a timely and accurate close.

Companies often rely on these EUCs as a cost-effective means of addressing a perceived problem. They then move on to the next issue that arises instead of treating the EUCs as a stopgap measure that is the stepping-off point to fully automating and controlling the activity.

- ***Inadequate staffing and technological resources in the finance department:*** If a firm's finance department lacks the needed skill sets to prepare and plan for upcoming accounting changes, a fire-drill environment is created. Such operating conditions create a place where change is not integrated into the close cycle, but is rather managed as a quick fix for the immediate goal of finishing the present cycle on time.

Additionally, when the finance function is understaffed and overwhelmed, there also comes with it a lack of management support to spend time building a system to accommodate change. It is easier to rely on legacy systems that may be out of date in conjunction with the rampant use of EUCs. This very short-sighted strategy causes high rates of employee burnout and makes it even harder to keep up with compliance requirements.

Accountants often believe the problematic close at hand is the exception, and that future ones will be more manageable. Yet they never reach that "light at the end of the tunnel." Organizations need to reverse their long-term underinvestment in the finance function, which limits their ability to cope with a changing accounting environment in a controlled and timely manner.

The organizational impact of a restatement

A firm's reputation and financial strength following a restatement depends on several key factors. The severity of the findings and the degree to which they affect the bottom line are paramount.

In their March 2005 article, "Why Are Some Corporate Earnings Restatements More Damaging?," Aigbe Akhigbe

It Could Happen to You

Due to the complexity of the regulations and the compliance demands placed on today's finance departments, no company is exempt from the possibility of facing a restatement.

The following names gathered from publicly available information illustrate some of the sophisticated members of the mortgage industry that have been down this daunting path:

Bank of America

Saxon Capital Inc.

Doral Financial

RG Financial Corporation

PHH Corporation

Countrywide Financial Corporation

Greater Atlantic Bank

Freddie Mac

Fannie Mae

Federal Home Loan Bank—Pittsburgh; Chicago; Des Moines, Iowa; Dallas and Ronald J. Kudla, with the Department of Finance, College of Business Administration at the University of Akron, Akron, Ohio; and Jeff Madura, with the Department of Finance at the Florida Atlantic University, Boca Raton, Florida, address why certain restatements are more damaging than others.

They write, "If an earnings statement is simply an accounting assessment to old information that is no longer being used for valuation purposes, it will not necessarily cause a change in a firm's value. However, the restatement may contain information that is used to reassess the future cash flows and credibility of the firm." The market-imposed penalty is more severe when the restatement is attributed to an adjustment in revenue, when it is found by the auditor or the SEC, and when the revised earnings level is lower than two proxies used to measure expected earnings."

Companies encounter other internal effects following a restatement that influence their ability to refocus attention on being competitive within the mortgage market.

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Culture shift

Studies conducted on the savings-and-loan industry in California found that it is important to observe "under what conditions change may be hazardous or helpful and whether the direction of change affects its impact on performance and survival," according to a March 1992 article by Heather A. Havemen in *Administrative Science Quarterly,* entitled, "Between a Rock and a Hard Place: Organizational Change and Performance Under Conditions of Fundamental Environmental Transformation."

There are two major cultural changes a company may experience after emerging from a restatement. They can prove either hazardous or helpful, depending upon their application by the organization. The two changes are organized restructuring and employee retention.

When there is a feeling that fresh management oversight is needed for the firm to move forward successfully, new leadership may be brought in after or even during a restatement. The leadership style and the manner in which these executives join the firm will play a large part in determining how well change is integrated and tolerated. If the new management moves too quickly to change the corporate culture without establishing trust or credibility first with employees, resistance and uncertainty will overtake productivity.

Additionally, time spent analyzing and restructuring an organization (eliminating/creating functions, changing staff roles, setting new corporate objectives, etc.) will potentially keep the firm in a state of transition for an extended period.

A key challenge after coming through what can be a labor-intensive and time-consuming restatement process is how to motivate and build enthusiasm for more hard work in building a best-in-class organization.

A study conducted by Simi Kedia and Thomas Philippon in January 2005 for their article published by the American Finance Association (AFA), "The Economics of Fraudulent Accounting," found that "restating firms grow at significantly higher rates during the period where they misreport relative to age, size and industry-matched firms. Growth in restating firms is significantly slower than growth-matched firms in the years after the restatement."

For this reason, a firm will want to keep its most valuable resources to help it grow competitively in the challenging times after restatement. It is important to take the time to celebrate and reward restatement work efforts to avoid employee burnout, to build loyalty and to allow the staff to embrace the desire to move forward with new plans.

Loss of Focus on Market Competitiveness

With all the demands on companies to ensure the accuracy and timeliness of the firm's announcement that its financials are once again current, the restating company can find it has spent minimal attention on building its competitive advantages. So executives must ask: Is my firm now behind the market because it has been preoccupied with cleaning up accounting issues?

For mortgage executives, two areas within the mortgage

Going At It:
When Restatements Get Ugly

Beyond burnout and the typical stress that comes with long hours, firms need to be aware that resentment and infighting can become insidious problems during a restatement. This is particularly problematic when new employees are brought into a company to clean up past problems.

Several points of tension arise because new employees have a tendency to believe that restatement problems were caused by veteran staff. In an environment replete with recriminations, the "old guard" can respond quickly by getting their hackles up. This builds a divisive culture at a time when cooperation and unity are paramount.

On the flip side, resentment of new staff (that are typically brought in and instantly given elevated titles) is a common reaction from existing staff. More profoundly unpopular among the veterans is when new employees are brought in at higher levels. This can result in key accounting staff heading for the doors, taking with them critical skills sets, experience and institutional knowledge.

While change and staffing-up can be expected during these trying times, a firm must be very deliberate, communicative and attentive to the mood of employees when introducing new change agents. The firm would also be wise to reward and build loyalties with critical existing staff members to ensure they are present throughout the successful completion of the restatement process and beyond.

market must be evaluated, including efficiency and automation as well as their effect on competitive elements such as new product introductions.

With efficiency becoming ever more critical, it is key that firms quickly redeploy the resources tied up in the restatement process to help develop and integrate the right technology to streamline processes. The firm must replace individual EUCs identified through the restatement process with controlled and centrally managed systems.

With new mortgage products emerging as a means of keeping the housing market vibrant, examining if a firm is able to handle newly created products is viewed as time well spent. For example, are internal processes able to handle the ramifications of the introduction of a 40- or 50-year mortgage product now that new controls have been put into place?

Innovation and flexibility must be embedded into establishing managed internal structures in order to keep up with a market that has been quickly adapting to a dynamic and volatile environment. It is clear that firms will be severely hobbled in creating profit-driven products if the accounting function is not efficient or automated and cannot easily integrate and support new products.

Valuable lessons can be gained from examining the life cycle of a financial restatement in the mortgage industry. It is a daunting path to go down. But when met with honesty and flexibility, it will allow the restating firm to emerge from the process with minimal impact to the bottom line and with the loyalties of the employees and shareholders who helped build the firm's value proposition.

It is most likely that regulators will not be able to simplify the complexities inherent in generally accepted accounting principles (GAAP) in the near term. Thus mortgage companies would be far better off investing in the time, people and tools needed to stay controlled, well-prepared and adaptable in an environment that will continue to change. **MB**

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