
STAFF AUDIT PRACTICE ALERT NO. 7

**AUDITOR CONSIDERATIONS OF LITIGATION AND OTHER CONTINGENCIES
ARISING FROM MORTGAGE AND OTHER LOAN ACTIVITIES**

December 20, 2010

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts are not rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Background

In the fall of 2010, allegations surfaced that banks may have misrepresented the quality of mortgages sold and that those banks could be required to repurchase the affected mortgages.^{1/} Additional allegations have been made that companies servicing \$6.4 trillion in American mortgages may have bypassed legally required steps to foreclose on homes.^{2/} Some of these practices could result in loss contingencies for certain financial institutions that may require recognition of liabilities or disclosure in financial statements.^{3/}

The situation remains fluid, with estimates of potential costs associated with foreclosure irregularities and mortgage repurchases ranging from "manageable" to an exposure for the industry of up to \$52 billion.^{4/} Some experts have acknowledged

^{1/} Congressional Oversight Panel, *November Oversight Report* (November 16, 2010), available at: <http://cop.senate.gov/reports/library/report-111610-cop.cfm>.

^{2/} Ibid.

^{3/} Loss contingencies may include, among others, accruals for liabilities relating to representations and warranties made at the time loans were sold or for litigation costs.

^{4/} *November Oversight Report*, p. 52.

scenarios in which the title and legal documentation problems related to foreclosures could lead to significant effects on banks' balance sheets.^{5/}

Numerous federal and state agencies are coordinating their efforts to review practices that may not comply with state foreclosure laws or applicable federal laws^{6/} and to provide for better disclosures and improve transparency in the securitization market.

As part of the efforts to provide for better disclosures, in October 2010, the United States Securities and Exchange Commission's ("SEC") Division of Corporation Finance sent letters to certain public companies as a reminder of their disclosure obligations with respect to their forthcoming quarterly reports on Form 10-Q and subsequent filings. The letters highlighted continued concerns about potential risks and costs associated with mortgage and foreclosure-related activities or exposures. The sample letter posted to the SEC Web site stated that companies should consider certain items for disclosure, including, without limitation, "the impact of various representations and warranties regarding mortgages made to purchasers of the mortgages (or to purchasers of mortgage-backed securities) including to the government-sponsored entities (GSEs), private-label mortgage-backed security (MBS) investors, financial guarantors and other whole loan purchasers."^{7/}

The letters further reminded companies of the requirements for disclosures in Management's Discussion and Analysis for Forms 10-Q and 10-K under Item 303 of Regulation S-K and for accruing and disclosing loss contingencies in the financial statements under the Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC") Topic 450, Contingencies, Subtopic 450-20. Companies were reminded that, as appropriate, they should consider the need to accrue loss contingencies and to provide clear and transparent disclosure regarding obligations relating to the various representations and warranties that were made in connection with securitization activities and whole loan sales, and to discuss any implications of any foreclosure reviews, including potential delays in completing foreclosures. If applicable, these disclosures would address the company's role as an originator, securitizer, servicer, and investor.

^{5/} Ibid.

^{6/} White House, Office of the Press Secretary, *Fact Sheet: Federal Government Efforts to Support Accountability, Stability and Clarity in the Housing Market*, dated October 20, 2010.

^{7/} Neither companies nor public accounting firms should rely on the summary of the SEC staff letter in this practice alert, but should review the letter in its entirety. The SEC staff sample letter is available at:
<http://www.sec.gov/divisions/corpfin/guidance/cfoforeclosure1010.htm>.

The letters cautioned companies to consider a number of matters when preparing their quarterly and subsequent filings (e.g., litigation risks and uncertainties related to any known or alleged defects in the securitization process, including any potential defects in mortgage documentation or in the assignment of the mortgages). The letter also cautioned that some of these issues are not limited to financial institutions.

This practice alert advises auditors that the potential risks and costs associated with mortgage and foreclosure-related activities or exposures, such as those discussed in the SEC staff letters, could have implications for audits of financial statements or of internal control over financial reporting. These implications might include accounting for litigation or other loss contingencies and the related disclosures. Auditors should consider the effect of these matters during their reviews of interim financial information, year-end audits, and attestation engagements on assessments of compliance with servicing criteria.

Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* ("Practice Alert No. 3"), was issued in December 2008 to assist auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis.^{8/} Among other things, Practice Alert No. 3 provides auditors with information on selected financial reporting areas, including contingencies and guarantees that may be affected by the economic environment, and reminds auditors of the requirements regarding accounting estimates.

Audit risks that existed in December 2008 with respect to contingencies and guarantees, as well as potential other issues, continue to exist today. These audit risks potentially affect the risk of material misstatement, as evidenced by recent concerns regarding problematic foreclosures and asserted claims or potential litigation relating to representations and warranties made in connection with securitizations or whole loan sales. Auditors may need to consider the possible effects that these issues might have on the nature, timing, and extent of planned audit procedures.^{9/}

Matters for the auditor's consideration

In light of continued concerns about potential risks and costs associated with mortgage and foreclosure-related activities or exposures, this practice alert reminds auditors of their responsibilities with respect to auditing loss contingencies, disclosures, and other related topics.

^{8/} Staff Audit Practice Alert No. 3 is available at: http://pcaobus.org/Standards/QandA/12-05-2008_APA_3.pdf.

^{9/} Paragraph .33 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*.

Auditing Litigation, Claims, and Assessments

Companies that may be affected by mortgage and foreclosure-related activities or exposures may need to accrue for or provide disclosures relating to legal contingencies.^{10/}

AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*,^{11/} establishes requirements with respect to litigation, claims, and assessments. This standard states that in order to identify litigation, claims, and assessments, and to become satisfied with the accounting and reporting of such matters, the auditor should gather sufficient and appropriate audit evidence relevant to the following factors:

- The existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments;
- The period in which the underlying cause for legal action occurred;^{12/}
- The degree of probability of an unfavorable outcome; and
- The amount or range of potential loss.^{13/}

^{10/} FASB ASC Subtopic 450-20 requires companies to establish accruals for litigation and other contingencies when it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated. In an audit of a foreign private issuer ("FPI") whose financial statements are prepared in conformity with International Financial Reporting Standards ("IFRS"), the auditor should refer to applicable accounting and disclosure requirements of the International Accounting Standards Board ("IASB"). PCAOB standards apply regardless of the applicable financial reporting framework.

^{11/} AU sec. 337.01.

^{12/} According to paragraphs .01 and .04 of AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, when an auditor becomes aware of information that relates to financial statements previously reported on by the auditor, but which was not known to the auditor at the date of the report, and which is of such a nature and from such a source that the auditor would have investigated it had it come to the auditor's attention during the course of the audit, the auditor should take the actions described in AU sec. 561.

^{13/} AU sec. 337.04.

AU sec. 337 discusses the procedures the auditor should perform regarding litigation, claims, and assessments^{14/} and also states that although certain audit procedures may be undertaken for other purposes, they might also disclose litigation, claims, and assessments (e.g., reading minutes of meetings of stockholders, directors, and appropriate committees held during and subsequent to the period being audited; reading contracts, loan agreements, leases, and correspondence from taxing or other governmental agencies; or inspecting similar documents).^{15/} Further, the auditor should obtain a letter from the client's lawyer to assist the auditor in corroborating the information furnished by management concerning litigation, claims, and assessments.^{16/}

Auditing Accounting Estimates

Companies involved in mortgage and foreclosure-related activities may need to estimate and accrue amounts for other potential loss contingencies including those related to various representations and warranties. AU sec. 342, *Auditing Accounting Estimates*, establishes requirements regarding obtaining and evaluating sufficient appropriate audit evidence for accounting estimates. In auditing accounting estimates, the auditor normally should consider the company's historical experience in making past estimates as well as the auditor's experience in auditing companies in the same industry.^{17/} However, changes in facts, circumstances, or a company's procedures may cause factors different from those considered in the past to become significant to the accounting estimate.^{18/} For example, a company's historical experience relating to repurchasing loans sold into securitization structures may not be indicative of future trends in that area.

According to AU sec. 342, when planning and performing procedures to evaluate the reasonableness of the company's accounting estimates, the auditor should consider, with an attitude of professional skepticism, the subjective and objective factors included in the estimate.^{19/} When evaluating accounting estimates relating to mortgage loan repurchase losses, such factors may include, among others, estimated levels of defects based on the company's review or experience, default expectations, investor repurchase demand, or appeal success rates.

^{14/} AU sec. 337.05.

^{15/} AU sec. 337.07.

^{16/} AU sec. 337.08.

^{17/} AU sec. 342.09.

^{18/} Ibid.

^{19/} AU sec. 342.04.

Evaluating Financial Statement Presentation and Disclosure

Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements (which include the related notes).^{20/} When such information is set forth elsewhere in a report to shareholders "it should be referred to in the financial statements."^{21/} If management omits from the financial statements, including the accompanying notes, information that is required by generally accepted accounting principles, the auditor should express a qualified or adverse opinion and should provide the information in the audit report, if practicable.^{22/}

In addition, the auditor should read the other information accompanying the interim and annual financial statements contained in reports filed with the SEC,^{23/} including the Management's Discussion and Analysis of Financial Condition and Results of Operations sections of annual reports and other filings.^{24/} The auditor should consider whether that information or the manner of its presentation is materially inconsistent with the financial statements. If the auditor concludes that there is a material inconsistency or becomes aware of information that he or she believes is a material misstatement of fact, the auditor should determine if the financial statements, the audit report, or both, require revision. If the auditor concludes that the financial statements or audit report do not require revision, the auditor should request the company to revise the other information.^{25/}

FASB ASC Topic 450, Contingencies, Subtopic 450-20 requires that when a loss is not both probable and estimable, an accrual is not recorded, but disclosure of the contingency is required to be made when there is at least a reasonable possibility that a

^{20/} Paragraph .41 of AU sec. 508, *Reports on Audited Financial Statements*.

^{21/} Ibid.

^{22/} Paragraph .03 of AU sec. 431, *Adequacy of Disclosure in Financial Statements*.

^{23/} Paragraph .18(f) of AU sec. 722, *Interim Financial Information*, and paragraph .04 of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

^{24/} For example, Item 303(a)(1) of Regulation S-K instructs management to "[i]dentify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way."

^{25/} AU secs. 550.04-05.

loss or an additional loss has been incurred.^{26/} Companies involved in mortgage and foreclosure-related activities or exposures may need to establish new disclosures or enhance existing disclosures regarding litigation and other contingencies or estimates. For example, companies that sold or securitized loans but may not have complied with representations and warranties may be at risk of being forced to repurchase such loans. These companies may need to disclose or enhance their existing disclosures regarding the nature, timing, and uncertainty of their potential exposures as additional claims arise and are resolved.

Communication with Audit Committees

To the extent potential risks and costs associated with mortgage and foreclosure-related activities or exposures are identified, auditors are reminded of their responsibility to communicate with the audit committee. AU sec. 380, *Communication With Audit Committees*, includes requirements regarding communications relating to management judgments and accounting estimates.^{27/} Other communication with the audit committee includes such matters as the clarity and completeness of the company's financial statements, which include related disclosures^{28/} and a discussion of items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements.^{29/} For example, in appropriate circumstances, this discussion would include the auditor's view on disclosures relating to representations and warranties that were made in connection with securitization activities.

Reviewing Interim Financial Information

The objective of a review of interim financial information is to provide the auditor with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles.^{30/} AU sec. 722, *Interim Financial Information*, requires the auditor to make inquiries regarding unusual or complex situations that may have an effect

^{26/} In an audit of a FPI whose financial statements are prepared in conformity with IFRS, the auditor should refer to applicable accounting and disclosure requirements of the IASB. PCAOB standards apply regardless of the applicable financial reporting framework.

^{27/} AU sec. 380.08.

^{28/} AU sec. 380.11.

^{29/} Ibid.

^{30/} AU sec. 722.07.

on the interim information.^{31/} These situations may include changes in estimated loss contingencies as well as trends and developments affecting accounting estimates.^{32/}

If information obtained from performing review procedures leads the auditor to believe that the interim financial information may not be in conformity with generally accepted accounting principles in all material respects, the auditor should make additional inquiries or perform other procedures considered appropriate to provide a basis for communicating whether any material modifications should be made to the interim financial information.^{33/} AU sec. 722 provides additional requirements in cases where the auditor believes that a material modification should be made to the interim financial information.^{34/}

Ongoing Audit Considerations

As additional information is determined in future periods regarding the potential risks and costs associated with mortgage and foreclosure-related activities or exposures, auditors planning or performing an audit should acquire a sufficient understanding to assess how the additional information affects the nature and potential magnitude of the associated risks. Auditors should modify the overall audit strategy and the audit plan as necessary if circumstances change significantly during the course of the audit, including changes due to a revised assessment of the risks of material misstatement or the discovery of a previously unidentified risk of material misstatement.^{35/} Accordingly, auditors may need to consider, e.g., how documentation issues in the loan origination process at a bank affect the auditors' initial risk assessment, overall audit strategy and the audit plan.

^{31/} AU sec. 722.18c.

^{32/} AU sec. 722.55B1.

^{33/} AU sec. 722.22.

^{34/} AU sec. 722.29 -722.31.

^{35/} Paragraph 15 of Auditing Standard No. 9, *Audit Planning*. On August 5, the Board adopted Auditing Standards No. 8 through No. 15 related to the auditor's assessment of and response to risk ("the Risk Assessment Standards"), which, if approved by the SEC, would become effective for audits of fiscal periods beginning on or after December 15, 2010. For audits of fiscal periods before the Risk Assessment Standards are effective, auditors should refer to the relevant requirements of AU sec. 311, *Planning and Supervision*, AU sec. 312, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, and Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

Risks of material misstatement can arise from a variety of sources, including external factors, including conditions in the company's industry and environment and company-specific factors, such as the nature of the company, its activities, and internal control over financial reporting which can affect the judgments involved in determining accounting estimates or create pressures to manipulate the financial statements to achieve certain financial targets.^{36/}

In an integrated audit, many factors can affect the risk associated with a control including the design of the control,^{37/} nature of the control and the frequency with which it operates as well as the competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance.^{38/} Accordingly, an increase in the volume of foreclosures or loan repurchases could affect the risks associated with related controls.

Attestation Reports on Assessments of Compliance with Servicing Criteria

Section 1122 of the SEC's Regulation AB requires an attestation report by a registered public accounting firm on a servicer's assessment of compliance with servicing criteria.^{39/} These criteria include, among other things, maintaining collateral or security on pool assets as required by the transaction agreements or related pool asset documents; and initiating, conducting, and concluding loss mitigation or recovery actions in accordance with the timeframes or other requirements established by the transaction agreements.^{40/}

In adopting Regulation AB, the SEC provided that AT sec. 601, *Compliance Attestation*, applies to the preparation of these attest reports^{41/} and generally requires that,

^{36/} Paragraph 5 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

^{37/} Paragraph 42 of Auditing Standard No. 5.

^{38/} Paragraph 47, Auditing Standard No. 5.

^{39/} Item 1122, *Compliance with applicable servicing criteria*, under Regulation AB.

^{40/} *Ibid.*

^{41/} See SEC Release No. 33-8518, *Asset-Backed Securities* (December 22, 2004), which states in part: "On April 25, 2003, the Commission approved the PCAOB's adoption of the auditing and attestation standards in existence as of April 16, 2003 as interim auditing and attestation standards. The Attestation Standard for Compliance

in assessing whether the servicer has complied with the criteria, an auditor should consider risk factors similar to those an auditor would consider when planning an audit of financial statements,^{42/} as well as factors relevant^{43/} to the compliance engagement.^{44/} For example, in assessing risk, the auditor considers whether the servicer or its parent has identified noncompliance as part of an internal investigation, internal audit, or other compliance review.

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Attestation (AT sec. 601) in those interim auditing and attestation standards should be used in performing this examination engagement."

^{42/} AT sec. 601.33.

^{43/} Ibid.

^{44/} Rules 13a-18(c) and 15d-18(c) under the Exchange Act require that the attestation report on the assessment of compliance with servicing criteria for asset-backed securities be made in accordance with standards for attestation engagements issued or adopted by the PCAOB.