AUDITING, CASE STUDY

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Financial crisis in a nutshell

Highly important before we start…

Link for you → https://www.youtube.com/watch?v=N9YLta5Tr2A&t=196s

01

Financial crisis in a nutshell

A bit more about ***sub-prime mortgages***

STATED-INCOME

Report annual income during the application process for the loan

INTEREST-ONLY

Pay only interest on his or her loan balance for a fixed period of the mortgage term (common term – 30 years)

02

Company's overview

Sub-Industry: Mortgage Finance
Industry: Specialty Finance
Sector: Financials

New Century Financial Corporation was a real estate investment trust. The Company was a full-service mortgage finance company that provided first and second mortgage products to borrowers nationwide through its operating subsidiaries.

Bloomberg.com. [online] Available at: https://www.bloomberg.com [Accessed 1 Nov. 2017].

02

Company's overview

"…the best is yet to come…"

Are you sure?

1995
Founded by Brad Morrice, Ed Gotschall, Bob Cole

1996
The company made its first loan went public

1998
1,151 employees, 111 offices, $2 billion in mortgages, $17.7 million in net profit

2004
Reorganization: real estate investment trust (REIT)

2006, 1st quarter
$56 billion of mortgage loans and securitized $17billion of those loans, resulting in net earnings of $411 million

02

Company’s overview

2006,3rd quarter

Increase in loan delinquencies

Feb,2007

Financial condition and operating results deteriorated rapidly

Mar 8, 2007

Stopped accepting new loan applications

Mar 12, 2007

Company's shares lost 90% of their value and its $1.5 billion market capitalization is wiped out

Apr 2, 2007

New Century Financial filed for Chapter 11 bankruptcy

02

Loan Repurchase Agreement

Company's overview

The Tipping Point

"…loan sale agreements require us to repurchase or substitute mortgage loans in the event **we breach a representation or warranty given to the mortgage loan purchaser or make a misrepresentation during the mortgage loan origination process**. In addition, we may be required to repurchase mortgage loans **as a result of borrower fraud or in the event of early payment default on a mortgage loan**. Likewise, we are required to repurchase or substitute mortgage loans if **we breach a representation or warranty in connection with our securitizations**…"

You will need it soon

03

KPMG related issues

"KPMG had failed to warn investors that New Century's "mortgage freight train was about to runoff the rails"

KPMG failed to perform its New Century **engagements** "in accordance with professional standards

KPMG failed to adequately consider serious **internal control problems** evident in accounting and financial reporting system

KPMG failed to properly audit the company's critically important **loan repurchase loss reserve.**

03

Engagement

- almost entirely **new team** of auditors, approximately 15 KPMG employees in total, was assigned in 2005 (13 of 15 members were new)
- the **conflict** among the audit engagement partner (John Donovan) and the senior manager (Mark Kim) from one side and New Century's controller (David Kenneally) from the other
- "near disaster" situation (KPMG's FDR team **refusal to sign off**, delaying the release of the 10-K) what, probably, *impaired KPMG's independence* during the remainder of the firm's tenure with New Century

The bankruptcy examiner:

"In particular, it is possible that Donovan and Kim were not as sceptical as they might otherwise have been with regard to critical assumptions [underlying New Century's accounting decisions]."

"Donovan and Kim may have looked for ways to add unique value in order to salvage KPMG's reputation, such as by providing proactive (though erroneous) advice in connection with the repurchase reserve calculation methodology."

03

Internal Control Problems

Section 404 of the Sarbanes-Oxley Act requires auditors of public companies to audit the effectiveness of their clients' internal controls over financial reporting

2004: five significant deficiencies BUT they were not considered as "material weaknesses" -> unqualified opinion
2005: no significant deficiencies or material weaknesses in internal controls were identified *(take into consideration a new team!)*
+ **person responsible for internal control** had neither experience auditing U.S. clients and no prior SOX experience

The Examiner found no evidence that the KPMG [2005] engagement team engaged in a formal process to compare year over year deficiency findings in connection with the 2005 SOX 404 audit. Conducting this analysis would have been prudent given the wholesale turnover in the KPMG engagement team. This failure is significant, as it impacted the planning for the 404 audit in 2005, the evaluation of findings in 2005, and the planning for the year-end audits.

03

Loan Repurchase Loss Reserve

We told you it will be useful (go to slide 7 if you want to refresh the memory)

- **2006**: New Century changed the method used to compute the period ending balance of the loan repurchase loss reserve; the calculation methodology was approved by KPMG.
- This change resulted in **large increases in the understatements** of that account at the end of each subsequent quarterly reporting period.

"If KPMG had performed adequate tests and calculations, it would have determined that Interest Recapture was omitted from the repurchase reserve calculation."

04

Questions & Answers

KPMG served as the independent audit firm of several of the largest subprime mortgage lenders. Identify the advantages and disadvantages of a heavy concentration of audit clients in one industry or sub-industry.

04

Questions & Answers

ADVANTAGES	DISADVANTAGES
• Develop loyal constituency • Employee expertise – faster to train, more effective • Can learn from mistakes of similar clientele • Provides economy of scale in terms of audit planning and procedures (as well as in term of team knowledge and expertise) • The most fundamental benefit is that of industry expertise (providing higher level of assurance) • The advantage of a performance quality of the overall audit	• Poor diversified client base • Exposes the audit firm to outside influences such as foreign competition and regulatory changes • May limit audit firm ability to attract clients outside its key sphere of influence • When industry weakens lose clients and money • Employees fall into cycle of overlooking details; become narrow-minded • Might make generalized assumptions (i.e.: KPMG's assumption of NC's internal control for interest recapture) • Making one mistake can often lead to repeated mistakes with different clients in the same industry • False sense of confidence or security

04

Questions & Answers

As noted in the case, there was an almost complete turnover of the staff assigned to the New Century audit engagement team from 2004 to 2005.
What quality control mechanisms should accounting firms have in such circumstances to ensure that a high-quality audit is performed?

04

Questions & Answers

It seems reasonable to suggest that KPMG should have emphasized the need for the 2005 engagement team to make full use of the large firm’s considerable “consultation” resources. In fact, as pointed out in the case, certain “specialists” were brought in to review some of New Century’s most complex transactions. Unfortunately, those “FDR” specialists did not complete their assigned procedures.

Other quality control measures that could be implemented when there is a large turnover in the members of an audit engagement team would include a more rigorous review of audit workpapers and more input from a “concurring” or “review” partner who has experience with the given client’s industry.

04

Questions & Answers

Section 404 of the Sarbanes-Oxley Act requires auditors of a public company to analyze and report on the effectiveness of the client's internal controls over financial reporting. Describe the responsibilities that auditors of public companies have to discover and report (a) significant deficiencies in internal controls and (b) material weaknesses in internal controls. Include a definition of each item in your answer. Under what condition or conditions can auditors issue an unqualified or clean opinion on the effectiveness of a client's internal controls over financial reporting?

04

Questions & Answers

Material weakness

is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company’s annual or interim financial statements will not be prevented or detected on a timely basis.

Significant deficiency

is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company’s financial reporting.

IC deficiency

a deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis

04

Questions & Answers

For an auditor to issue a standard unqualified audit report, there are five specific conditions required to be met:

- The financial statements must comprise all statements(Statement of Cash Flow, Income Statement & Balance Sheet);
- The engagement is following the International Standards of Auditing (ISAs) in all respects;
- Adequate evidences have been gathered to conclude that the three standards of fieldwork have been met;
- The approved accounting standards, which is the Financial Reporting Standards (FRS) and the Company Act are used to prepare the financial statements and the financial statements includes proper and sufficient disclosure of all relevant material matters;
- The financial report is under the condition that is not requiring any additional explanation or any modification.

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Questions & Answers

One of New Century's most important accounts was its loan repurchase loss reserve. Each accounting period, New Century was required to estimate the ending balance of that account. What general principles or procedures should auditors follow when auditing important "accounting estimates"?

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"Auditing Accounting Estimates" AU Section 342

Questions & Answers

1. "Review and test the process used by management to develop the estimate."
2. "Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate."
3. "Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation."
4. "Evaluate whether the [underlying] assumptions are consistent with each other, the supporting data, relevant historical data, and industry data."
5. "Consider whether changes in the business or industry may cause other factors to become significant to the [underlying] assumptions."
6. "Consider using the work of a specialist regarding certain [underlying] assumptions."
7. "Test the calculations used by management to translate the [underlying] assumptions and key factors into accounting estimates."

04

Questions & Answers

New Century's bankruptcy examiner charged that KPMG did not comply with applicable "professional standards" while auditing the company. List specific generally accepted auditing standards (GAAS) that you believe KPMG may have violated on its New Century engagements. Briefly defend each item you list.

04

Questions & Answers

General Standards

- Technical training and proficiency in auditing
- Maintaining an independent mental attitude
- Exercising due professional care

Field Work Standards

- Adequate planning and proper supervision of subordinates
- Obtaining a sufficient understanding of the entity, its environment, and its internal control
- Obtaining sufficient appropriate audit evidence

Reporting Standards

- Presentation in accordance with GAAP
- Consistent application of GAAP
- Assessment of adequacy of disclosure
- Expression of an opinion

04

Questions & Answers

Mortgage-backed securities (MBS) produced by New Century and other major subprime lenders have been a focal point of attention during the recent financial crisis. Many parties have maintained that the mark-to-market rule for securities
investments such as MBS has contributed significantly to that crisis and that the rule should be modified, suspended or even eliminated. Briefly summarize the principal arguments of those parties opposed to the mark-to-market rule. Do you believe that those arguments are legitimate? Why or why not?

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Questions & Answers

- Earning fluctuate dramatically from quarter to quarter due to large gains/losses on market value (provides no basis to calculate earnings expectations)
- Much more arbitrary and subjective than historical cost
- In general, it’s high risk (allow companies the opportunity to post large gains, but there always remains the danger of a huge loss)
- Yes, they are legitimate, as they reflect the a higher degree of conservatism

04

Questions & Answers

Identify what you consider to be the three most important “take-always” or learning points in this case. Rank these items in order of importance (highest to lowest). Justify or defend each of your choices.

04

Questions & Answers

1

Proper staffing of an audit engagement is critical to the performance of a high quality audit.

May influence on all the further stages

2

Auditors should consider internal control deficiencies when determining the nature, extent, and timing of substantive audit procedures.

3

When planning an audit, auditors should pay close attention to important industry developments that may impact the integrity of the client’s financial statements

THANK YOU FOR YOU ATTENTION