

CASE 1.11

New Century Financial Corporation

It is well enough that people of the nation do not understand our banking and monetary system, for if they did, I believe there would be a revolution before tomorrow morning.

Henry Ford

From 1962 to 1992, Ed McMahon served as the quintessential sidekick and straight man to Johnny Carson on the long-running and popular television program *The Tonight Show*. After leaving that program, McMahon stayed in the television spotlight for 12 years by serving as the host of *Star Search*, a syndicated talent show. McMahon's resume also included long stints as cohost of *TV Bloopers and Practical Jokes*, the annual Macy's Thanksgiving Day Parade, and the Jerry Lewis Labor Day Telethon and as commercial spokesperson for such companies as Budweiser and American Family Publishing.

McMahon's fifty-year-plus career in television made him one of the most recognized celebrities in that medium. Understandably then, the American public was shocked when press reports in June 2007 revealed that McMahon was more than \$600,000 past due on his home mortgage payments. The \$5 million mortgage on McMahon's Beverly Hills mansion was held by Countrywide Financial Corporation.

Unfortunately, millions of everyday Americans with mortgage balances only a fraction of Ed McMahon's have recently faced the unhappy prospect of losing their homes due to the worst financial crisis to strike the United States economy since the Great Depression. As that crisis quickly worsened and spread to the global economy, the search began for the parties responsible for it. Among the potential culprits identified by the press was the accounting profession, in particular, independent auditors.

Mortgage Mess

Nearly one-half of recent mortgage foreclosure victims in the United States obtained their loans from so-called subprime lenders that became dominant forces in the mortgage industry over the past two decades. The largest of those lenders were Countrywide, HSBC, New Century Financial Corporation (New Century), and Wells Fargo, but more than a dozen other large companies provided loans to borrowers with suspect credit histories. The implosion of the lucrative but high-risk subprime sector of the mortgage industry in 2007 and 2008 ignited a financial crisis in the United States that would quickly engulf the global economy.

The origins of the subprime mortgage debacle in the United States can be traced to the collapse of New Century, the nation's second largest subprime lender. New Century was founded in 1995 by three friends who had previously worked together at a mortgage banking company. New Century, which was based in Irvine, California, grew dramatically over its brief existence. In 1996, New Century reported total revenues of \$14.5 million and total assets of \$4.4 million. Nine years later, the company reported total revenues of \$2.4 billion and total assets of \$26 billion.

During the heyday of subprime mortgage lending in 2005 and 2006, New Century funded \$200 million of new mortgage loans on a typical business day. In early February 2007, just a few months after company executives insisted that New Century was financially strong, those same executives unsettled Wall Street when they revealed that the company would be restating previously released financial statements as a result of the misapplication of generally accepted accounting principles (GAAP).

Two months later, New Century declared bankruptcy. A court-appointed bankruptcy examiner summarized the far-reaching implications that New Century's downfall had for the global economy.

The increasingly risky nature of New Century's loan originations created a ticking time bomb that detonated in 2007. . . The demise of New Century was an early contributor to the subprime market meltdown. The fallout from this market catastrophe has been massive and unprecedented. Global equity markets were rocked, credit markets tightened, recession fears spread, and losses are in the hundreds of billions of dollars and growing.¹

In fact, New Century would be just the first of many high profile companies brought down by the turmoil in the United States's mortgage industry. Longtime stalwarts of the nation's financial services industry that fell victim to that turmoil included Bear Stearns, Lehman Brothers, and Merrill Lynch.

In September 2008, the federal government assumed control of the Federal National Mortgage Association and the Federal Home Loan Mortgage Company, two "government-sponsored" but publicly owned companies better known as Fannie Mae and Freddie Mac, respectively. At the time, the two organizations owned or guaranteed nearly one-half of the approximately \$12 trillion of home mortgages in the United States. For decades, the federal government had used Fannie Mae and Freddie Mac to create an orderly and liquid market for homeowner mortgages, but the enormous losses each suffered in 2007 and 2008 undercut that role and forced the U.S. Department of the Treasury to take over their operations.

Angry investors lashed out at a wide range of parties who they believed bore some measure of responsibility for the massive financial crisis. Those parties included the major subprime mortgage lenders in the United States, such as New Century, and the politicians, regulatory authorities, ratings agencies, and independent auditors who had failed to prevent or rein in the imprudent business practices of those lending institutions.

Only a few years removed from the sweeping reforms prompted by the Enron and WorldCom scandals, the accounting profession was once again forced to defend itself from a wide range of angry and often self-righteous critics. Among these critics was *The New York Times*. The prominent newspaper castigated the auditors of subprime lenders for stamping those institutions' financial statements with the accounting profession's equivalent of the Good Housekeeping Seal of Approval. "While accounting firms don't exert legal or regulatory authority over their clients, they do bestow seals of approval, the way rating agencies do. People in the financial industry, as well as investors, have reason to believe that a green light from an auditor means that a company's accounting practices have passed muster."²

1. "Final Report of Michael J. Missal, Bankruptcy Court Examiner," In re: New Century TRS Holdings, Inc., a Delaware corporation, *et al.*, U.S. Bankruptcy Court for the District Delaware, Case No. 07-10416 (KJC), 29 February 2008. Unless indicated otherwise, the quotations appearing in this case were taken from this source.

2. V. Bajaj and J. Creswell, "A Lender Failed. Did Its Auditor?" *The New York Times* (online), 13 April 2008.

The following section of this case provides a historical overview of subprime mortgage lending in the United States. Next, the history and operations of New Century Financial Corporation are reviewed with a particular focus on the company's major role in the subprime mortgage fiasco. The case then examines the criticism of KPMG, New Century's longtime independent audit firm, by the federal bankruptcy examiner appointed to investigate the company's sudden collapse in early 2007.

Subprime Lending: A Historical Perspective

Like all businesses, mortgage companies struggle to achieve a proper balance between "risk" and "return" in their operations. The principal risk historically faced by mortgage lenders is the possibility that their clients will be unable or unwilling to pay the principal and interest on their mortgage loans.

Prior to the 1980s, individuals who were poor credit risks effectively had only two choices for obtaining a mortgage to purchase a home. Those alternatives were obtaining a home loan insured by either the Federal Housing Administration (FHA) or the Department of Veteran Affairs (VA). Borrowers with good credit histories, so-called prime borrowers, would typically seek financing for a new loan directly from a bank, savings and loan, or other financial institutions.

The deregulation of the lending industry beginning in the 1980s made it much easier for subprime borrowers to obtain mortgage loans to finance the purchase of a new home. The Depository Institutions Deregulation and Monetary Control Act of 1980 did away with restrictions that imposed a ceiling on the interest rates lending institutions could charge on new mortgage loans. Subsequent legislation allowed mortgage lenders to create a wide array of financing alternatives to compete with the standard 30-year, fixed interest rate mortgage loan that had long been the industry's principal product. Most notably, these non-traditional mortgage loans included ARMs, or adjustable rate mortgages, that would become particularly popular with mortgage borrowers who had impaired or "subprime" credit histories or profiles.

Despite the deregulatory legislation of the 1980s, the subprime sector of the mortgage industry did not experience explosive growth until the "securitization" of mortgage loans became increasingly common following the turn of the century. Wikipedia defines securitization as "a structured finance process in which assets, receivables, or financial instruments [such as mortgage loans] are acquired, classified into pools, and offered as collateral for third-party investment."

The securitization option caused many mortgage lenders to adopt an "originate to distribute" business model. This new business model meant that the credit risk posed by new mortgages was no longer exclusively absorbed by lending institutions but rather was shared with investors worldwide who purchased so-called mortgage-backed securities or MBS. By 2006, nearly one-fourth of all new residential mortgage loans in the United States were made to subprime borrowers; three-fourths of those mortgages were securitized and sold to investors in the United States and around the world.

The insatiable demand for high-yield MBS among investors, particularly institutional investors such as large banks and hedge funds, caused subprime lenders to ratchet up their marketing efforts. To persuade individuals who were high credit risks to obtain mortgage loans, the subprime lenders developed new products designed specifically for that sector of the mortgage market.

Among the most popular mortgage products developed for the subprime lending market were "stated-income" and "interest-only" mortgages. An applicant for a stated-income loan was simply asked to report his or her annual income during

the application process for the loan. The applicant's self-reported income was used by the lender to determine the size of the loan that the individual could afford. Not surprisingly, many applicants for stated-income loans, commonly known as "liars' loans" in the mortgage industry, grossly overstated their annual incomes so that they could purchase a larger home than was economically feasible given their actual annual incomes.

A borrower who obtained an interest-only or IO mortgage loan was required to pay only interest on his or her loan balance for a fixed period of the mortgage term. The IO feature of these loans typically extended over either the first 5 or the first 10 years of the mortgage term. Similar to other mortgage loans, the most common term of an IO loan was 30 years.

Housing prices in those regions of the country where subprime lending was particularly prevalent—such as Arizona; California; south Florida; and Las Vegas, Nevada—rose steeply during the late 1990s and into the early years of the new century. Many subprime borrowers in those housing markets purchased a home with the express intention of reaping a short-term windfall profit. An individual who obtained a 100 percent loan to acquire a \$2 million home could realize a more than \$400,000 "profit" on that home in two years if housing prices rose 10 percent each year. After two years, the borrower could extract that profit by refinancing his or her mortgage. That profit could then be used to make the monthly payments on the new mortgage. Or, that individual could sell the home and use the resulting profit to purchase a much larger home—with a much larger mortgage—that he or she could also "flip" in a few years.

Housing prices generally reached their peak in the United States in mid-2006, although they had been declining in some regions of the country over the previous twelve months. By late 2007, prices in several major regional housing markets had declined by 10 percent from their peak levels. By mid-2008, housing prices in those same markets had declined by 20 percent, or more, from their high water marks.

As housing prices steadily fell, a growing number of subprime borrowers began defaulting on their monthly mortgage payments. In fact, many of those individuals quickly became "upside down in their homes," that is, the unpaid balances of their mortgages exceeded the market values of their homes. By early 2008, an estimated 9 million U.S. homeowners had a negative equity in their homes.

The sharp downturn in the housing market had an immediate and drastic impact on mortgage lenders, particularly subprime mortgage lenders such as New Century. Many of the subprime loans originated and packaged for sale by New Century included repurchase clauses. If the default rate on those packages of loans exceeded a certain rate, New Century could be forced to repurchase those loans. As the housing market weakened, New Century and other subprime lenders were flooded with loan repurchase requests.

The financial problems facing the mortgage industry soon spread to other sectors of the economy because of the securitization of subprime mortgage loans. Many high profile companies in the financial services industry, such as Merrill Lynch, that had no direct connection to the large subprime lenders, suffered huge losses as the market value of MBS plunged. Making matters worse, a large proportion of MBS that originated in the United States was sold worldwide. As one observer of the mortgage market noted, the securitization process effectively "spread the cancer of subprime mortgages to investors throughout the U.S. and the rest of the world."³

3. K. Amadeo, "Understanding the Subprime Mortgage Crisis," *About.com* (online), 9 October 2008.

New Century: Poster Child for Subprime Mortgage Lending

Bob Cole, Ed Gotschall, and Brad Morrice found themselves without jobs in 1995 when the company for which they had worked for several years, Plaza Home Mortgage, was purchased by a much larger competitor. The three friends decided to pool their resources and establish their own mortgage company, a company that would focus on the “low-end” or subprime sector of the mortgage market. Cole served as New Century Financial Corporation’s chief executive officer (CEO), Gotschall was the company’s chief financial officer, and Morrice oversaw New Century’s lending operations as the company’s chief operating officer (COO). Morrice would eventually replace Cole as New Century’s CEO. In June 1997, the company went public by listing its stock on the NASDAQ—New Century’s stock would be switched to the New York Stock Exchange in late 2004.

Cole, Gotschall, and Morrice earned relatively modest annual salaries throughout their tenure with the company. For example, in 2005, each of them received a salary of \$569,250. New Century’s incentive compensation plan, however, rewarded the three co-founders handsomely with significant bonuses and stock option grants when the company met or exceeded its financial goals. During 2005, the three executives received total compensation of approximately \$15 million each. In addition, *The New York Times* reported that, collectively, they realized more than \$40 million in trading profits on the sale of New Century stock between 2004 and 2006.⁴

New Century thrived from its inception thanks largely to three key factors. First, mortgage interest rates, which had spiked during the mid-1990s, stabilized and then generally trended downward for more than a decade. Second, the economic and regulatory environment at the time made subprime lending the most lucrative sector of the mortgage industry. Finally, the booming housing market in Orange County, California, where the company was located, gave New Century a large and easily accessible market to tap.

Once New Century was well established in Orange County, the company’s ruling troika of Cole, Gotschall, and Morrice began pursuing expansion opportunities for their company in other “hot” real estate markets in the United States. At its zenith, New Century operated more than 200 retail mortgage offices in the United States from which company employees originated new mortgage loans. The company’s wholesale division, which produced the bulk of its loan originations, operated through a far-flung network of more than 35,000 independent mortgage brokers.

New Century’s 2003 Form 10-K filed with the Securities Exchange Commission (SEC) provided a concise summary of the company’s business model.

We offer mortgage products designed for borrowers who generally do not satisfy the credit, documentation or other underwriting standards prescribed by conventional mortgage lenders and loan buyers, such as Fannie Mae and Freddie Mac. We originate and purchase loans on the basis of the borrower’s ability to repay the mortgage loan, the borrower’s historical pattern of debt repayment and the amount of equity in the borrower’s property (as measured by the borrower’s loan-to-value ratio, or LTV). We have been originating and purchasing these types of loans since 1996 and believe we have developed a comprehensive and sophisticated process of credit evaluation and risk-based pricing that allows us to effectively manage the potentially higher risks associated with this segment of the mortgage industry.

In 2004, New Century’s management reorganized the company as a real estate investment trust (REIT) so that it would qualify for favorable tax treatment under the

4. V. Bajaj, “Report Assails Auditor for Work at Failed Home Lender,” *The New York Times* (online), 26 March 2008.

Internal Revenue Code. This organizational change had little impact on the company's operations or the underlying nature of its principal line of business, that is, originating subprime mortgage loans.

New Century experienced impressive growth from its founding in 1996 through 2001, however, a significant increase in subprime lending activity quadrupled New Century's revenues from fiscal 2002 to fiscal 2005. In the latter year, New Century originated or purchased more than \$56 billion of mortgage loans and securitized \$17 billion of those loans, resulting in net earnings of \$411 million for the company.

The decision by New Century's management to focus the company's marketing efforts principally on stated-income and IO loans contributed significantly to its remarkable growth in revenues beginning in 2002. By 2005, approximately three-fourths of the company's loan originations involved one of those two products.

Throughout the period that New Century's revenues were increasing dramatically, company spokespeople repeatedly insisted in press releases and public filings with the SEC that the company had a strong and sophisticated system of internal controls. That contention was subsequently questioned by the bankruptcy examiner appointed to investigate the collapse of New Century.

Several interviewees told the Examiner that they thought New Century's information technology and data entry and processing systems were not "state of the art" and were not sufficient for a business of the size and nature of New Century's. In particular, New Century's loan production processes were apparently manual and people-intensive through the fall of 2005. Up until that time, New Century apparently used an outdated DOS-based loan underwriting and appraising operating system, which according to one Management interviewee, allowed users to "finagle anything."

The bankruptcy examiner's report went on to note that the company's accounting system was particularly lax with regard to tracking "loan repurchase claims." According to the examiner, New Century did not develop an "automated system or protocol" for tracking such claims until late 2006. By that time, the company was being swamped by loan repurchase requests due to the weakening housing markets in the principal geographical areas that it served. Besides failing to properly track loan repurchase requests throughout most of its history, New Century "did not have a formal policy spelling out exactly how to calculate reserves"⁵ for loans that it would be required to repurchase.

By late 2005, several members of New Century's board of directors were openly challenging top management's high-risk business strategies as well as questionable accounting and financial reporting decisions made by the company. The most vocal of these critics was Richard Zona, an outside director who also served on the company's audit committee.

Earlier in his long and distinguished career, Zona had been a senior partner with Ernst & Young (E&Y) and had served for a time as E&Y's National Director of Financial Services, a position in which he oversaw the firm's audit, tax, and management consulting services. In the late 1990s, Zona had also served on an advisory council to the Federal Reserve Board.

In late 2005, Zona drafted a resignation letter, which he addressed to New Century's board of directors. In that letter, Zona suggested that company management was manipulating reported earnings, employing "aggressive" revenue recognition methods, and failing to provide an adequate allowance for loan losses.⁶ Excerpts from Zona's letter are included in Exhibit 1.

5. Bajaj and Creswell, "A Lender Failed."

6. Zona eventually rescinded the 2005 resignation letter and remained on the company's board until September 2007.

At the October 25th and 26th [2005] Board meeting, Management informed the Board that its current forecast and analyst consensus for third quarter EPS of \$2.24 per share could not be achieved unless Management reversed \$.26 per share of loan loss reserves . . . Obviously, Management's desire to reverse reserves in the third quarter smacked of earnings manipulation.

Management use of off balance sheet gain on sale accounting substantially overstates earnings when compared to cash flows, thus generating extremely aggressive income recognition.

Our largest shareholder has questioned the appropriateness of our accounting for loan losses.

As to accounting for loan losses, it is a long standing accounting maxim that accounting should be designed and applied to match revenues with expenses. Management's methodology to provide for loan losses based upon their estimate of charge offs over the next 18 months does not accomplish that objective . . . Management's methodology does not result in a proper matching of revenues with costs, (loan loss provisions), because charge offs are back ended.

Source: "Final Report of Michael J. Missal, Bankruptcy Court Examiner," In re: New Century TRS Holdings, Inc., a Delaware corporation, *et al.*, U.S. Bankruptcy Court for the District Delaware, Case No. 07-10416 (KJC), 29 February 2008.

EXHIBIT 1

EXCERPTS FROM
DRAFT OF 2005
RESIGNATION
LETTER SUBMITTED
BY RICHARD ZONA
TO NEW CENTURY'S
BOARD

Throughout 2006, New Century's financial condition and operating results deteriorated rapidly. To quell concerns regarding the company's health, New Century management repeatedly assured Wall Street that the company was financially sound. In August 2006, New Century reported a significant increase in its earnings for the second quarter of the year compared with that for the same period of the prior year. A company spokesperson noted that those operating results were "evidence of the strength and stability of our franchise." New Century's third quarter earnings press release for 2006 admitted that subprime lenders faced "challenging" market conditions because of increasing loan delinquencies. Nevertheless, the press release assured the investing public that New Century was "adequately reserved for the expected higher level of loan losses."

On January 31, 2007, New Century's management team met with the company's board of directors and audit committee. At that meeting, management told the board and audit committee that New Century had understated its reserve for loan repurchase losses for each of the first three quarterly reporting periods of 2006. New Century's controller, David Kenneally, attributed those understatements to an "inadvertent oversight" in the method used to compute the reserve. Members of New Century's board and audit committee testified that they were "shocked" by this revelation and described the January 31 meeting as "ugly" and "very emotional."

On February 7, 2007, New Century filed a Form 8-K with the SEC, which publicly disclosed the prior understatements of the loan repurchase loss reserve. The 8-K indicated that the understatements were due to the company failing "to account for expected discounts upon the disposition of repurchased loans" and due to its failure to "properly consider the growing volume of repurchase claims outstanding that resulted from the increasing pace of repurchase requests." The 8-K filing did not disclose to what extent the loan repurchase loss reserve had been understated but instead simply indicated that the previously reported earnings for the first three quarters of 2006 "should no longer be relied upon."

EXHIBIT 2

FICTITIOUS LETTER
SUPPOSEDLY
WRITTEN BY
FORMER NEW
CENTURY CEO
FOLLOWING THE
COMPANY'S
BANKRUPTCY FILING

Dear BankNet360 Readers:

Hi, my name is Brad Morrice and I've just bailed out of my sinking ship, the SS New Century Financial.

But don't feel bad for me; I'll be doing just fine. I may have bankrupt the company, treated mortgage underwriting like a bad cold, and helped cause more layoffs than a recession, but I should still bank about \$25 million. To the creditors I say, "nanee-nanee billy goat."

Regrets? Sure, I've got some. I should have cashed in more of my options when the NEW stock was on a rocket ship fueled by option ARMs and I.O. loans from heaven. Ah, those were the days, when loans fell from the sky—and into the laps of subprime borrowers who can more easily discern Britney from J-Lo than understand all the conditions of their upcoming loan repricings.

You know, I wonder also how I can walk away from New Century with so much dough. This Chief Restructuring Officer, Holly Etlin, I don't know what planet she is from, but she can come over to my palace, er, place, anytime.

Oh, look at the time. That money's going to hit my account any moment now, and I've got shopping to do. Well, my regards to the subprime mortgage industry. All you Wall Street guys—hope you can handle the risk.

Sincerely yours,

Brad A. Morrice
Founder (ret.)
New Century Financial Corp. (bankrupt)

Source: BankNet360.com (http://www.banknet360.com/viewpoints/Discussion.do?discussion_id=191), 13 June 2007.

On March 2, 2007, New Century informed the SEC that its 2006 Form 10-K would be delayed and that it would eventually report a loss for the entire year. At the same time, New Century disclosed that KPMG was considering issuing a going-concern opinion on the company's 2006 financial statements—KPMG resigned as New Century's auditor a few weeks later without having issued an opinion on those financial statements. On April 2, 2007, New Century filed for bankruptcy in a U.S. federal court. At the time, New Century was the ninth largest company to file for bankruptcy in U.S. history.⁷ In May 2008, company management announced that New Century's audited financial statements for 2005 should no longer be relied upon.

Within a few days of New Century's bankruptcy filing, the company's stock price fell to less than \$1 per share, down from more than \$30 per share two months earlier—the stock had reached its all-time high of \$66 per share in 2004. Not surprisingly, stockholders and other parties were enraged by the company's sudden collapse that mimicked the downfall of Enron and WorldCom a few years earlier. Exhibit 2 presents a sarcastic commentary on New Century's collapse by one of the company's many critics. This commentary was in the form of a fictitious letter addressed to the readers of an online banking forum.

7. The five largest companies to file for bankruptcy in 2007 were mortgage lenders. Four of those five companies were subprime lenders.

“Go-to Auditor”

The New York Times characterized KPMG as the “go-to auditor” for the subprime sector of the mortgage industry.⁸ KPMG’s audit clients in that sector included the largest subprime lenders, namely, Countrywide, HSBC, New Century, and Wells Fargo. KPMG served as New Century’s auditor from the company’s inception in 1995 until its resignation in April 2007.

New Century’s bankruptcy filing resulted in heated criticism of KPMG. *The New York Times* drew a parallel between Arthur Andersen’s audits of Enron Corporation that had failed to expose the huge energy company’s aggressive accounting treatments and KPMG’s audits of New Century. According to the newspaper, KPMG had failed to warn investors that New Century’s “mortgage freight train was about to run off the rails.”⁹

*New Century’s accounting methods let it prop up profits, charming investors and allowing the company to continue to tap a rich vein of Wall Street cash that it used to underwrite more mortgages. Without the appearance of a strong bottom line, New Century’s financial lifeline could have been cut earlier than it was.*¹⁰

The federal bankruptcy examiner appointed for New Century carried out an exhaustive investigation of the large subprime lender’s sudden failure. A major focus of that investigation was KPMG’s 2005 audit of New Century and the accounting firm’s reviews of the financial statements included in the company’s Form 10-Qs for the first three quarters of 2006. KPMG was required to provide the bankruptcy examiner with nearly 2 million pages of documents relating to those engagements. Exhibit 3 presents KPMG’s audit report on New Century’s 2005 financial statements.

In his 560-page report, the bankruptcy examiner alleged that KPMG had failed to perform its New Century engagements “in accordance with professional standards.” The examiner’s specific allegations included charges that the 2005 New Century audit was improperly staffed and that the independence of certain KPMG auditors may have been impaired. The examiner also maintained that KPMG failed to adequately consider serious internal control problems evident in New Century’s accounting and financial reporting system and failed to properly audit the company’s critically important loan repurchase loss reserve.

Staffing Issues on the New Century Engagement

In the spring of 2005, shortly after KPMG completed the 2004 audit of New Century, an almost entirely new team of auditors, approximately 15 KPMG employees in total, was assigned to that client. The only two members of the 2004 audit engagement team “held over” for the 2005 audit were two first-year associates. The two key members of the 2005 audit team, the audit engagement partner and the senior manager, had just joined the Los Angeles office of KPMG, the practice office responsible for servicing New Century.

John Donovan, the engagement partner for the 2005 New Century audit, had served for 17 years as an audit partner with Arthur Andersen prior to that firm being forced to disband in 2002. After Andersen’s demise, Donovan became an audit partner with E&Y, which he left in early 2005 to take a similar position with KPMG.

8. Bajaj and Creswell, “A Lender Failed.”

9. *Ibid.*

10. *Ibid.*

EXHIBIT 3

NEW CENTURY
FINANCIAL
CORPORATION
AND SUBSIDIARIES
REPORT OF
INDEPENDENT
REGISTERED
CERTIFIED PUBLIC
ACCOUNTING FIRM

KPMG's 2005 Audit Report on New Century's Financial Statements

The Board of Directors

New Century Financial Corporation

We have audited the accompanying consolidated balance sheets of New Century Financial Corporation and subsidiaries as of December 31, 2005, and 2004, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2005. These consolidated financial statements are the responsibility of Company's Management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of New Century Financial Corporation and subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 15, 2006 expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting.

KPMG LLP
Los Angeles, California
March 15, 2006

Source: New Century's 2005 10-K.

New Century's audit committee was unhappy with KPMG's decision to appoint Donovan as the audit engagement partner for the 2005 audit. Members of the audit committee believed that Donovan's lack of experience with the mortgage industry made him a poor choice to supervise that audit and asked KPMG to appoint another partner to oversee the engagement. When KPMG refused, the audit committee considered dismissing KPMG and retaining a different audit firm. "Ultimately, the Audit Committee determined that a switch to a new accounting firm would be tremendously disruptive and would send a bad signal to its lenders."

Mark Kim accepted a position with KPMG in May 2005, shortly before being assigned to serve as the senior manager on the 2005 New Century audit engagement. Kim had several years of prior experience as an auditor and had served for three years as the assistant controller of a small mortgage lending company.

During his tenure on the New Century audit team, Mark Kim complained to John Donovan that it was difficult to recruit a “good team” of auditors to work on the engagement. In an e-mail to Donovan, an exasperated Kim remarked, “We will never get a good team out here because of the reputation that the engagement has.” Another e-mail sent by a New Century accountant to the company’s controller, David Kenneally, seemed to corroborate Kim’s opinion. This latter e-mail noted that KPMG had not assigned the “A team” to the New Century audit.

In fact, Kenneally, a former KPMG employee, was apparently the key reason that the New Century engagement had a negative reputation within KPMG’s Los Angeles office. Evidence collected by the New Century bankruptcy examiner suggested that the company’s accounting function was “weak” and was overseen by Kenneally who was “domineering” and “difficult, condescending, and quick-tempered.” One KPMG subordinate on the New Century audit team testified that Kenneally often berated Donovan and Kim. In another e-mail sent by Kim to Donovan, the KPMG senior manager indicated that “Dave [Kenneally] seems to know the answers for everything and anything and the rest of the accounting department is on almost the same boat as the audit team is—little knowledge of what’s going on. This intimidates everyone on the engagement team.”

The tense relationship between the KPMG audit engagement team and New Century’s management, particularly Kenneally, worsened as the 2005 audit neared completion. Two individuals with KPMG’s FDR (Financial Derivatives Resource) Group were brought in to review New Century’s accounting for certain hedges and other financial derivatives during the final phase of the audit. They requested various documents from New Century that were needed to complete their review of the aforementioned items. When New Century failed to provide that documentation, the two specialists refused to “sign off” on the company’s relevant accounting decisions. This refusal prevented Donovan from releasing the opinion on New Century’s financial statements that were to be included in the company’s 2005 Form 10-K.

Hours before the SEC filing deadline for New Century’s 2005 10-K, an angry Donovan e-mailed one of the FDR specialists. “I am very disappointed we are still discussing this. As far as I am concerned, we are done. The client thinks we are done. All we are going to do is p___ everybody off.” Later that same day, a high-ranking KPMG partner in the firm’s New York headquarters office told Donovan to release the unqualified opinion on New Century’s 2005 financial statements. Donovan was instructed to release the opinion even though the two FDR specialists had not approved the company’s accounting decisions for its financial derivatives.¹¹

The following day, New Century’s audit committee called a meeting with Donovan and Kim. In that meeting, members of the audit committee reportedly “yelled” and “screamed” at the two KPMG auditors. Later, Kenneally told the New Century bankruptcy examiner that he had been “furious” over the “near-disaster”—that is, the fact that New Century’s filing of its 2005 10-K with the SEC had almost been delayed. Because of the incident, New Century’s audit committee deferred the decision of whether to reappoint KPMG as the company’s auditor for the 2006 fiscal year.

11. The FDR specialists were allowed to dissociate themselves from the decision to issue the audit opinion on New Century’s 2005 financial statements in a “disagreement memorandum” included in the 2005 workpapers. The following month, New Century finally provided the documentation that had been requested by those specialists. A review of that documentation revealed that New Century had improperly accounted for certain of its derivatives, resulting in “a misstatement of several million dollars.” However, KPMG ruled that those errors were immaterial, meaning that it was not necessary to restate the 2005 financial statements.

Donovan later testified that he had been concerned that the audit committee would dismiss KPMG.

Over the following two months, Donovan assured New Century's audit committee that "a situation like this will never happen again." After receiving that assurance, the audit committee reappointed KPMG as New Century's audit firm.

The bankruptcy examiner speculated that the 2005 10-K incident impaired KPMG's independence during the remainder of the firm's tenure with New Century. "In particular, it is possible that Donovan and Kim were not as skeptical as they might otherwise have been with regard to critical assumptions [underlying New Century's accounting decisions]." The examiner went on to suggest that "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."

In a subsequent interview with *The New York Times*, the bankruptcy examiner further questioned KPMG's independence when he maintained that the New Century auditors had been eager to please the company's management team. "They acquiesced overly to the client, which in the post-Enron era seems mind-boggling."¹² In another interview with the Reuters news agency, the examiner expressed a similar point of view. "In the post-Enron era, one of the lessons should have been that accountants need to be skeptical, strong, and independent. You didn't have any of those attributes here."¹³

Inadequate Consideration of 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.¹⁴ In both 2004 and 2005, KPMG concluded that New Century maintained effective internal control over its financial reporting function.

During the 2004 internal control audit, the KPMG auditors identified five "significant deficiencies" in internal controls that they reported to New Century's audit committee. Since the KPMG auditors concluded that those deficiencies did not qualify as "material weaknesses," the audit firm was able to issue an unqualified opinion on New Century's internal controls for 2004. No significant deficiencies or material weaknesses in internal controls were identified by KPMG during the 2005 internal control audit.

New Century's bankruptcy examiner challenged KPMG's conclusion that the company's internal controls over financial reporting were effective during 2004 and 2005. The examiner pointed out that throughout its existence New Century did not have an "effective mechanism for tracking, processing and handling [loan] repurchase claims." This internal control weakness prevented the company from determining the magnitude of loan repurchase requests at any point in time, which, in turn, prevented the company from properly considering those requests in arriving at the period-ending balances of the loan repurchase loss reserve.

12. Bajaj, "Report Assails Auditor."

13. A. Beck, "KPMG Allowed Fraud at New Century, Report Says," *Reuters.com*, 27 March 2008.

14. KPMG's 2004 and 2005 audits of New Century were completed while PCAOB *Auditing Standard No. 2*, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements" was in effect. That standard has subsequently been replaced by PCAOB *Auditing Standard No. 5*, "An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements." The two standards are very similar.

A related internal control weakness was New Century's failure to adopt "formal policies and procedures" for calculating the loan repurchase loss reserve at the end of each accounting period. The lower-level accountants who were assigned the task of computing the reserve balance each reporting period testified that they simply followed the instructions passed down to them by the individual who had previously been responsible for the reserve computation.

During both the 2004 and 2005 audits, the KPMG auditors discovered the internal control weaknesses related to New Century's loan repurchase loss reserve. The bankruptcy examiner noted that those control weaknesses had particularly critical implications for New Century in 2005 when the volume of loan repurchase requests was increasing rapidly. Despite those implications, KPMG characterized those weaknesses as "inconsequential" during the 2005 audit. Since the internal control problems were not deemed significant deficiencies or material weaknesses, KPMG did not communicate them to New Century's audit committee.

The bankruptcy examiner insisted that for at least the 2005 audit, the inadequate accounting procedures for loan repurchase requests qualified as a material weakness in internal control that should have caused KPMG to issue an adverse opinion on New Century's internal controls. In fact, New Century's management reached a similar conclusion in early 2007.

The material weaknesses identified [by New Century's management in early 2007] were: (1) the failure to maintain effective controls over the interpretation and application of the accounting literature relating to the Company's critical accounting policies (specifically as to the calculation of repurchase reserves); and (2) the failure to maintain effective controls to provide reasonable assurances that the Company collected, analyzed, and used information relating to outstanding purchase claims when establishing the allowance for repurchase losses.

Debbie Biddle was the KPMG audit senior principally responsible for the 2005 internal control audit. Similar to John Donovan and Mark Kim, Biddle had joined KPMG's Los Angeles office shortly before the 2005 New Century audit began. Biddle had transferred to the Los Angeles office from a KPMG affiliate in the United Kingdom. Prior to being assigned responsibility for the 2005 New Century internal control audit, Biddle had "virtually no experience auditing U.S. clients and no prior SOX experience."

The bankruptcy examiner reported that Biddle and her colleagues failed to thoroughly review the 2004 audit workpapers for New Century. As a result, they may have been unaware of the internal control problems discovered by KPMG auditors the prior year and thus failed to properly consider those problems in planning and carrying out the 2005 audit.

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.

Failure to Properly Audit New Century's Loan Repurchase Loss Reserve

In early 2005, the quality of New Century's loan portfolio, as measured by such objective criteria as delinquency and default rates, began declining rapidly. Internal data collected by New Century revealed that the delinquency rate on loans originated

during 2005 was approximately double that of loans originated during the previous year. The delinquency rate continued to rise throughout 2006 as conditions within the housing market deteriorated.

The increasing delinquency and default rates on loans originated by New Century caused a large increase in the number of loan repurchase claims filed by investors that had purchased large blocks of those loans. Because of the inadequate accounting procedures and internal controls for loan repurchase claims, New Century's accounting staff failed to record the needed increases in the loan repurchase loss reserve throughout 2005 and beyond. For example, despite the large increase in loan repurchase requests in 2005, New Century's loan repurchase loss reserve actually declined from the end of 2004 to the end of 2005.

New Century's bankruptcy examiner estimated that the understatement of the loan repurchase loss reserve and errors in related accounts inflated New Century's reported pre-tax earnings for fiscal 2005 by 14.3 percent or approximately \$64 million. The examiner determined that errors in those same accounts overstated New Century's reported pre-tax earnings for the first three quarters of 2006 by approximately \$200 million or 59 percent.

New Century's accountants used a 90-day "look-back" period in determining the adequacy of the loan repurchase loss reserve each financial reporting period. That is, only repurchase requests for loans sold in the 90 days immediately preceding the balance sheet date were considered in arriving at the reserve balance. In fact, the company often received repurchase requests for loans sold more than three months earlier.

The bankruptcy examiner criticized KPMG for not insisting that New Century use a longer than 90-day "window" in computing the loan repurchase loss reserve. However, a KPMG workpaper suggested that policy was reasonable. "Based on the review of the Company's repurchase log and discussions with management, it appears reasonable that the most recent 3 months sales are at risk for repurchase." The bankruptcy examiner contested the assertion that KPMG had reviewed the log of loan repurchase requests since that accounting record indicated that loans were being reacquired by New Century as long as three years after the date they were sold. The examiner also uncovered evidence suggesting that a New Century executive had informed a KPMG auditor that a significant number of loans older than 90 days were being repurchased by the company.

KPMG's audit workpapers documented the ominous increase in loan repurchase requests received by New Century beginning in late 2004. In 2005, New Century repurchased \$332 million of loans, compared with \$135 million the prior year. Despite this large increase, the bankruptcy examiner reported that KPMG "failed to perform any increased procedures or testing of New Century's repurchase reserves" during the 2005 audit.

A secondary factor that contributed to the understatement of New Century's loan repurchase loss reserve was the company's failure to consider an "interest recapture" element in computing that reserve each reporting period. The bankruptcy examiner found this obvious oversight by the company's accountants "perplexing."

The failure to include Interest Recapture in the repurchase reserve calculation from the outset is perplexing because the Examiner understands that it was a long time requirement under loan repurchase agreements for New Century to pay investors the amount of interest that the borrower had failed to pay.

In fact, the workpaper memorandum that summarized the audit tests KPMG applied during the 2005 audit to the loan repurchase loss reserve indicated that interest recapture was a component of the reserve.

A KPMG workpaper from January 2006 notes that estimated losses on future repurchases “include accrued interest the investor [loan purchaser] would have collected from the borrower, if the loan had performed, that New Century must pay to the investor at the time of repurchase.”

The evidence that KPMG relied on to reach that erroneous conclusion was a statement made by David Kenneally. The bankruptcy examiner criticized the KPMG auditors for not corroborating Kenneally’s assertion with other audit evidence. “If KPMG had performed adequate tests and calculations, it would have determined that Interest Recapture was omitted from the repurchase reserve calculation.”

During early 2006, New Century changed the method used to compute the period-ending balance of the loan repurchase loss reserve.¹⁵ This change resulted in large increases in the understatements of that account at the end of each subsequent quarterly reporting period—by the third quarter the reserve was understated by approximately 1000 percent.

Kenneally testified that the change in accounting for the reserve account was recommended by Mark Kim, the KPMG senior audit manager. Kim would later testify that he did not explicitly remember making that recommendation. Nevertheless, evidence collected by the bankruptcy examiner caused him to conclude that a KPMG auditor “almost certainly” recommended the change in accounting for the reserve account.

At a time when KPMG was aware, as evidenced by its own workpapers, that market conditions were worsening and repurchases were increasing, KPMG made a recommendation to New Century to remove a component of the repurchase reserve that had the effect of decreasing the reserve . . . and then failed to inform the Audit Committee of the change in this critical accounting policy.

In November 2006, New Century hired a new chief financial officer (CFO) who had 30 years of prior experience in the mortgage industry. The CFO immediately questioned the adequacy of the company’s loan repurchase loss reserve and asked KPMG to provide him with a written statement that the reserve was properly stated. KPMG refused to provide that written assurance.

As a result of the new CFO’s persistent inquiries, New Century’s accounting staff eventually recognized that the accounting change made in early 2006 for the loan repurchase loss reserve had been improper and had materially understated the reserve for each of the first three quarterly reporting periods of 2006. That realization led to the February 7, 2007, 8-K filing in which New Century reported those understatements. That 8-K disclosure triggered the series of events that resulted in New Century filing for bankruptcy less than two months later.

In Defense of KPMG

Representatives of KPMG responded forcefully to the allegations against their firm in the report prepared by New Century’s bankruptcy examiner. Particularly galling to the large accounting firm was the suggestion that KPMG auditors had “deferred

15. The change in the method of computing the loss reserve involved deleting the “inventory severity” component of that reserve. That component involved those losses expected to be incurred by New Century on loans that had already been reacquired as of the given balance sheet date. Kim allegedly suggested dropping this component because he believed that it was considered by New Century in arriving at the balance of a related valuation account for the company’s portfolio of outstanding loans. In fact, that was not the case.

excessively”¹⁶ to client executives during the course of the New Century engagements. In response to that allegation, a KPMG spokesperson told a reporter with *The New York Times*, “[t]here is absolutely no evidence to support that contention.”¹⁷ In a subsequent interview with the *Times*, that same individual suggested that the bankruptcy examiner’s report was unfair and “one-sided.”

*The examiner was appointed by the court to identify potential lawsuits in a bankruptcy case. Consistent with that charge, he has prepared an advocacy piece, which has many one-sided statements and significant omissions. In the end, the examiner concluded that the bankruptcy estate may be able to file a lawsuit against KPMG for negligence—a claim we strongly dispute—and a claim even the examiner notes in his report for which KPMG has strong defenses.*¹⁸

Several other parties also came to KPMG’s defense. An accounting professor at the University of Chicago maintained that KPMG was not at fault in the New Century case and instead attributed the company’s bankruptcy to its high-risk business model. “The business model of New Century depended on real estate values that would continue to go up and certainly not go down. The economic model here is what is at fault. It’s the cause of what happened, not anything that KPMG did.”¹⁹

At a minimum, the New Century bankruptcy report served to sustain a string of embarrassing public relations incidents for KPMG. In 2005, KPMG had faced potential criminal charges for a series of questionable tax shelters that it had marketed to well-heeled tax clients. In that same year, KPMG had agreed to pay the SEC \$22.5 million to settle charges that audits of one of its largest clients, Xerox, had been flawed. Subsequent to that announcement, KPMG paid \$80 million to settle civil litigation stemming from its Xerox audits.

Even before the New Century bankruptcy report was released, KPMG had been linked to the ongoing crises and scandals in the mortgage industry. Charges of large-scale earnings manipulation by Fannie Mae called into the question the quality of KPMG’s audits of that organization, which for decades had played such a large role in the mortgage industry. Finally, in early January 2008, KPMG had been named a co-defendant in a large class-action lawsuit that charged Countrywide, another KPMG audit client, with perpetrating an accounting fraud.

EPILOGUE

In August 2008, Ed McMahon revealed that he had finally found a buyer for his Beverly Hills mansion that would allow him to pay off his large mortgage.²⁰ Most individuals snared by the financial crisis that overwhelmed the mortgage industry and housing market in the

United States did not share McMahon’s good fortune. By the end of 2008, more than 1.5 million Americans would face foreclosure proceedings on their homes, easily the largest number of residential foreclosures in U.S. history.

16. Bajaj, “Report Assails Auditor.”

17. *Ibid.*

18. Bajaj and Creswell, “A Lender Failed.”

19. *Ibid.*

20. Unfortunately, Mr. McMahon passed away in June 2009.

In an effort to thwart the nationwide financial panic caused by the meltdowns in the mortgage and housing industries, the U.S. Congress passed a massive bailout plan in October 2008. The price tag for that rescue effort, intended to shore up the nation's crumbling financial

infrastructure, was measured in hundreds of billions of dollars. Even if the rescue effort proved successful, most experts expected that the U.S. economy, as well as the global economy, would suffer adverse lingering effects for years, if not decades, to come.

Questions

1. 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.
2. 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?
3. 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?
4. 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"?
5. 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.
6. 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?
7. Identify what you consider to be the three most important "take-aways" or learning points in this case. Rank these items in order of importance (highest to lowest). Justify or defend each of your choices.