



October 17, 2014

Michael P. Stephens
Acting Inspector General
Office of Inspector General (IG)
Federal Housing Finance Agency
400 7th Street, S.W.
Washington DC 20024

RE: *Systemic Implication Report: TBW-Colonial Investigation Lessons Learned*
SIR No.: SIR-2014-0013
OIG Case No: I-11-0010

Dear Mr. Stephens:

The Mortgage Bankers Association (MBA)¹ read with interest your report and letter dated August 21, 2014, to Melvin L. Watt, Director of the Federal Housing Finance Agency (FHFA) titled *Systemic Implication Report: TBW-Colonial Investigation Lessons Learned* (IG Report). The first two of the seven recommendations in the report call on FHFA to issue guidance limiting the number of years that an independent public accountant (IPA) may audit a seller/servicer counterparty after which the IPA must be replaced. MBA and its members strongly disagree with this recommendation. It would not promote auditor independence and in fact may harm audit quality. The following letter provides background information and the reasons that we believe such recommendations are not prudent.

Background

The IG Report is the result of a study of the multifaceted and multiyear fraud scheme perpetrated by certain officers and employees of Taylor, Bean & Whitaker Mortgage Corporation (TBW) and Colonial Bank (Colonial) that resulted in over \$1 billion in loss claims by various parties, including Freddie Mac.

The paper cites the five stages of the fraud, Colonial's collusion in each of those five stages, and the red flags that various parties missed. It then makes recommendations to FHFA to prevent recurrence.

¹ The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

No Case Is Made by the Inspector General That the IPA Failed

The IG Report found that many different parties were at fault for the lack of timely detection and correction of the fraud:

- Page 3 of the IG Report noted that Colonial changed charters and regulators three times in ten years. It appears that Colonial's directors and officers and bank regulators missed this red flag.
- Page 7 of the IG Report states that Fannie Mae terminated TBW as a seller in January 2000 because they discovered that TBW had double pledged or double sold certain loans. They did not formally advise their regulator or Freddie Mac. This red flag, if appropriately communicated and acted upon, could have ended the fraud in its earlier phases.
- Page 8 discusses many red flags that Freddie Mac was aware of and failed to act upon.

MBA notes that the IG Report does not cite specific instances where the IPA failed in its audit of TBW or where Colonial's IPA failed in its audit of Colonial. It implies that TBW's auditor lacked independence due to its length of tenure, but does not discuss why it came to that conclusion. We are, therefore, at a loss as to why the IG Report has as its primary recommendation the need for all seller/servicer counterparties to periodically rotate their respective outside auditors. Although there may be facts we are unaware of, the IG Report itself does not show a clear causal relationship between the two.

Audits of Financial Statements Are Not Designed to Detect Fraud When Collusion With a Major Outside Third Party Exists

Prior to 2002, the role of IPAs did not include the detection of financial fraud. However, effective for audits of financial statements beginning on or after December 15, 2002, the AICPA promulgated Statement of Auditing Standards No. 99 (SAS 99) which states, "The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."²

Paragraph .10 of SAS 90 talks about one of the factors that may result in successful concealment of a fraud from the IPA. It states³:

Fraud also may be concealed through collusion among management, employees, or third parties. Collusion may cause the auditor who has properly performed the audit to conclude that evidence provided is persuasive when it is, in fact, false. For example, through collusion, false evidence that controls have been operating effectively may be presented to the auditor, or consistent misleading explanations may be given to the auditor by more than one individual within the entity to explain an unexpected result of an analytical procedure. As another example, the auditor may receive a false confirmation from a third party that is in collusion with management.

² AICPA, *Consideration of Fraud in a Financial Statement Audit*, as found in AU Section 312.02, page 1719.

³ IBID, AICPA, page 1723.

The British equivalent of SAS 99 provides further insight into fraud that is covered up by collusion⁴:

... fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved.

Colonial was in collusion with TBW in each of the five phases of the fraud. It should be noted – although the IG Report did not -- that the TBW fraud was discovered by a Deloitte audit in 2009.⁵ It is doubtful that auditor rotation would have resulted in uncovering the fraud any sooner given the extent of collusion between TBW and Colonial and the level of involvement by senior management. In fact, studies indicate that a new audit firm lacking familiarity with TBW might have had less of a chance of uncovering fraud.⁶

Prior Studies Advise Against Rotation of Auditors

Over the past 40 years, there have been numerous “blue chip” studies on the pros and cons of outside auditor rotation conducted by experts in the field of auditing. None resulted in a recommendation for auditor rotation. The following summarizes those studies and conclusions.

- In the 1970's the American Institute of Certified Public Accountant's (AICPA) Cohen Commission was chartered to perform a review of the role of the independent auditor and whether a gap may exist between what the public expects and what the auditor could reasonably be expected to deliver. On auditor rotation, the Cohen Commission stated that “rotation would considerably increase the costs of audits because of the frequent duplication of the start-up and learning time necessary to gain familiarity with a company and its operations that is necessary for an effective audit.”⁷
- The Cohen Commission went on to say, “the study of cases of substandard performance by auditors, several of the problem cases were first- or second-year audits.” “...while not conclusive, this indicates the higher peril associated with new audit clients.”⁸

⁴ International Standards on Auditing (UK and Ireland) 240, *The Auditor's Responsibilities Relating to Fraud In An Audit Of Financial Statements*, page 4.

⁵ Chris DiMarco, Inside Counsel, Deloitte Settles Taylor Bean Auditing Lawsuits, October 4, 2013.

⁶ See, e.g., Audit Analytics study, *A Restatement Analysis of the Russell 1000 Companies: The extent to which the "fresh eyes" of a newly engaged auditor provided assistance in the discovery of a misstatement*, February 2012.

⁷ Cohen Commission, *The Commission on Auditors' Responsibilities, Report, Conclusions and Recommendations*, 1978.

⁸ Ibid, Cohen Commission Report.

- The SEC in 1994 was requested by Congress to study auditor independence. The resulting report stated, “that the profession’s requirement for periodic change in the engagement partner in charge of the audit, especially when coupled with the profession’s requirement for second partner reviews, provides a sufficient opportunity for bringing a fresh viewpoint to the audit without creating the significant costs and risks associated with changing accounting firms that were identified by the Cohen Commission.”⁹
- In 2002, Congress directed the GAO to conduct a study and prepare a report on mandatory audit firm rotation. The GAO concluded that “mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality...”¹⁰ The GAO’s report also stated, “According to the GAO survey, 79% of larger audit firms and Fortune 1000 companies that responded believed that changing audit firms increases the risk of an audit failure in the early years of the audit, and most believed that mandatory firm rotation ‘would not have much effect on the pressures faced by the audit engagement partner’”¹¹
- In 2011, the Public Accounting Oversight Board (PCAOB) released its request for comment No. 2011-006 titled *Concept Release on Auditor Independence and Audit Firm Rotation*. Over 600 responses were received, including responses from audit committees, investors, academics, non-US regulators, and other stakeholders. Over 90 percent of the responses opposed mandatory firm rotations. After several years of study, in 2014 the PCAOB publicly stated that it was no longer considering mandatory firm rotation, and instead would pursue other means of promoting auditor independence and skepticism.¹²

The lessons learned from these studies:

- Auditor rotation can be very costly and disruptive for companies of all sizes. While these costs could perhaps be justified if rotation resulted in higher audit quality or greater auditor independence, such a result has not been proven.
- Auditor rotation increases the risk of audit failure during the early years of the audit.

Based on these studies, which focused specifically on the risks and benefits of auditor rotation, MBA urges the Inspector General to re-evaluate the recommendations in the Report.

Longer Auditor Tenure May Enhance Audit Quality

Rather than decrease independence, studies suggest that longer auditor tenure may enhance audit quality due the auditor’s familiarity with the company.¹³ This is particularly true in highly

⁹ SEC, Office of the Chief Accountant, *Staff Report on Auditor Independence*, 1994.

¹⁰ U.S. General Accounting Office, *Required Study on the Potential Effects of Audit Firm Rotation*, 2003.

¹¹ U.S. General Accounting Office, *Required Study on the Potential Effects of Mandatory Audit Rotation*, 2003.

¹² Vincent Ryan, *PCAOB Abandons Auditor Rotation*, CFO.com, February 6, 2014.

¹³ M. Cameran, A. Prencipe and M. Trombetta, *Auditor Tenure and Auditor Change: Does Mandatory Auditor Rotation Really Improve Audit Quality?*, Working Paper Bocconi University and IE Business School, 2010; Soo Young Kwon, Youngdeok Lim and Roger Simnett, *Mandatory Audit Firm Rotation and Audit Quality: Evidence from the Korean Audit Market*, 19 November 2010.

complex industries such as mortgage banking. Over time, auditors gain significant knowledge about a company as well as an awareness of its risks.

While the IG's report acknowledged that both overly short or long auditor tenure may be indicative of a problem, it also suggested that Deloitte's 6-year audit engagement at TBW may be too long. This is a counterintuitive conclusion, given that Deloitte withdrew as auditor due to its discovery of the fraud at TBW in its sixth year as auditor, thereby bringing the fraud to light. Rather than demonstrating that Deloitte was TBW's auditor for too long, it is equally likely that this supports the conclusion that it may only be possible for an auditor to discover a fraud after developing deep knowledge about the company over time.

Audit Committees and Boards of Directors Are Best Positioned to Oversee Auditors

Audit committees are responsible for overseeing the work of the auditor and determining whether the current auditor is meeting the needs of shareholders and the company. Through their interactions with the auditor and management, they are able to determine whether the auditor is carrying out its work with an independent and skeptical mindset. This proximity to the work of auditors allows audit committees to take into consideration a wide range of factors when deciding whether to retain or hire a new auditor, including expertise, independence, professional skepticism and transparency. Imposing an arbitrary limit on the length of an auditor's engagement undermines this important role, to the detriment of the overall governance of the company.

The Auditing Profession Has Controls and Processes in Place to Ensure Independence and Healthy Auditor Skepticism

Auditor independence and professional skepticism are of critical importance to the conduct of audits, and various mechanisms are already in place to help ensure that auditors exercise these characteristics when carrying out an audit. For example, accounting firms generally require a second partner review, and those reviews focus especially on areas of highest concern and risk. Firms also require periodic rotation of the lead partner on audit engagement. In addition, many firms conduct periodic QC reviews for a sample of engagements and/or hire a peer accounting firm to conduct an independent review of their policies and practices and a sample of audit workpapers and reports. Many state CPA boards require such peer reviews.

As noted above, the SEC's study in 1994 concluded that audit firm rotation is not necessary because of the existence of these industry controls, which have been furthered strengthened since then.

If the client is a publicly held corporation, the SEC and the PCAOB require rotation of the lead partner but not the auditing firm. The PCAOB monitors auditor independence of all firms that audit publicly owned clients. Large firms are reviewed annually, smaller firms are reviewed at least every three years.

Requiring Auditor Rotation Would Impose Significant Costs and No Benefits

The costs of changing auditors are quite significant. For example, for large banks with worldwide operations, millions of shareholders, and thousands of counterparties a forced change of its external auditor could cost of tens of millions of dollars. In the case of a community bank or a small, independent mortgage bank, auditor rotation could cost tens of

thousands of dollars. As discussed above, it has not been proven that these costs would be offset by an improvement in audit quality or auditor independence. Moreover, for small lenders the current outside auditor may be the only CPA in that region with the specialized knowledge of mortgage banking industry accounting. Forcing a change to an auditor with no such expertise would lower audit quality. At times, a change in auditor may be in the best interests of shareholders and companies. However, this decision should be made by audit committees and boards of directors.

Mortgage Bank Accounting and Auditing Is Highly Complex Requiring IPA Expertise

Mortgage bank accounting is complex and requires specialized knowledge. The Financial Accounting Standards Board has issued numerous pronouncements related to industry accounting including but not limited to the following subjects:

- Accounting for loans held for sale
- Fair value option for loans
- Recognition of mortgage servicing rights (MSRs)
- Fair value option for MSRs
- Sale recognition criteria for sales of MSRs
- Hedge accounting for loans held for sale and MSRs carried at amortized cost
- Deferred costs and revenues on loans originated
- Troubled debt restructuring and accounting for loan modifications
- In substance foreclosure
- Classification and measurement of loans and mortgage-backed securities
- Sale recognition for sales or securitizations of loans
- Consolidation of loan securitizations where the party is deemed to be the primary beneficiary of a securitization trust
- Interest income recognition
- Credit impairment of mortgages and mortgage-backed securities
- Accounting for FHA foreclosures: receivable or real estate owned
- Accounting for dollar rolls of TBA transactions
- Fair value hierarchy

Further, an auditor for a mortgage company may be required to issue numerous special reports for the benefit of Fannie Mae, Freddie Mac, Ginnie Mae, HUD and investors in private-label MBS. These include, but are not limited to, HUD adjusted net worth, USAP, and Reg AB reports.

MBA believes that the complexity of the above pronouncements and reporting requirements makes rotation of auditors even riskier for small mortgage companies and community banks involved in mortgage banking than for other industries.

Firms Available May Be Limited

For the largest seller/servicers, the choices of accounting firms may be limited to the Big 4 firms who have worldwide operations. However, audit standards limit the types of services that a CPA firm can perform and still maintain its independence. So, if a large bank engages one firm

to outsource certain internal audit work and another firm performs certain consulting services, that only leaves one of the Big 4 for rotation.

Likewise, small independent mortgage companies may have a limited choice of CPA firms in their area, or they may engage a small firm that specializes in auditing mortgage companies. Auditor rotation in this environment is difficult and risky.

MBA strongly recommends that the Inspector General reconsider its recommendation to FHFA for Fannie Mae and Freddie Mac's seller/servicer counterparties to rotate auditors. Such rotation will be costly to seller/servicers and would likely increase the risk of outside audit failure in the first few years after auditor rotation. We look forward to discussing the contents of the letter and our recommendation further. Please feel free to contact Jim Gross at 202-557-2860 or jgross@mba.org.

Sincerely,

A handwritten signature in black ink, appearing to read "Pete Mills". The signature is written in a cursive, flowing style.

Pete Mills
Senior Vice President of Residential Policy
and Member Engagement

cc: The Honorable Mel Watt, Director of FHFA