

## **Case 2-10**

### **Imperial Valley Thrift & Loan – Part I\***

Bill Stanley, of Jacobs, Stanley & Co., started to review the working paper files on his client, Imperial Valley Thrift & Loan, in preparation for the audit of the client's financial statements for the year ended December 31, 2010. The bank was owned by a parent company, Nuevo Financial Group, and it serviced a small western Arizona community by Yuma that reached south to the border of Mexico. The bank's preaudit statements are presented in Exhibit 1.

Bill Stanley knew there were going to be some problems to contend with during the course of the audit, so he decided to review several items in the file in order to refresh his memory about the client's operations.

#### **BACKGROUND**

The first item Stanley reviewed was the planning memo he had prepared about two months ago. This memo is summarized in Exhibit 2.

The next item Stanley reviewed was an internal office communication on potential audit risks. This communication described three areas of particular concern.

1. The client charged off \$420,000 in loans in 2009 and had already charged off \$535,000 through July 31, 2010. Assume reserve requirements by law are a minimum of 1.25% of loans outstanding.

**\* Part II of the case appears in Chapter 5.**

However, given prior history, this statutory amount probably would not be large enough for the loan loss reserve. This, in combination with the prior auditors' concerns about proper loan underwriting procedures and documentation, indicates that we should carefully review loan quality.

2. The audit report issued on the 2009 financial statements contained an explanatory paragraph describing the uncertainty about the client's ability to continue as a going concern. The concern was caused by the "capital impairment" declaration by the Arizona Department of Corporations.
3. The client had weak internal controls according to the prior auditors. Some of the items to look out for, in addition to proper loan documentation, were whether the preaudit financial statement information provided by the client is supported by the general ledger, whether the accruals were appropriate, and whether all transactions were properly authorized and recorded on a timely basis.

### **Audit Findings**

The audit was conducted during January and February 2011. Based on information gathered during the audit, the following were the areas of greatest concern to Stanley:

1. **Adequacy of Loan Collateral.** A review of 30 loan files representing \$2,100,000 of total loans outstanding (33.3% of the portfolio) indicated that much of the collateral for the loans was in the form of second or third mortgages on real property. This gave the client a potentially unenforceable position due to the existence of very large senior liens. For example, in the event foreclosure became necessary to collect Imperial Valley's loan, the client would have to first pay off

these large senior liens. Other collateral often consisted of personal items such as jewelry and furniture. In the case of jewelry, often there was no effort made by the client after granting the loan to ascertain whether the collateral was still in the possession of the borrower. The jewelry could have been sold without the client's knowledge.

2. **Collectibility of Loans.** Many loans were structured in such a way as to require interest payments only for a small number of years (two or three years), with a balloon payment for principal due at the end of this time. This structure made it difficult to properly evaluate the payment history of the borrower. Although the annual interest payments may have been made for the first year or two, this was not necessarily a good indication that the borrower would come up with the cash needed to make the large final payment, and the financial statements provided no additional disclosures about this matter.
3. **Weakness in Internal Controls.** Internal-control weaknesses were a pervasive concern. The auditors recomputed certain accruals and unearned discounts, confirmed loan and deposit balances, and reconciled the preaudit financial information provided by the client to the general ledger. Some adjustments had to be made as a result of this work. A material weakness in the lending function was identified. Loans were too frequently granted merely because the borrowers were well known to Imperial Valley officials who believed they could be counted on to repay their outstanding loans. An ability to repay these loans was based too often on "faith" rather than on clear indications that the borrowers would have the necessary cash available to repay their loans when they came due. This was of

great concern to the auditors, especially in light of the inadequacy of the loan reserve, as detailed in item 5, below.

4. **Status of Additional Capital Infusion.** We are working under the assumption that under Arizona regulatory requirements, a thrift and loan institution must maintain a 6:1 ratio of thrift certificates to net equity capital. Based on the financial information provided by Imperial Valley, the capital deficiency was only \$32,000 below capital requirements (preaudit), as follows:

Thrift certificates ratio	<u>\$7,392,000</u>
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Net equity capital required	\$1,232,000
Net equity capital reported	\$1,200,000
Deficiency	\$ 32,000

However, audit adjustments explained in Exhibit 3 increased the capital deficiency to \$622,000, as follows:

Net equity capital required	\$1,232,000
Net equity capital (postaudit)	\$ 610,000
Deficiency	\$ 622,000

There was a possibility that the parent company, Nuevo Financial Group, would contribute the additional equity capital. Also, management had been in contact with a potential outside investor about the possibility of investing \$600,000. This investor, Manny Gonzalez, has strong ties to in the Imperial Valley community and to the family ownership of Imperial Valley.

5. **Adequacy of General Reserve Requirement.** The general reserve requirement of 1.25% had not been met. Based on the client's reported outstanding loan balance of \$6,300,000, a reserve of \$78,750 would be necessary. However, audit adjustments for the charge-off of uncollectible loan amounts significantly affected the amount actually required. Additionally, the auditors felt that a larger

percentage would be necessary because of the client's history of problems with loan collections; initially, a 5 percent rate was proposed. Management felt this was much too high, arguing that the company had improved its lending procedures in the last few months and that it expected to have a smaller percentage of charge-offs in the future. A current delinquent report received in February 2011 showed only two loans from 2010 still on the past due list. The auditors agreed to a 2 percent reserve, and an adjusting entry (AJE #3) shown in Exhibit 3 was made.

## **REGULATORY ENVIRONMENT**

Imperial Valley Thrift & Loan was approaching certain regulatory filing deadlines during the course of the audit. Stanley had a meeting with the regulators at which representatives of management were present. Gonzalez also attended the meeting, since he had expressed some interest in possibly making a capital contribution. There was a lot of discussion about the ability of Imperial Valley to keep its doors open if the loan losses were recorded as proposed by the auditors. This was a concern because the proposed adjustments would place the client in a position of having net equity capital significantly below minimum requirements.

The regulators were concerned about the adequacy of the 2% general reserve because of the prior collection problems experienced by Imperial Valley. The institution's solvency was a primary concern. At the time of the meeting, the regulators were quite busy trying to straighten out problems caused by the failure of two other savings and loan institutions in Arizona. Many depositors had lost money as a result of the failure of these S&Ls. The regulators were concerned that a domino effect might occur as had happened in the early 1990s, and Imperial Valley would get caught up in the

mess. Also, the regulators were unable to make a thorough audit of the company on their own, so they relied quite heavily on the work of Jacobs, Stanley & Co. In this sense, the audit was used as leverage on the institution to get more money in as a cushion to protect depositors. The regulators viewed this as essential in light of the other S&L failures and the fact that the insurance protection mechanism for thrift and loan depositors was less substantial than depository insurance available through FDIC in commercial banks and in savings and loan institutions.

### **SUMMARY OF CLIENT POSITION**

The management of Imperial Valley Thrift & Loan placed a great deal of pressure on the auditors to reduce the amount of the loan write-offs. It maintained that the customers were “good for the money.” Managers pointed out the payments to date on most of the loans had been made on a timely basis. The client felt that the auditors did not fully understand the nature of its business. Managers contend that a certain amount of risk had to be accepted in their business because they primarily made loans that commercial banks and savings and loan institutions did not want to make. “We are the bank of last resort for many of our customers,” commented bank president Eddie Salazar. Salazar then commented that the auditors’ inability to understand and appreciate this element of the thrift and loan business was the main reason the auditors were having trouble evaluating collectibility on the outstanding loans.

EXHIBIT 1  
Imperial Valley Thrift & Loan  
Balance Sheet (preaudit)  
December 31, 2010

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Assets

Cash and cash equivalents .....	\$1,960,000
Loans receivable.....	6,300,000
Less: Reserve for loan losses .....	(25,000)
Unearned discounts & fees .....	(395,000)
Accrued interest receivable.....	105,000
Prepayments.....	12,000
Real property held for sale.....	514,000
Property, plant, & equipment.....	390,000
Less: Accumulated depreciation.....	(110,000)
Contribution to Thrift Guaranty Corp.....	15,000
Deferred start-up costs.....	<u>44,000</u>
Total assets.....	<u>\$8,810,000</u>

Liabilities & Equity

**Liabilities**

Regular & money market savings .....	\$2,212,000
T-bills & CDs .....	5,180,000
Accrued interest payable .....	190,000
Accounts payable & accruals .....	<u>28,000</u>
Total liabilities .....	<u>\$7,610,000</u>

**Equity**

Capital stock.....	\$ 700,000
Additional paid-in capital .....	1,120,000
Retained earnings (deficit) .....	(620,000)
Total equity .....	<u>\$1,200,000</u>
Total liabilities and equity .....	<u>\$8,810,000</u>

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Imperial Valley Thrift & Loan  
Statement of Operations (preaudit)  
For the Year Ended December 31, 2010

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**Revenues**

Interest earned .....	\$ 820,000
Discount earned .....	210,000
Investment income .....	82,000
Fees, charges, & commissions .....	<u>78,000</u>
Total revenues .....	<u>\$1,190,000</u>

**Expenses**

Interest expense .....	\$ 815,000
Provision for loan losses .....	180,000
Salary expense .....	205,000
Occupancy expense including depreciation .....	100,000
Other administrative expense .....	160,000
Legal expense .....	12,000
Thrift Guaranty Corp. payment .....	<u>48,000</u>
Total expenses .....	<u>\$1,520,000</u>
Net loss for the year .....	<u>\$ 330,000</u>



EXHIBIT 2  
Planning Memo

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1. The firm of Jacobs, Stanley & Co. succeeded the firm of Nelson, Thomas & Co. as auditors for Imperial Valley Thrift & Loan. The prior auditors conducted the 2008 and 2009 audits. Jacobs, Stanley & Co. communicated in writing with Nelson, Thomas & Co. prior to acceptance of the engagement. Additionally, authorization was given by the client for a review of the predecessor auditors' working papers. The findings of these inquiries are summarized in item 6 below and the previously discussed internal office communication.
2. Imperial Valley Thrift & Loan was incorporated in Arizona on June 12, 1994. It is a wholly owned subsidiary of Nuevo Financial Group, S.A., a Mexican corporation. As an industrial loan company, it is restricted to certain types of business, including making real estate and consumer loans and certain types of commercial loans.
3. Imperial Valley accepts deposits in the form of interest-bearing passbook accounts and investment certificates. Most of the depositors are of Spanish descent. The client primarily services the Spanish-speaking community in the Imperial Valley of southern Arizona, which is a rural community located on the Mexican border.
4. The principal officers of Imperial Valley are Jose Ortega and his brother Arturo. They serve as the chief executive officer and the chief financial officer, respectively. Two cousins serve as the chief operating officer and chief compliance officer.
5. Imperial Valley is subject to the regulations of the Arizona Industrial Loan Law and is examined by the Department of Corporations. It was last examined in December 2009 and was put on notice as "capital impaired." Additional capital was being sought from local investors.
6. Based on review of the prior auditors' working papers, the following items were noted:
  - a. The client's lack of profitability was due to a high volume of loan losses resulting from poor underwriting procedures and faulty documentation.
  - b. Imperial Valley has a narrow net interest margin due to the fact that all deposits are interest bearing and it pays the highest interest rates in the area.
  - c. Due to the small size of the client and its focus on handling day-to-day operating problems, the internal controls are marginal at best. There were material weaknesses in their loan

underwriting procedures and documentation, as well as in compliance with regulatory requirements.

- d. There are no reports issued by management on the internal controls.

### EXHIBIT 3

#### Audit Adjustments

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AJE #1 –	Reserve for loan losses .....	\$200,000	
	Loans receivable .....		\$200,000
	To write down loans to net realizable value		
AJE #2 -	Reserve for loan losses .....	300,000	
	Unearned discounts & fees .....	80,000	
	Loans receivable .....		380,000
	To write off loans more than 180 days past due in compliance with statutes		
AJE #3 -	Provision for loan losses .....	590,000	
	Reserve for loan losses .....		590,000
	To increase the reserve balance to 2% of outstanding loans as follows:		
	Reserve balance (preaudit) .....		\$(25,000)
Less Adjusting entry			
	#1 .....	\$200,000	
	#2 .....	<u>300,000</u>	
			<u>500,000</u>
Subtotal .....			\$475,000
Add: Desired balance			
	Loan balance (preaudit) .....	\$6,300,000	
	Less: AJE #1 .....	(200,000)	
	#2 .....	<u>(380,000)</u>	

Loan balance (postaudit) .....	\$5,720,000	
Reserve requirement .....	2%	
Desired balance (approx) .....		<u>115,000</u>
Adjustment required .....		\$590,000

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This case focuses on the appropriateness of issuing an unqualified opinion with an explanatory paragraph about the going concern issue, a qualified opinion, an adverse opinion, or a disclaimer of opinion. Instructors may want to review with students the criteria for issuing these types of opinions before discussing the responses to the questions.

### **Ethical Issues**

The inclusion of an explanatory paragraph following the opinion paragraph usually serves to adequately inform the users of the financial statements. However, a disclaimer of opinion is proper if the scope of the audit is not sufficient to enable the auditors to form an opinion about the ability of Imperial Valley to continue as a going concern. A disclaimer of opinion should be accompanied by disclosure of the going concern issue and its possible effects on the financial statements.

An adverse opinion is appropriate if, in the judgment of the accounting firm, the financial statements of Imperial Valley taken as a whole are not presented in conformity with GAAP. This type of opinion does not seem to fit the facts of the case since the audit adjustments are designed to bring the loans receivable account and related reserve balance in conformity with expectations about collectibility, given the scope limitations of the audit. The important point is for the firm to be certain that adequate disclosures exist about the entity's ability to continue as a going concern.

From a rule-utilitarian perspective, Rule 102 of the AICPA Code requires that Stanley should not subordinate his judgment to that of client management. A rights perspective requires consideration of whether any stakeholder rights would be violated by any anticipated actions. Manny Gonzalez, the parent company (Nuevo Financial Group), and the regulators all have a right to rely on the auditor's opinion. The audit firm has a duty to disclose all relevant information to assist in their decision making needs. A justice perspective requires the fair and impartial treatment of all stakeholders with due consideration of their interests. Even though management might pressure the auditors for an unqualified opinion, management's interests should not be placed ahead of other stakeholders. If Manny Gonzalez commits funds based on his reliance on an unqualified opinion, then the audit firm's exposure to a potential lawsuit will increase if conditions deteriorate in the future. Stanley would be reasoning at Stage 4 and 5 levels of Kohlberg when he refers to the profession's rules and standards for guidance, attempts to foresee the likely consequences of alternative actions before making a decision, and showing due consideration for stakeholder interests. Stanley should have the moral courage (virtue) necessary to withstand client pressure and to act in accordance with the public's interest.

### **What Actually Happened**

The accounting firm disclaimed an opinion. After the opinion was issued, the accounting firm was fired and a new firm was hired, which sequentially issued a clean or unqualified opinion. The firm of Jacobs, Stanley & Co. had \$20,000 of unpaid audit fees, which they were unsuccessful in attempts to collect. Manny Gonzalez did provide the needed capital to keep Imperial Valley operating. Gonzalez insisted on managerial changes which were made. These actions satisfied the regulators about the continued existence of the bank. The bank was sold to Comerica Bank in the late 1990s.

## **Questions**

### **1. What is the role of professional skepticism in auditing financial statements?**

**Do you think the auditors were skeptical enough in evaluating the operations of Imperial Valley?**

As discussed in the chapter, characteristics of skepticism are a questioning mind, suspension of judgment, and a search for knowledge. These characteristics include being unlikely to accept information at face value, requiring proof or justification and suspend judgments until making additional inquiries and obtaining evidence.

Based upon the facts presented in the case, the auditors have not been skeptical enough in evaluating the operations of Imperial Valley. The auditors originally proposed a 5 percent loan loss reserve provision. Based upon discussions with management and a current delinquency report in February 2001 showing only two loans from 2010 still on the past due list, the auditors agree to a 2 percent reserve instead of 5 percent. However, this decision seems to be based on management say so and a good current delinquency report. The delinquency report does not address whether the borrowers can come up with the cash needed to make the large final payment, or an indication that the financial statements will provide additional disclosures about the matter. The auditors should also

be concerned about the lack of competent evidential matter concerning the existence of certain collateral, the collectability of loan principal amounts, and resolutions to documented weaknesses in internal control.

- 2. (a) Assume the auditors decide to support management's position and reduce the amount of loan writeoffs. The decision was made in part because of concerns that regulators might force the bank to close its doors and many customers would have no where else to go to borrow money. Evaluate the auditors' stage of moral reasoning in this instance.**

If Stanley gives in to the firm's pressure on the amount of loan writeoffs out of regulatory closing, he is reasoning at Stage 3, Fairness to Others. This may also be using utilitarianism or concern for the greatest good for greatest number.

- (b) Assume instead that the auditors *insist* on a higher level of loan writeoffs and allowance for uncollectibles. Use Rest's model and explain how and why you think the auditors might have reached this conclusion.**

If Stanley were to insist on a higher level of loan writeoffs and allowance for uncollectibles, he would be reasoning at the post conventional level. He would be considering whether it is fair to the current and potential future investors to emphasize the firm's interest and those of Imperial Valley over the interests of the investors and the public good. Using Rest's model, Stanley would be aware or moral sensitive of the ethical dilemma presented by Imperial Valley; use moral judgment to follow regulatory

and generally accepted accounting principles; and exhibit moral courage (motivation and character) to withstand client pressures and act in accordance with the public's interest.

**3. Are there parallels to be drawn between the facts of Imperial Valley Thrift & Loan and problems with subprime loans during the 2008-2009 period?**

**Explain.**

The loans at Imperial Valley were second or third mortgages on real estate. Other collateral often consisted of personal items such as jewelry and furniture, which the thrift did not secure. The loans were structured in such a way as to require interest payments for two or three years with a balloon payment for principal at the end of this time. The payments of interest for a year or two are not a concrete indication that the borrower had the ability to make the balloon payment. Additionally loans were often granted based on the borrower being known to Imperial Valley officials, without evidence of resources to support repayment of the loans.

The subprime loans were made to borrowers concerned subprime as opposed to prime borrowers, who had the ability to make a down payment of twenty percent or more and strong evidence of ability to repay the loan. Subprime borrowers were often first time home buyers. These borrowers did not have the necessary down payment and would have to purchase private mortgage insurance for the difference between the required twenty percent and amount of the actual down payment. There were special categories of loans to these borrowers: NINA, no income, no assets and NINJA, no income, no job or assets. The lenders making loans to the subprime borrowers were motivated by greed and the

being able to effect the bottom line three times in generation of the loans: once with the origination fee, second with the gain from the sale of the loans for securitized bonds, and third with the servicing fee for collecting the payments. Additionally, the borrowers were tempted by low initial interest rates which were increased after two to three years. Many of these borrowers could make the payments while the interest rate was low and then could not make the payments when the rate was adjusted drastically upward.

The loans at the Imperial Valley and to subprime borrowers both allowed artificial low (interest) payments for the first two years without evidence that the borrowers could repay the larger payments or principal.