1974

Accounting practices in the mortgage banking industry, December 30, 1974; Statement of position 74-12;

American Institute of Certified Public Accountants. Accounting Standards Division

Statement of Position on

74-12

Accounting Practices in the Mortgage Banking Industry

December 30, 1974

Recommendation to Financial Accounting Standards Board

Issued by
Accounting Standards Division

American Institute of
Certified Public Accountants

AICPA

Notes

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of Statements of Position is to influence the development of accounting and reporting standards in directions the Division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

AICPA

American Institute of Certified Public Accountants

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 30, 1974

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position presents recommendations of the Accounting Standards Division on Accounting Practices in the Mortgage Banking Industry. It was prepared on behalf of the Division by the Accounting Standards Executive Committee for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate.

The Statement takes the position that a mortgage banker's loan portfolio (other than loans held for long-term investment) should be valued using the lower of cost or market method. A mortgage banker will occasionally hold mortgage loans for long-term investment, and in those situations the cost method of valuing such loans is found to be appropriate. The Statement recommends procedures to be followed in determining the lower of cost or market in various circumstances and offers guidance for identifying those mortgage loans which are long-term investments.

With respect to transactions between affiliates, the Statement notes that, except in rare circumstances, generally accepted accounting principles require the postponement of profit until sale to unrelated third parties. Consequently, it takes the position that sales of mortgages to an affiliate by a mortgage banker should, in most cases, be recorded at the lower of cost or market value at the date a management decision has been reached that a sale between affiliates will occur.

The Statement indicates that both classified and unclassified balance sheets are acceptable, but recommends that mortgages held for sale and mortgages held for investment should be distinguished in any balance sheet.

The Division would appreciate being advised as to the Board's proposed action on the recommendations set forth in this Statement of Position.

Sincerely yours,

Stanley J. Scott (ml)

STANLEY J. SCOTT
Chairman
Accounting Standards Division

ACCOUNTING PRACTICES IN THE MORTGAGE BANKING INDUSTRY

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INTRODUCTION

1. The Accounting Standards Division of the American Institute of Certified Public Accountants has reviewed certain accounting practices used by mortgage bankers in accounting for their inventory of permanent mortgage loans held for sale and in preparing their balance sheets. This review indicated that two accounting methods are widely used in accounting for such loans held for sale, the cost method and the lower of cost or market method. The review also indicated that practices vary in measuring the lower of cost or market and in recording transactions with affiliates. Both classified and non-classified balance sheets were also noted.

2. In recent years, accountants, investors and other users of financial statements have expressed concern over the acceptability of alternative accounting methods in accounting for similar business transactions. The Division believes that it is not desirable to have alternative methods and measurement practices acceptable for accounting for mortgage loans held for sale by mortgage bankers. Therefore, the Division is expressing in this Statement its position on a preferable accounting method and on preferable measurement practices for such mortgage loans.

3. The Division's position as set forth herein applies to financial statements of mortgage bankers which purport to present financial position, changes in financial position, or results of operations in conformity with generally accepted accounting principles.

4. The key terms in this Statement are defined in the Glossary. Excerpts from accounting literature relating to each Division position are also included in an Appendix.

THE MORTGAGE BANKING INDUSTRY

5. Mortgage bankers, an important part of the real estate industry, by bringing potential borrowers and investors together, originate, market and service real estate mortgage loans. Other mortgage banking operations, including insurance, property management, real estate development and sales, management of real estate investment trusts and joint venture investments are subsidiary or collateral to the fulfillment of this primary role. While some mortgage bankers trace their ancestry to real estate firms operating prior to 1900, the real impetus to mortgage banking occurred in the 1930s with the advent of the insurance of residential mortgages by the Federal Housing Administration. The existence of government insurance enhanced the salability of such loans to financial institutions, particularly in capital-rich areas. Both by law and custom, the geographically distant permanent investor needed a local representative to collect payments, make periodic property inspections, and make certain that insurance and property tax payments were kept current by mortgagors. After World War II, residential loans guaranteed by the Veterans Administration became an important source of loan origination and servicing operations for mortgage bankers.

In recent years, mortgage bankers have also originated a significant volume of non-insured residential loans and of income property mortgages, including loans on shopping centers, office buildings and multi-family apartment complexes. A considerable number of these income property or commercial loans are originated for sale on a servicing-released basis, with the servicing performed by the investor. However, most servicing of residential loans and a very significant portion of the servicing of commercial loans is still performed by the mortgage banker for a fee based on a percent of the outstanding principal balance of the loan.

6. Mortgage bankers acquire mortgage loans for sale to permanent investors from a variety of sources. Among these sources are applications directly from borrowers, purchases from realtors and brokers, purchases from investors and conversions of various forms of interim financing, such as construction loans, to permanent financing. Residential loans guaranteed or insured by the Federal Housing Administration or the Veterans Administration have usually been acquired at a discount from par, due to the submarket interest rate of such loans. Non-Federally guaranteed or conventional residential mortgages are also often acquired at a discount from par. Commercial loans are generally acquired at par. Current industry practice, with which the Division agrees, is to defer recording any purchase discounts as income until final placement of the loans with the permanent investor.

7. The mortgage banker sells the mortgages he originates to a variety of permanent investors, including savings and loan associations mutual savings banks, insurance companies, pension funds, the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association. Since 1970, many mortgages have also been placed in trusts to collateralize Mortgage Backed Securities issued by mortgage bankers and guaranteed by the Government National Mortgage Association. Mortgage banker activities thus primarily consist of two separate but interrelated operations: the origination and marketing of real estate mortgages, and the subsequent long-term servicing of such loans.

8. Most mortgage bankers originate and service two types of loans, residential and income or commercial. While the servicing procedures are somewhat similar for the two loan types, the origination operation are significantly different and almost always require separate organizations, procedures, and decisions. Residential loans are usually obtained directly from borrowers referred to the mortgage banker by real estate brokers or builders. Since the amount of any one loan is relatively small, the mortgage banker will often originate residential loans without specific commitments from a permanent investor to purchase the loans. If the mortgage banker has any commitment to cover such loans it will normally be a block commitment for a large dollar volume of residential loans meeting broad general criteria.

9. Income or commercial loan origination procedures differ significantly from residential loan originations. Some of the more common commercial loan origination procedures are:

(a) Normally, the mortgage banker does not issue a commitment to the borrower without first obtaining an investor's commitment to purchase the specific loan.

(b) Each borrower's loan application is matched to an investor's commitment rather than packaging several loans to one commitment.

(c) A single commercial loan representative may deal with both the borrower and the investor.

(d) Each loan is usually large in amount and requires careful appraisal, analysis, and packaging for an investor commitment.

(e) Most loans, upon borrower acceptance of the permanent loan commitment, are not funded for several months until construction of the project is completed.

10. After originating a mortgage loan the mortgage banker normally must hold the loan for a period ranging from 60 to 180 days, during which time processing of documentation is completed and marketing efforts are made. During the processing period the loans are usually pledged as collateral for the short-term bank loans (the "warehouse line") used to finance the purchase and ownership of the mortgages. During the holding period, the mortgage banker must assume the primary risk for the collectibility of the loan, fluctuations in carrying costs due to changes in short-term interest rates, and fluctuations in the final sales price of the loan due to changes in long-term interest rates. These risks may be partly reduced through government guarantees

or through the purchase from permanent investors of commitments to buy loans at stated prices and under stated conditions, as described in paragraphs 8 and 9.

BASIS OF VALUATION OF MORTGAGE LOANS OWNED

Current Industry Practice

11. Mortgage bankers have traditionally been short-term brokers of mortgage loans, acquiring such loans from third parties, processing and marketing them, and selling them to permanent investors. The mortgage banker has typically not become an investor himself because of a desire to avoid competing with his investors and because mortgage bankers generally have had limited equity and long-term funds. However, mortgage loans held for sale, because of the 60 to 180 day processing period, usually constitute the largest asset owned by a mortgage banker.

12. Practices with regard to risks assumed by mortgage bankers during the processing and marketing phase of their operating cycle have varied. Some mortgage bankers have avoided assuming any risk by purchasing commitments from investors to cover loans as they are acquired, and thus only in rare circumstances could those mortgage bankers suffer a marketing loss. Other companies have elected to

rely on their marketing efforts to avoid a loss on the sale of their loans, and even hopefully to generate a profit, and consequently have not acquired commitments for any of their loans. Most companies, of course, fall between these two extremes, obtaining specific commitments for commercial loans and block commitments for some of their residential loans. Such block commitments, when purchased in advance of loan production, carry some element of risk because changes in acquisition costs may reduce or eliminate the protection afforded by such commitments. Finally, although rare, an investor may fail to honor a commitment, so that the mortgage banker assumes some risk even with fully commited loans.

13. The following paragraphs discuss the two valuation methods, "cost" and "lower of cost or market", commonly used by mortgage bankers during the processing and holding period to account for their mortgages owned. These loans, variously labeled "inventory", "loans held for sale to others", "mortgage loans" or "mortgage loans receivable", are classified as current assets by mortgage bankers using classified balance sheets. A majority of mortgage bankers, in terms of asset size and servicing portfolio size, use the lower of cost or market valuation method. A minority of mortgage bankers use the cost valuation method.

Cost Valuation Method

14. The cost valuation method defers any adjustment for changes in the market value of mortgage loans until completion of the processing and marketing period. Acquired loans are recorded at the principal balance of the loan with any acquisition discounts placed in a purchase discounts account and offset against the related asset on the balance sheet. While industry practice is to record origination fees as income at loan closing, some companies defer recognizing such fees until the loans are sold to investors.

Lower of Cost or Market Valuation Method

15. The lower of cost or market valuation method recognizes, during the holding period, any decrease in estimated net realizable value below acquisition cost. Specific industry practices with respect to the computation of the lower of cost or market are discussed in detail in paragraphs 22 through 24.

The Division's Position

Loans Held for Sale

16. All, or almost all, of the loans owned by a mortgage banker are held for sale during his normal business cycle either as individual loans or as collateral for GNMA securities. Occasionally, some owned loans may be held for longer periods as described in paragraphs 17 through 21. The basic accounting concepts relating to the use

of the cost or lower of cost or market methods for valuing loans held for sale are discussed in detail in the accounting literature quoted in paragraphs 44 through 51. The Division finds convincing the rationale advanced for the use of the lower of cost or market valuation method for loans held for sale by mortgage bankers. This conclusion is based on the fact that such a valuation method most clearly represents the economic realities of the mortgage banker's operations. The Division believes that mortgage loans held for sale have characteristics similar to both accounts receivable and finished goods inventory, even though some processing and marketing efforts may still have to be made. Consequently, the accounting principles recommended by the Division are drawn from the principles followed in providing for valuation adjustments for receivables and for reduction of carrying values to the lower of cost or market for inventories. The Division further believes that the computation of market value requires some variation from procedures followed in valuing manufacturing inventories. Such variations are discussed more fully in paragraphs 25 through 32. The Division believes the cost method for valuing loans held for sale fails to reflect economic realities and fails to meet the "conservatism", "accrual", or "measuring of unfavorable event" principles of accounting and, therefore, should not be acceptable.

Loans Held for Market Recovery

17. The mortgage banker may hold mortgage loans or GNMA securities for extended periods of time if he expects a favorable long-term interest trend. Although these loans may technically not be held for sale during the company's normal operating cycle, the Division believes such loans should also be valued in accordance with the lower of cost or market method prescribed for loans held for sale.

Loans Held for Long-term Investment

18. The Division finds that accounting practices followed for many years by commercial banks, savings and loan associations, insurance companies and others support the use of the cost method of valuing mortgage loans held as long-term investments. While historically mortgage bankers have not customarily made long-term investments in mortgage loans, the Division recognizes that occasionally such companies may choose to make such investments. The Division considered two areas of concern associated with a mortgage banker's making long-term mortgage loan investments: (1) ways to distinguish between long and short-term investments and (2) the definition of cost.

19. Determination and verification of a mortgage banker's intent to carry mortgage loans as a long-term investment will always be a difficult judgment. The Division believes that the following conditions, as they existed at the time the investment decision was made, should be considered in verifying a mortgage banker's intent to carry mortgage loans as a long-term investment:

(a) The loans are to be segregated in the accounting records and reports of the company.

(b) There is documentary evidence of a corporate decision to hold such loans to maturity or at least for an extended term.

(c) The loans will be classified as non-current assets if the company's balance sheet is classified.

(d) The mortgage banker has the financial strength to carry such investments for extended periods. Evidence of such financial strength would be an amount of equity and long-term borrowings in excess of the carrying value of such investments. A non-revocable line of credit, effective for the projected holding period from a substantial financial institution would also constitute evidence of substantial financial strength.

20. The Division believes mortgages transferred into a long-term investment category must be transferred at the lower of cost or market, as defined in paragraphs 25 through 32, at the date of transfer, except that the carrying value of such loans must be further reduced, if necessary, to provide a yield not less than the rate of interest paid on the debt, if any, used to carry the investment. While the transfer to long-term investment will terminate any necessity to write down such loans further in the event of subsequent market declines, the Division also believes it is inappropriate to adjust such loans for any subsequent market recovery. Consequently, so long as a mortgage banker holds loans as long-term investments, such loans should be valued at the lower of cost or market at the date of formal identification as a long-term investment, unless some event occurs indicating a permanent impairment of value, in which case a further reduction in carrying value may be necessary. The Division does believe that,

with respect to long-term mortgage loans, any difference between par value of the loans and carrying value as determined above should be amortized and recorded in income. Since mortgage loans are rarely outstanding for their full term, due to prepayments, sales of property etc., the Division believes this amortization may be based on the estimated life of the loans instead of their stated term.

Loans Sold Under Repurchase Agreements

21. Some mortgage bankers, as a means of financing a portion of their inventory of loans held for sale, temporarily transfer such loans to banks or other financial institutions under repurchase agreements. When the loans are marketed to permanent investors they are reacquired from the banks and sold to the investors. The loans may also be temporarily transferred without a formal repurchase agreement but under circumstances which indicate such an agreement exists on an informal basis; e.g., all marketing efforts are made by the mortgage banker, not the bank; the positive or negative interest spread is the property of the mortgage banker; fluctuations in loan market values are the risk of the mortgage banker; uncollectible loans are reacquired by the mortgage banker; and the mortgage banker routinely reacquires all or almost all of the loans from the bank and resells them to permanent investors. While loans transferred to banks under such "sold loan lines" may technically be sales, the Division believes the existence of a formal repurchase agreement or the existence of evidence of an informal repurchase practice indicates that the risk of market loss is retained by the mortgage banker and such transactions

are essentially financing in nature and should be accounted for as such. Therefore, the Division believes the mortgage banker should value all such loans at the lower of cost or market whenever making a loan valuation computation. GNMA certificates sold under repurchase agreements should also be valued at the lower of cost or market.

DEFINITION OF LOWER OF COST OR MARKET

Current Industry Practice

22. Mortgage bankers generally have two types of loans held for sale: (1) those loans that have been originated specifically to fill existing investor commitments and (2) those loans originated on a speculative or uncommitted basis to fill future investor needs. Mortgages, like other assets, are initially recorded at cost. Cost is generally considered to be the cash or fair value of other assets given in exchange for the asset acquired. While outlays incident to the acquisition as well as the outlay for the asset itself are generally considered to comprise the cost of the asset, the mortgage banking industry generally has not attempted to capitalize the administrative costs involved in the origination of a mortgage. This is due to many factors, including the charging of an origination fee, usually 1% of the mortgage amount, to cover some or all of these origination costs.

23. Most mortgage bankers have reduced the carrying value of their loans held for sale to market when such market value was less than cost.

Generally, such valuation computations are made in the aggregate, either in total or by type of loan, so that any potential losses are reduced by potential gains before a write-down is recorded. However, some companies calculate the write-down on an individual loan basis without offsetting gains against losses. The market values used for comparison are usually those associated with each company's normal investor outlets.

24. Loans held for sale by mortgage bankers are almost universally financed with short-term bank borrowings collateralized by the mortgages. Normally, long-term mortgage interest rates exceed the short-term rates mortgage bankers pay the banks and a favorable interest spread is an important source of income to the mortgage banker. On occasion, sometimes for extended periods, such short-term rates are higher than long-term rates. This condition not only puts powerful economic pressure on the mortgage banker but also creates an additional problem of valuation. Very few mortgage bankers have considered this "negative interest" factor in their valuation procedures, although some have considered it in their marketing strategy, but if loans are to be held for extended periods, because of market or other conditions, such a factor could become a material problem.

The Division's Position

25. The Division concludes that the procedures described in paragraphs 26 through 30 should be used in defining the lower of cost or market basis for mortgage loans held for sale.

Computation of Market

26. Market value of mortgage loans and GNMA Mortgage Backed Securities should be computed by appropriate type of loan with, at a minimum, separate computations made for residential and commercial loans. When calculating the lower of cost or market, either the aggregate or individual loan basis may be used, and the method used should be disclosed in the financial statements. The computation of market is a two tier calculation as follows: first, those loans held subject to existing purchase commitments (committed loans) and, second, those loans held on a speculative basis (uncommitted loans).

Committed Loans and GNMA Securities: Market value for loans and GNMA securities covered by investor commitments should be computed based upon commitment prices. These loans must meet the specific terms of the commitments. Where such loans do not meet the requirements of the commitments, or there exists a reasonable doubt as to acceptance, the loans should be considered uncommitted loans for the calculation of market value.

Uncommitted Loans: Computations of market value for uncommitted loans should be based on the market within which the mortgage banker normally operates. This would include consideration of the following:

(a) Commitments obtained after or shortly before balance sheet date. To the extent such commitments clearly represent market conditions existing at year end, market value computations should be based on these commitment prices.

(b) General indications of market prices and yields sought by the company's normal market outlets.

(c) Quoted GNMA security prices or other public market quotations for long-term mortgage loan rates.

(d) Federal National Mortgage Association Free Market System action prices. Generally all mortgage banking firms are approved seller/servicers of the Federal National Mortgage Association (FNMA) which is the major secondary market source of funds for mortgage bankers. FNMA operates a nationwide mortgage action program called the Free Market System which gives an indication of current market prices for both government and conventional loans via an action system for the purchase of FNMA's commitment to acquire loans from seller/servicers at specific periods of time.

Uncommitted GNMA Mortgage Backed Securities: The mortgage banker may hold GNMA securities in the open market for trading purposes. With respect to the uncommitted securities which are collateralized by his own loans, the current market value of the underlying loans and the current market value of the securities will normally be very similar. If the trust holding the mortgage banker's own loans may be readily terminated and the loans sold directly, the securities may be valued at the lower of cost or market of either the loans or the securities, preferably based on the mortgage banker's sales intent. Other GNMA securities should be valued at the lower of cost or market using the published GNMA securities yield.

Costs Associated with Bulk Purchases: Mortgage bankers sometimes acquire large blocks of existing mortgage loans from investors, including GNMA. Some mortgage bankers have capitalized certain costs associated with these purchases as costs of future servicing income and amortized such costs over the estimated life of the loans. Where such capitalization is appropriate, the costs to be capitalized may be excluded from the cost of the mortgages for the purpose of establishing the lower of cost or market. Where such capitalization is not appropriate, such costs must be considered as part of the cost of the mortgages.

Valuation Dates and Subsequent Changes in Market Conditions

27. Valuations are to be made at the close of all stockholder reporting periods, including those for interim financial statements. The provisions of APB Opinion No. 28 as to temporary market declines may be applied to such interim financial statements if market conditions have actually improved subsequent to the interim reporting period. Otherwise, market changes subsequent to the valuation date should be considered subsequent period events and, if such changes are material, adequate disclosure should be included in the notes to financial statements as set forth in Sections 560.05 and 560.07 of Statement on Auditing Standards No. 1.

Subsequent Recoveries of Previous Writedowns

28. The Division believes, as previously noted, that the lower of cost or market valuation procedure for mortgage bankers combines elements of receivable valuation with elements of inventory valuation. Traditionally, inventory valuation concepts have required that, with respect to items which have been written down below cost, the reduced amount is to be considered "cost" for subsequent accounting purposes. Conversely, receivable valuation reserves have often been determined for each reporting period independently, so that receivables are carried at current realizable value. The Division believes it is acceptable for a mortgage banker to calculate the lower of cost or market value at each valuation date independent of any previous calculation. Thus, loans written down in one accounting period (other than those held for long-term investment -- see paragraph 20) need not be carried at such reduced value in a later period if their market value has partly or completely recovered.

Excess of Interest Paid Over Interest Received During the Period Mortgages are Held Pending Sale to Investors

29. Occasionally, interest paid on warehouse lines exceeds interest received on the underlying mortgage loans. This phenomenon of short-term interest rates exceeding long-term rates is unusual and has occurred infrequently in the past. The Division views the warehousing of mortgages as essentially a financing activity and, accordingly, any negative spread should be charged to current operations as incurred.

<u>Servicing Fee Rates at Other Than Current Market</u>

30. Occasionally, a mortgage banker will sell or commit to sell loans at a servicing fee rate that is significantly different from rates currently prevalent in the industry. In such cases the loans will generally be sold at prices higher than otherwise available. The result is the recognition of increased income (or reduced loss) at the time of sale offset by reduced servicing income to be recognized in future periods. In other cases a mortgage banker may act as a broker and sell loans with servicing released (no servicing income to be collected nor is the mortgage banker to perform any servicing functions) to either the investor or another servicer. This circumstance is particularly apt to occur with respect to commercial loans, and the mortgage banker may or may not have known and considered the terms of sale at the time the related loans were produced and their acquisition cost was negotiated. In some such cases the loans may be sold at prices higher than otherwise available, in which instance the result would be the recognition of increased income (or reduced loss) at the time of sale but with no servicing income nor related servicing cost in future periods.

31. The Division concludes that when loans are sold with servicing released, no adjustment of the sales price should be made. However, when loans are sold at a servicing fee rate that is significantly lower than rates currently prevalent in the industry, the Division concludes that an adjustment to the sales price will be required whenever the impact on operating results is significant. Such adjustments

would result in deferred credits to be written off into servicing fee income over future years. The amount of any such adjustment and the method of write-off should be determined in such a way that the resulting total of the write-off and actual servicing fee income recognized in each subsequent year from the related loans would approximate the servicing fee income that would have been earned in each subsequent year if the related loans had been sold at a "normal" servicing fee rate. Any such adjustment should be made as of the date the sale of the loans is recorded and any resulting gain or loss is recognized. An adjustment may similarly be required if servicing rates are significantly higher than normal. In determining the market value of mortgage loans held for sale, a similar adjustment should be made to the sales price of any commitment which provides for a servicing fee rate that is lower than rates currently prevalent in the industry.

32. The Division recognizes that it may be difficult to determine what are "normal" servicing fee rates currently prevalent in the industry It is necessary that such a determination be made both for the purpose of deciding whether an adjustment is required and for the purpose of quantifying the amount of the adjustment. The Division concludes that a minimum acceptable "normal" servicing fee rate is one that will

provide, over the estimated life of the loans, servicing fee income in excess of estimated servicing costs.

ACCOUNTING FOR TRANSACTIONS WITH AFFILIATES

Current Industry Practice

33. Mortgage banking firms began generally as relatively small, independently owned businesses with nominal equity. They financed their operations, particularly loans held for sale, through bank borrowings collateralized by the related loans. Many mortgage banking firms subsequently were acquired by larger financial institutions. This change was heightened with the expansion of bank holding companies and the inclusion of mortgage banking as a permitted activity by the Board of Governors of the Federal Reserve System. The acquisition of mortgage banking firms resulted in the acquired firms having access to much greater amounts of capital for carrying their mortgage loan inventories and for expansion in construction and development lending.

34. As many mortgage bankers have become affiliated with banks and other financial institutions the number and magnitude of transactions with related companies have increased. Generally, mortgage loan transactions between affiliated companies have been recorded at the lower of cost or market at the date of transfer. However, some of

these transactions have been recorded at original cost, thus not recognizing any marketing losses, since the mortgage banker recovers his basis in the loans and the purchasing affiliate records the loans in its investment account at cost. Occasionally other affiliate transaction techniques have been used, such as purchases at cost using non-interest bearing notes or purchases on a zero-servicing-fee basis. Some mortgage bankers have reported gains or losses on sales of mortgages to their affiliates in the mortgage banker's separate financial statements but have eliminated such gains or losses in the group's consolidated financial statements, while others have reflected such gains and losses on both separate and consolidated financial statements. Transactions with affiliates are a particular problem for mortgage bankers because they must issue separate financial statements.

The Division's Position

35. APB Opinion No. 18 establishes a number of criteria for determining whether a subsidiary or affiliate relationship exists. These criteria include (a) a presumption of an affiliated relationship if a 20% or greater voting stock ownership exists, either directly or indirectly, and (b) the ability to exercise significant influence over operating and financial policies. The ability to exercise significant influence may be indicated in several ways, such as representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel or technological dependency. The Opinion specifically does not apply

to investments in nonbusiness entities, such as estates, trusts, and individuals. The Division believes that transactions by mortgage bankers with affiliates, as defined herein, should be accounted for as described in the appropriate sections of paragraphs 36 through 41.

36. The Division considered accounting for sales of mortgages (other than those held for long-term investment) by a mortgage banker to an affiliated company by recording such sales at (a) the cost basis on the records of the mortgage banker, (b) at the agreed intercompany sales price, or (c) the carrying value (lower of cost or market).

37. Generally, transactions between affiliated companies should not result in the reporting of gains or losses, as discussed in ARB No. 51, "...any intercompany profit or loss on assets remaining within the group should be eliminated". This principle supports the recording of sales of mortgages to affiliated companies at the mortgage banker's cost basis. However, particularly when the market value of the mortgages being sold is less than the cost basis, this method tends to disguise the mortgage banker's marketing results. Since the agreed intercompany sales price represents the cash flow reality, support also exists for recording the transaction at this amount. However, for an affiliated group such a sales price may not represent the economic facts and may reflect elements more akin to capital contributions or dividends than to realized gains or losses. The Division, therefore, believes that for transactions with affiliates neither the cost basis nor the agreed sales price basis adequately reflects the nature of the mortgage banker's business.

38. The Division believes that the separate financial statements of mortgage bankers should reflect the economic conditions within which the mortgage banker operates. In addition, transfers to affiliates are usual similar in nature to transfers to the long-term investment category, and the Division believes both transactions should be accounted for in the same manner. Conversely, however, generally accepted accounting principles require the postponement, except in rare circumstances, of recognition of profits until sale to unrelated third parties. Consequently, the Division believes that sales of mortgages to an affiliate by a mortgage banker should be recorded at the lower of cost or market value as determined at the measurement date, which is the date a management decision has been reached that a sale between affiliates will occur. Although not susceptible of precise definition, determination of the date such a decision is reached should be based upon, at a minimum, formal approval by the appropriate investment authorities of the purchaser, issuance of a binding commitment to purchase the mortgages, and acceptance of the commitment by the selling mortgage banking firm. The amount of any loss should be computed as the difference between market value, calculated in accordance with paragraphs 25 through 32, and the cost of the loans. Since any marketing loss was incurred by the mortgage banker prior to the sale to the affiliate, such loss should not be eliminated in consolidation.

39. Any amounts paid by an affiliated company in excess of the lower of cost or market value at the measurement date should not be recorded by the mortgage banker as income and any amounts paid which are less than the lower of cost or market value should not be recorded as a loss.

40. On rare occasions, a mortgage banker may originate a particular class of loans or all loans exclusively for an affiliated company. In such instances the mortgage banker is acting as agent for the affiliate and such loan transfers should be recorded at the mortgage banker's acquisition cost. The Division does not believe, however, that sucn an agency relationship exists in the case of "right of first refusal" contracts or similar types of agreements or commitments. While the mortgage banker may earn a fee for originating loans as an agent for an affiliated party, the risks, including the marketing risks, associated with ownership of the loans should be born by the affiliate, not the mortgage banker, for any agency relationship to exist.

41. In accounting for the sale of mortgages between affiliated companies, there is a presumption that the purchasing company intends to hold purchased mortgages as long-term investments. If repurchase agreements exist (for example, resales of such mortgages by the affiliated purchaser either to the mortgage banking affiliate or to other permanent investors), such presumption may not be sustainable. In this event, consideration should be given to accounting for the transactions as intercompany loans collateralized by the mortgages.

In such cases the mortgage banker should continue to value the mortgages as loans held for sale.

CLASSIFICATION OF BALANCE SHEETS

Current Industry Practice

42. Practices vary within the mortgage banking industry with respect to the preparation of classified or unclassified balance sheets. Historically, government agencies and some investors have requested (but not always required) balance sheets showing current and non-current assets and liabilities. Many mortgage bankers, however have published non-classified balance sheets in their annual reports, arguing that ordinary working capital ratios are not meaningful tests of mortgage banker financial statements. For most mortgage bankers, a large portion of their short-term liabilities are represented by bank borrowings collateralized by specific mortgage notes receivable. The receivables were purchased using funds obtained from the notes collateralized by the receivables and the notes will be paid off from the funds received from the sale of the receivables. The Mortgage Bankers Association has recently made the following recommendation to the Department of Housing and Urban Development:

"Elimination of References to Current Assets and Liabilities and Net Working Capital in FHA Form 2001-K

"We suggest references to current assets and liabilities and net working capital be deleted from Form 2001-K. Accounting Research Bulletin No. 43, issued by the American Institute of Certified Public Accountants states:

> '...In the past, definitions of current assets have tended to be overly concerned with whether the asset may be immediately realizable.
>
> '(The current)tendency (is) for creditors to rely more upon the ability of debtors to pay their obligations out of the proceeds of current operations and less upon the debtors' ability to pay in case of liquidation. It should be emphasized that financial statements of a going concern are prepared on the assumption that the company will continue in business.'

"Generally, the existence of a normal operating cycle is the major prerequisite for requiring classification of a company's balance sheet; conversely, where normal operating cycles are not identifiable, the presentation of current asset and liability classifications may not be meaningful. Such is often the case where primarily investing and financing activities are involved. In these cases, due to the direct financing relationship of a substantial portion of total assets to total liabilities, the flow of resources through a normal cycle is unidentifiable. This is also true in very long cycle industries, such as the land development industry. Most mortgage and construction loans of approved mortgagees are not due within one year. In addition, it is reasonable to assume that repayments on loans will generally be used to curtail direct financing activities or be invested in new loans. Also, the general practice of an approved mortgagee is to repay his short-term notes through the specific application of cash received from the sale of his mortgage loan inventory.

"Industry practices for Real Estate Investment Trusts, Banks, Finance Companies and Savings and Loan Associations have eliminated classifications for current assets and liabilities in financial statements. In addition, an increasing number of mortgage banking companies are issuing financial statements without these classifications."

The Division's Position

43. The Division concurs with the recommendation of the Mortgage Bankers Association to the Department of Housing and Urban Development. However, classified balance sheets are also acceptable. The mortgage banker should distinguish in either type of balance sheet between mortgages held for sale and mortgages held for investment, if any. The notes to the financial statements should disclose to the reader of such financial statements sufficient data to permit the proper evaluation of a company's financial position and results of operations.

SURVEY OF ACCOUNTING LITERATURE

Basis of Valuation

44. The Division found in existing pronouncements of the American Institute of Certified Public Accountants and the Financial Accounting Standards Board no definitive guidance on classifying the balance sheet or valuing the loans held for sale of a mortgage banking company. The Division also examined recent pronouncements on applicable general principles, industry audit guides for related industries, and the suggested chart of accounts and sample financial statements published by the Mortgage Bankers Association for guidance. The following paragraphs summarize the applicable literature.

45. The concepts of measurement bases and timing of recognition of effects of transactions are discussed in APB Statement No. 4, Paragraph 35. Measurement bases are described as follows: "Several measurement bases are used in financial accounting, for example, net realizable value (receivables), lower of acquisition cost and present market price (inventories), and acquisition cost less accumulated depreciation (plant and equipment). Financial statements in general do not purport to reflect the current value of the assets of the enterprise or their potential proceeds on liquidation under present generally accepted accounting principles." The timing of effects of transactions are described as follows: "The effects of transactions and other events on the assets and liabilities of a business enterprise are recognized and reported in the time periods to which they relate rather than only when cash is received or paid."

46. Paragraph 160 discusses immediate expense recognition as follows:

> "Immediate recognition. Some costs are associated with the current accounting period as expenses because.... (2) costs recorded as assets in prior periods no longer provide discernible benefits....The principle of immediate recognition also requires that items carried as assets in prior periods that are discovered to have no discernible future benefit be charged to expense."

Paragraph 171 describes another underlying principle as follows:

> "Conservatism. Frequently, assets and liabilities are measured in a context of significant uncertainties. Historically, managers, investors, and accountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets. This has led to the convention of conservatism, which is expressed in rules adopted by the profession as a whole such as the rules that inventory should be measured at the lower of cost or market and that accrued net losses should be recognized on firm purchase commitments for goods for inventory. These rules may result in stating net income and net assets at amounts lower than would otherwise result from applying the pervasive measurement principles."

47. Principles of resource measurement are discussed in APB Statement No. 4, Paragraph 70:

> "Resources are measured in terms of money through money prices, which are ratios at which money and other resources are or may be exchanged. Several types of money prices can be distinguished based on types of markets (purchase prices and sales prices) and based on time (past prices, present prices, and expected future prices). Four types of money prices are used in measuring resources in financial accounting.
>
> 1. Price in past purchase exchange of the enterprise
> This price is usually identified as historical cost or acquisition cost because the amount ascribed to the resource is its cost, measured by the money or other resources exchanged by the enterprise to obtain it.

2. <u>Price in a current purchase exchange</u>
This price is usually identified as replacement cost because the amount ascribed to the resource is measured by the current purchase price of similar resources that would now have to be paid to acquire it if it were not already held or the price that would now have to be paid to replace assets held.

3. <u>Price in a current sale exchange</u>
This price is usually identified as current selling price because the amount ascribed to the resource is measured by the current selling price of the resource that would be received in a current exchange.

4. <u>Price based on future exchanges</u>
This price is used in several related concepts-present value of future net money receipts, discounted cash flow, (discounted) net realizable value, and value in use. Each indicates that the amount ascribed to the resource is measured by the expected net future money flow related to the resource in its present or expected use by the enterprise, discounted for an interest factor.."

48. Principles of measuring and recording unfavorable events are discussed in Paragraph 183:

"S-5. <u>Unfavorable external events other than transfers recorded. Certain unfavorable external events, other than</u> transfers, that decrease market prices or utility of assets or increase liabilities are recorded."

"M-5. <u>Measuring unfavorable events.</u> The amounts of <u>those assets whose decreased</u> market price or utility is recorded are adjusted to the lower market price or recoverable cost resulting from the external event."

"S-5B. <u>Decline in market price of certain marketable securities. If market price of marketable securities</u> classified as current assets is less than cost and it is evident that the decline is not due to a temporary condition a loss is recorded when the price declines."

"M-5B. Measuring losses from decline in price of marketable securities. The loss on a price decline of marketable securities is measured by the difference between the recorded amount and the lower market price."

"S-5E. Decline in market prices of noncurrent assets generally not recorded. Reductions in the market prices of noncurrent assets are generally not recorded until the assets are disposed of or are determined to be worthless."

49. However, the principle of non-recognition of declines in market prices of non-current assets is modified with respect to long-term investments in the AICPA Statement on Auditing Standards No. 1, Section 332.03: "With respect to the carrying amount of investments, a loss in value which is other than a temporary decline should be recognized in the financial statements of an investor. The independent auditor should, therefore, also examine sufficient competent evidential matter to the extent he deems necessary to determine whether such a loss in value has occurred."

50. Since mortgage loans held by mortgage bankers have characteristics of both security investments and inventory, and since, while heretofore an extremely rare occurrence, it is possible some mortgage bankers may hold loans for extended periods, the Division further reviewed accounting literature for applicable principles relating to short and long-term investments and inventories.

51. The AICPA Industry Audit Guide Audits of Banks, page 42, describes principles relating to bank security investments (generally bonds, but often mortgages also) as follows: "With relatively few exceptions, securities held by banks are of investment grade. If they are

held to maturity, they will be redeemed at an amount equal to their amortized cost. Accordingly, it is not customary practice for banks to provide specifically in their accounts for unrealized depreciation in the investment portfolio. This practice appears to be sound. Banks which are dealers in securities, however, should carry their trading account securities, which are in effect inventories, at the lower of cost or market".

Definition of Lower of Cost or Market

52. Inventory and inventory pricing is discussed in ARB No. 43, Chapter 4, as follows:

> "Statement 1 - The term inventory is used herein to designate the aggregate of those items of tangible personal property which are held for sale in the ordinary course of business."
>
> "Statement 5 - A departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, changes in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as market.

Discussion

> "8. Although the cost basis ordinarily achieves the objective of a proper matching of costs and revenues, under certain circumstances cost may not be the amount properly chargeable against the revenues of future periods. A departure from cost is required in these circumstances because

cost is satisfactory only if the utility of the goods has not diminished since their acquisition; a loss of utility is to be reflected as a charge against the revenues of the period in which it occurs. Thus, in accounting for inventories, a loss should be recognized whenever the utility of goods is impaired by damage, deterioration, obsolescence, changes in price levels, or other causes. The measurement of such losses is accomplished by applying the rule of pricing inventories at cost or market, whichever is lower. This provides a practical means of measuring utility and thereby determining the amount of the loss to be recognized and accounted for in the current period."

"Statement 7 - Depending on the character and composition of the inventory, the rule of cost or market, whichever is lower may properly be applied either directly to each item or to the total of the inventory (or, in some cases, to the total of the components of each major category). The method should be that which most clearly reflects periodic income.

Discussion

"11. The purpose of reducing inventory to market is to reflect fairly the income of the period. The most common practice is to apply the lower of cost or market rule separately to each item of the inventory. However, if there is only one end-product category the cost utility of the total stock--the inventory in its entirety--may have the greatest significance for accounting purposes. Accordingly, the reduction of individual items to market may not always lead to the most useful result if the utility of the total inventory to the business is not below its cost. This might be the case if selling prices are not affected by temporary or small fluctuations in current costs of purchase or manufacture. Similarly, where more than one major product or operational category exists, the application of the cost or market, whichever is lower rule to the total of the items included in such major categories may result in the most useful determination of income.

"12. When no loss of income is expected to take place as a result of a reduction of cost prices of certain goods because others forming components of the same general categories of finished products have a market equally in excess of cost, such components need not be adjusted to market to the extent that they are in balanced quantities. Thus, in such cases, the rule of cost or market, whichever is lower may be applied directly to the totals of the entire inventory rather than to the individual inventory items, if they enter into the same category of finished product and if they are in balanced quantities, provided the procedure is applied consistently from year to year."

Accounting for Transactions with Affiliates

53. The basic accounting theory regarding the appropriate accounting for transactions among affiliated companies was stated in ARB No. 51, Paragraph 1, which states:

"The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions. There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies."

54. In addition, APB Opinion No. 18 concluded in Paragraph 17:

"The equity method of accounting for an investment in common stock should also be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock. Ability to exercise that influence may be indicated in several ways, such as representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency."

55. The guidelines for consolidation procedure as set forth in ARB No. 51, Paragraph 6, are:

> "In the preparation of consolidated statements, intercompany balances and transactions should be eliminated. This includes intercompany open account balances, security holdings, sales and purchases, interest, dividends, etc. As consolidated statements are based on the assumption that they represent the financial position and operating results of a single enterprise, such statements should not include gain or loss on transactions among the companies in the group. Accordingly, any intercompany profit or loss on assets remaining within the group should be eliminated."

56. The above principle was extended to non-subsidiary investments by Paragraph 19.b of APB Opinion No. 18 as follows:

> "Intercompany profits and losses should be eliminated until realized by the investor or investee as if a subsidiary, corporate joint venture or investee company were consolidated."

GLOSSARY

Commercial Loans -- Loans on income producing property, such as apartments, shopping centers, office buildings and maufacturing facilities.

Commitment Fee -- Any fee paid by a potential borrower to a potential lender for the lender's promise to lend money in the future. The issuer may or may not expect to fund the commitment.

Construction Loans -- Loans which finance the acquisition of sites for and the construction of residential and income-producing properties. Such loans are usually repaid with the proceeds from the permanent financing.

FNMA -- Federal National Mortgage Association - an investor-owned corporation which acts as a secondary market for mortgage loans. Formerly a U.S. Government agency, this corporation frequently performs a counter-cyclical function, supplying funds for the mortgage market when other investor funds are limited and selling mortgages when other investor funds are plentiful.

GNMA -- Government National Mortgage Association - A U.S. Government agency which guarantees certain types of mortgage banker debt securities and which funds and administers certain types of low income housing assistance programs.

Loan Commitment -- A written promise by a lender to loan a certain sum at a certain rate of interest.

Origination Fee -- A fee, normally expressed as a percentage of the principal balance of a loan, charged to compensate the mortgage banker for taking a loan application, obtaining an investor commitment, making property inspections and performing other services related to originating a mortgage loan.

Residential Loans -- Loans on one to four family living units.

Servicing Fee -- A fee, normally expressed as a percentage of the principal balance of a mortgage loan, charged by a mortgage banker for performing the loan administration functions.

APPLICATION OF LOWER OF COST OR MARKET METHOD ON AGGREGATE BASIS TO LOANS HELD FOR SALE

	Stated Loan Interest Rate	Loan Principal Balance	Acquisition Cost	Market Value(A)	Carrying Value
Loan A	9 %	$10,000	$ 9,600	$10,000	
Loan B	8 1/2	10,000	10,000	9,600	
Loan C	9 1/2	10,000	10,500	10,400	
Loan D	8	10,000	9,500	9,200	
Loan E	8	10,000	9,800	9,200	
Loan F	8 1/2	10,000	9,200	9,600	
		$60,000	$58,600	$58,000	$58,000(2)

Note A -- Based on long-term interest rate of 9%

COMPUTATIONAL NOTES

(1) Based on an average residential loan life of 12 years, a 1% difference between stated loan interest rate and current market interest rate equals approximately 8% of loan principal balance.

(2) The carrying value of the loans for a mortgage banker using the identified loan method of applying the lower of cost or market basis would be $57,200, with Loan A valued at its cost, $9,600, and Loan F valued at its cost of $9,200, since unrealized gains are not used to offset unrealized losses in this method.

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December 30, 1974

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December 30, 1974

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