Cases in Strategic-Systems Auditing

Lincoln Savings and Loan

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The Lincoln Savings and Loan Case

Overview

Today's businesses face fierce competition and a rapidly changing global business environment. The trend toward mergers and acquisitions, the growth of joint ventures and strategic alliances, and the continuous introduction of new technology have created a business climate that is fluid and volatile. To maintain viability, companies must be poised to react to customer-driven preferences, regulatory changes, and the possibility of product obsolescence. Understanding the dynamics of these external forces, how the entity responds to them, and whether the entity's responses are effective has become imperative to performing, and not just planning, the audit. In a global business environment that is becoming increasingly complex, this knowledge is pivotal to forming the opinion.

This case focuses on the 1987 audit of Lincoln Savings and Loan (LSL). Although the audit of LSL took place more than a decade ago, the lessons still are relevant today. During the 1980s, the business environment of the savings and loan (S&L) industry changed dramatically. Many S&Ls responded by changing their strategies and business operations. LSL was no exception. This case enables you to gain some experience evaluating a company's attempt to adapt to its changing business environment. Your challenge is to evaluate LSL's environmental and operational changes and the accounting and auditing implications of those changes at the time of the audit. In order to make that evaluation, you must develop an understanding of LSL's business, operating philosophy, and incentives during that period of change.

Case Document Day One:

Lincoln Savings and Loan Background and Operations

Background

During the early 1980s, Lincoln Savings and Loan (LSL), a state-chartered, federally insured savings and loan had 30 branch offices throughout California. The branches performed typical savings and loan (S&L) operations such as making mortgage loans and obtaining deposits. Competitors were other S&Ls, banks, and investment companies. Through its branch offices, LSL solicited deposits and made loans for single and multi-family residences. The interest income from these loans was the primary source of LSL's revenue. Funding for these loans came from customer deposits in savings, checking, and retirement accounts. Interest expense from these deposits constituted LSL's largest expense. Profitability was dependent on the interest-rate spread between loans and deposits, that is, the spread had to be large enough to cover expenses and generate a profit.

Environment. Beginning in the late 1970s and continuing on to the early 1980s, the interest-rate spread narrowed and then became negative for many S&Ls. Inflation caused interest rates to climb as high as 20 percent on newly originated loans and 15 percent on deposits. These changes in the business environment had a severe consequence for many S&Ls. Pre-inflation fixed-rate loans with interest rates as low as 5-6 percent had to be honored, while at the same time S&Ls had to pay up to 15 percent on to attract deposits. Not only were S&Ls caught short holding these low fixed-rate loans, but they were unable to generate demand for new mortgages at the prevailing 20 percent rate. A fundamental problem was that S&Ls made long-term, fixed-rate loans but could not match the loans with long-term, fixed-rate deposits.

Based on federal regulations in effect prior to 1983, S&Ls' asset operations were restricted to making loans for residential mortgages and to investing in government-backed securities. S&Ls could only lend to homebuyers who tended to take on 30-year fixed-rate mortgages and could not obtain deposits for the same length of time (e.g. 30-year certificates of deposit would be extremely rare). In 1983, the federal government changed the rules governing the assets of S&Ls. In addition to making loans for residential mortgages and investing in government-backed securities, the new rules allowed S&Ls to make commercial loans and to invest in corporate securities and real estate. Regulators thought the new rules would help S&Ls by allowing them to better match their income-producing assets to their expense-producing liabilities.

Competition. After deregulation, S&Ls and banks (as well as other depository institutions) competed directly with each other for deposits and loans. Banks had always competed with S&Ls and other depository institutions for retail customer (individual) deposits but they dominated the market for corporate deposits. Banks also dominated the market for commercial loans because regulations had prevented S&Ls from making commercial (corporate) loans prior to 1983. Commercial loans tended to carry variable interest rates, thereby allowing banks to adjust more easily to the rising interest rates that had crippled the S&L industry in the early 1980s.

S&Ls had difficulty obtaining large commercial clients when the commercial market was opened to them by deregulation. S&Ls simply did not have a competitive advantage in breaking the

long-established relationships between commercial customers and their banks. However, S&Ls did have a competitive advantage with real-estate developers and builders because of the S&Ls history of selling mortgages. Many S&Ls worked with home developers to supply financing to new homebuyers. After deregulation, it was natural for S&Ls to branch further into real estate by lending money directly to real-estate developers and homebuilders.

Competition for deposits was largely interest-rate driven. Commercial banks and S&Ls offered federal insurance up to $100,000 on individual deposits and the insurance aspect of deposits gave customers little reason to prefer one depository institution to another. Of course, institutions competed fiercely for customer deposits by offering incentives like free checking and interest-bearing checking accounts. While depository institutions generally could expect a core portion of deposits to remain with the institution no matter what the interest rate, to obtain new deposits they had to offer competitive interest rates. Additional competition for deposits came from credit unions and brokerage houses.

LSL's Strategic Reorientation

In late 1984, American Continental Corporation (ACC), primarily a real-estate developer located in Phoenix, Arizona, acquired LSL and made Phoenix the headquarters location for both companies. In the early 1980s, ACC had participated in a number of successful real-estate developments in and around the Phoenix area. Phoenix's phenomenal growth in population and business relocation drove ACC's early success. This growth created tremendous opportunities to buy and develop real estate for commercial and residential use.

The business combination brought changes to LSL's and ACC's strategies. ACC's brand equity as a real-estate developer, relationships with builders, and real-estate development expertise could help LSL rapidly develop its commercial lending business. In addition, LSL's brand equity as a residential mortgage lender, lending expertise, and base of core deposits could help ACC expand its real estate development activities by integrating the financing function into core business activities.

After the acquisition of LSL, ACC merged its real-estate development operations into subsidiaries of LSL. With that move, more than 95 percent of ACC's investments came under the LSL corporate umbrella. Essentially, ACC/LSL was a wholesaler of partially developed land, much as ACC had been before the acquisition. ACC's main expertise was in purchasing undeveloped land, obtaining the necessary zoning and building authorizations, and developing the necessary infrastructure such as roads. Then, ACC would sell the land to builders. In late 1985, ACC/LSL sold approximately 50 percent of its mortgage loan portfolio to another S&L. The proceeds from the sale were invested into LSL's real-estate subsidiaries and used to fund loans made to real-estate developers.

Top management of ACC and the board of directors included Charles Keating Jr., a real-estate developer with over 20 years experience who owned and operated ACC, and Keating's family members and close friends. Keating, who had started ACC in Ohio in 1978 and moved the business to Arizona just prior to Arizona's real-estate boom in the early 1980s, controlled the board and, thereby, the company's strategic direction. Keating had a very strong personality and oversaw the day-to-day operations of both companies. Often, he would lure promising employees away from competitors by not only paying above market salaries but also by offering a substantial amount of cash as a signing bonus. As a result, top-level employees for ACC and LSL were paid very well by industry and Phoenix standards.

LSL's Operations[1]

Deposits. LSL obtained deposits from two sources: individuals and brokers. Its 30 branch offices pursued deposits from individuals by offering certificates of deposit, interest-bearing checking, and interest-bearing savings accounts. Also, LSL obtained brokered deposits from individuals and institutions throughout the United States. Brokers (much like stockbrokers) solicited these deposits and LSL paid a commission to them. Brokers allowed customers to deposit amounts up to the maximum insurable amount ($100,000) in different federally insured depository institutions. By depositing no more than $100,000 in any individual institution, the depositor could insure against loss of principle.[2] After its acquisition by ACC, LSL significantly increased its deposit base by pursuing brokered deposits. In fact, brokered deposits made up a substantial portion of LSL's deposits by the end of 1987 and enabled LSL to expand its investment and loan portfolios significantly.[3]

Loans. By the end of 1987**,** 80 percent of LSL's loan portfolio consisted of approximately 100 commercial loans to real-estate developers, while the remaining 20 percent consisted of traditional mortgages issued prior to ACC's purchase of LSL. Approximately 80 percent of the commercial loans were secured by real estate, while the remaining 20 percent were unsecured. Customers generally used a majority of their loan proceeds to fund real-estate development and construction costs. LSL estimated borrowers used approximately 20 percent of their real-estate loans for working capital purposes.

LSL also made a number of loans in conjunction with sales of real estate by its real-estate subsidiary. These loans were called carryback notes. It was common in the real-estate industry for the seller to accept notes for a portion of the purchase price. SFAS 66, "Accounting for Sales of Real Estate" provides authoritative guidance on the recognition of gains from real-estate transactions when a note is received as partial payment. Under certain conditions SFAS 66 requires gains on sales of real estate involving notes to be deferred until cash is received.

LSL typically refinanced the loans made in connection with real-estate sales. In almost every case, loans made in connection with 1986 real-estate sales were refinanced in 1987. In addition, the real-estate buyers received additional construction and working capital loans during 1987. To remain in compliance with SFAS 66, LSL was careful not to refund the 25 percent down payment when it restructured the loans.

As CEO, Keating made most of the loan decisions in 1987. It was not uncommon for loans to be granted by him before they were formally approved by LSL's loan committee. The required documentation would be gathered after the fact. For each loan made by an S&L, federal

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[1] LSL's 1986 and 1987 balance sheets are included in the attached tables. Balance sheets for Home Savings and Loan, a California S&L, are included for comparative purposes. Although Home Savings and Loan was larger, its financial statements are typical of an S&L in 1987.

[2] The Federal Savings and Loan Insurance Corporation (FSLIC) insures deposits for each individual customer at a given S&L up to a maximum of $100,000. To obtain insurance on deposits greater than $100,000, a customer must set up several accounts in different S&Ls. For example, one customer with two 5-year certificates of deposit each worth $100,000 at the same S&L would only have insurance of $100,000. However, if each CD were placed at a different S&L, both CDs would be fully insured.

[3] A summary of LSL's 1987 year-end deposits is included in the attached tables. A comparison of the 1987 year-end deposits for Home Savings and Loan also is included.

regulations required detailed documentation supporting the decision be maintained in a loan file. LSL maintained loan files for each of its outstanding loans.

Interest Rate Management. LSL had a small group of employees who monitored market interest rates for deposits. This group was responsible for ensuring LSL remained competitive for certificates of deposit and brokered deposits. The group monitored interest rates on deposits in the local California branch market and in other geographic markets around the nation. LSL authorized the group to raise rates for new deposits in response to competition.

Securities Investments. LSL operated a securities trading subsidiary dedicated to managing its investments in publicly traded securities. Based on federal rules enforced by the Federal Home Loan Bank Board (FHLBB), a large portion of LSL's investments were restricted to mortgage-backed or government-backed securities that included Government National Mortgage Association securities (GNMAs) and U.S. treasury bonds. LSL would attempt to take advantage of interest rate fluctuations to capture trading gains on the sale of these securities. When interest rates decline, prices of GNMAs and U.S. treasury bonds increase, and vice versa. To realize gains, LSL would sell its investments in GNMAs and U.S. treasury bonds when interest rates decline. When interest rates increase, LSL would purchase these same securities in anticipation of future interest rate declines. LSL was an active trader in these securities with both portfolios turning over more than 17 times in 1987.

Approximately 20 percent of LSL's securities portfolio consisted of investments in high-risk/high-return corporate debt called "junk bonds." Corporations issued these bonds to finance restructurings or expansions. Junk bonds typically carried coupon rates well above rates on government or high-grade corporate bonds. Investment bankers introduced junk bonds to the market in 1985 and they became very popular with issuers and investors by 1987.

Real-estate Investments. LSL also generated a significant amount of income from its real-estate subsidiaries, which invested in a variety of real-estate projects ranging from hotels and apartments to undeveloped land. LSL's largest investments were in undeveloped raw land, the largest of which were two adjacent properties—Estrella and Hidden Valley. These properties were two 10,000-acre parcels located 25 miles southwest of Phoenix. LSL planned to develop them into a master-planned community.

Estrella/Hidden Valley. The Estrella/Hidden Valley development started in 1985 when LSL acquired the land in a series of transactions. LSL paid an average of $3,000 per acre for the land and, after acquisition, worked with local governments to obtain the necessary zoning and building permits. In addition, LSL put into place a limited infrastructure in Estrella consisting of a few roads, while Hidden Valley remained accessible only by four-wheel drive vehicles. LSL planned to develop Estrella first and then, approximately ten years later (about 1997), to develop Hidden Valley. LSL expected the completed development to contain 50,000 homes and over 200,000 people. The plans also included some commercial development, especially facilities to serve the expected population (e.g. grocery stores, gas stations, etc.). By the end of 1987, LSL had incurred approximately $100 million in costs for the Estrella/Hidden Valley investments. Most of the cost was in the Estrella investment, with some minor zoning costs allocated to Hidden Valley. The $100 million investment cost included capitalized interest on both projects in accordance with measurement criteria set forth in SFAS No. 34. LSL used the interest rate it paid on brokered deposits to estimate the cost of capital and reduced its reported interest expense by capitalizing this interest.

The real-estate market in Arizona and the Phoenix area was very strong in the early to mid-1980s. However, by 1986 the market had begun to slow down.[4] During 1987, LSL sold seven parcels of land from the Hidden Valley development, most of which were sold to homebuilders. The average acreage and selling price on these seven parcels ranged from 500 to 1,000 acres and $14,000 to $17,000 per acre. In each transaction, the buyer made a down payment in cash equal to 25 percent of the purchase price with the remainder in carryback notes payable to LSL. These notes ranged from 6-20 years, had stated interest rates of between 8-12 percent, and required annual payments of principal and interest in equal installments.

Regulation. The regional FHLBB bank located in San Francisco supervised LSL's compliance with federal regulations. S&Ls are required to maintain a minimum level of "regulatory" capital. Regulatory capital (similar to the book value of equity) is calculated using a complex formula based on an institution's investment mix, term structure of liabilities (deposits), and size. In 1987, the FHLBB raised the capital requirement to 6 percent of assets due to concerns about the financial health of the industry and to bring the requirements in line with the capital requirements for banks. Prior to the start of 1987, LSL had regulatory capital of approximately 4.5 percent of assets. Similar to other S&Ls, it had to reach the 6 percent threshold within six years.

FHLBB Audit Report. During 1987, the FHLBB completed an audit of LSL's financial condition and operations. The preliminary FHLBB audit report raised three concerns about the institution.

Auditors cited LSL for:

- failing to maintain complete loan files
- investing in real estate at rates higher than allowed by direct investment regulations enacted during 1985
- having too much high-risk debt.

For the first citation, auditors found that many files lacked sufficient documentation to support the issuance of a loan. For example, a number of loan files did not contain appraisals on land used as collateral. For the second citation, LSL strongly disagreed on the grounds that it was grandfathered under the old rules with which it did comply. Finally, for the third citation, LSL stated that it met the regulations concerning its investments and that the FHLBB was not taking into account LSL's success in managing its real estate and high-risk debt investments.

LSL was not required to take any action on these matters until a final report was issued. In the interim, LSL had the right to negotiate and/or object to the contents of the report. The final FHLBB report had not been issued by year-end 1987. LSL reviewed the preliminary report and raised a number of objections to its contents. Also, LSL believed that the FHLBB auditors did

[4] For a more complete picture of the Arizona real-estate market in 1987, see "Arizona's Economy," published in July 1987 by the University of Arizona's College of Business and Public Administration. The publication includes Arizona's economic data compiled from public sources. A table from the periodical that summarizes key real-estate economic indicators is included at the end of the case.

not understand its business because it no longer operated as a traditional S&L dependent on residential mortgages for income. LSL appealed the report to the main office of the FHLBB in Washington, D.C. and contacted a number of congressmen from California, Arizona and Ohio to intervene on its behalf.

Comparative LSL and Home Savings and Loan Income Statements

LSL Income Statement —1986 and 1987:

Revenues:	1987	% to Total Revenue	1986	% to Total Revenue
Real-estate sales	220,924	31%	296,039	35%
Interest and fees on loans	162,275	23%	134,450	16%
Interest and fees from mortgage banking operations	29,604	4%	87,873	10%
Interest and dividends on investment securities	135,937	19%	134,906	16%
Gains on sales of securities and loans	102,663	14%	73,477	9%
Other income	66,882	9%	125,707	15%
Total revenue	718,285	100%	852,452	100%
Expenses:				
Cost of real -estate sales	139,364	19%	216,157	25%
Interest expense	-		-	
Savings deposits	210,314	29%	198,825	23%
Mortgage banking operations	29,703	4%	74,651	9%
Borrowed funds	102,721	14%	102,023	12%
Selling and administrative expense	154,002	21%	126,146	15%
Provision for losses	20,536	3%	32,496	4%
Other	35,657	5%	58,720	7%
Total expenses	692,297	96%	809,018	95%
Earnings before tax	25,988	4%	43,434	5%
Tax on earnings	12,612	2%	12,601	1%
Earnings from continuing operations	13,376	2%	30,833	4%

Home Savings and Loan Income Statement —1986 & 1987:

Revenues:	1987	% to Total Revenue	1986	% to Total Revenue
Real -estate sales	22,888	1%	8,536	0%
Interest and fees on loans	2,080,022	81%	2,102,753	71%
Interest and fees from mortgage banking operations	79,178	3%	71,343	2%
Interest and dividends on investment securities	275,362	11%	442,095	15%
Gains on sales of securities and loans	112,081	4%	293,902	10%
Other income	8,623	0%	59,153	2%
Total revenue	2,578,154	100%	2,977,782	100%
Expenses:				
Cost of real-estate sales	22,748	1%	9,393	0%
Interest expense	-		-	
Savings deposits	1,356,127	53%	1,503,561	50%
Mortgage banking operations	-		-	
Borrowed funds	277,099	11%	153,762	5%
Selling and administrative expense	612,039	24%	616,091	21%
Provision for losses	26,216	1%	27,799	1%
Total expenses	2,294,229	89%	2,310,606	78%
Earnings before tax	283,925	11%	667,176	22%
Tax on earnings	109,064	4%	209,951	7%
Earnings from continuing operations	174,861	7%	457,225	15%

Balance Sheets
December 31, 1986 and 1987

	1987	% of Total Assets	1986	% of Total Assets
Cash	223,811	4%	125,292	3%
Securities purchased under agreements to resell	45,075	1%	255,789	6%
Investment securities - equity	169,070	3%	97,457	2%
Investment securities - debt	1,358,165	27%	1,221,676	27%
Mortgage-backed certificates	504,822	10%	318,526	7%
Mortgage and other loans receivable	1,170,196	23%	987,827	22%
Mortgage loans accounted for as real-estate investments	69,757	1%	97,714	2%
Other receivables	154,448	3%	261,832	6%
Real-estate investments	820,637	16%	714,117	16%
Investments in unconsolidated affiliates	60,525	1%	87,516	2%
Property, plant, and equipment	292,173	6%	163,703	4%
Prepaid expenses	120,266	2%	130,503	3%
Excess of cost over net assets acquired, net	106,252	2%	109,184	2%
Total assets	5,095,197		4,571,136	
Saving deposits	3,374,531	66%	2,821,375	62%
Short-term borrowings	364,669	7%	73,796	2%
Accounts payable	112,810	2%	115,296	3%
Long-term debt	814,505	16%	1,241,879	27%
Policyholder liabilities	182,897	4%	172,247	4%
Deferred income taxes	16,122	0%	17,952	0%
Total liabilities	4,865,534		4,442,545	
Minority interest in hotel operations	92,902			
Preferred stock	54,943	1%	40,225	1%
Common stock	176	0%	123	0%
Capital in excess of par value	11,261	0%	19,530	0%
Marketable equity securities reserve	(21,264)	0%	(8,597)	0%
Retained earnings	109,924	2%	96,899	2%
Deferred compensation	(17,000)	0%	(18,500)	0%
Less treasury stock	(1,279)	0%	(1,089)	0%
Total stockholders' equity	136,761	3%	128,591	3%
Total liabilities and stockholders' equity	5,095,197		4,571,136	

Home Savings and Loan
Balance Sheets
December 31, 1986 and 1987

	1987	% of Total Assets	1986	% of Total Assets
Cash	2,977,654	10%	2,214,140	8%
Securities purchased under agreements to resell	414,769	1%	1,329,229	5%
Investment securities - equity	-	0%	68,494	0%
Investment securities - debt	-	0%	2,222,632	8%
Mortgage-backed certificates	3,133,728	10%	976,933	4%
Mortgage and other loans receivable	21,625,192	71%	18,680,570	68%
Mortgage loans accounted for as real-estate investments	-	0%	-	0%
Other receivables	450,810	1%	149,193	1%
Real-estate investments	432,905	1%	314,718	1%
Investments in unconsolidated affiliates	-	0%	-	0%
Property, plant, and equipment	584,435	2%	469,725	2%
Prepaid expenses	347,316	1%	652,782	2%
Goodwill, net	489,411	2%	513,878	2%
Total assets	30,456,220		27,592,294	
Saving deposits	22,432,669	81%	21,687,190	79%
Short-term borrowings	3,000,596	3%	605,135	2%
Accounts payable	3,026,949	10%	3,388,076	12%
Long-term debt	-	0%	-	0%
Policyholder liabilities	-	0%	-	0%
Deferred income taxes	230,730	1%	234,475	1%
	28,690,944		25,914,876	
Minority interest in hotel operations	-			
Preferred stock	-		-	0%
Common stock	985	0%	979	0%
Capital in excess of par value	446,515	1%	440,745	2%
Marketable equity securities reserve	(3,069)	0%	40	0%
Retained earnings	1,327,952	4%	1,248,530	5%
Deferred compensation	(7,107)	0%	(12,876)	0%
Less treasury stock	-	0%	-	0%
Total stockholders' equity	1,765,276	6%	1,677,418	6%
Total liabilities and stockholders' equity	30,456,220		27,592,294	

Comparative Summary of Deposits

Lincoln Savings and Loan —Deposits:

	1987		1986		1985	
	Rate	Amount	Rate	Amount	Rate	Amount
Passbook	5.50%	43,985	5.50%	61,958	5.50%	54,434
NOW accounts	5.21%	110,745	5.21%	120,562	6.46%	121,981
Money market savings accounts	6.37%	354,882	5.25%	63,094	6.70%	69,835
Total demand deposits		509,612		245,614		246,250
Certificates of deposit						
Retail	9.48%	2,730,884	9.64%	2,435,867	10.47%	2,005,130
Jumbo	7.95%	134,035	7.73%	139,894	8.80%	155,578
		2,864,919		2,575,761		2,160,708
Total deposits		3,374,531		2,821,375		2,406,958
Weighted-average interest rate		8.90%		9.17%		9.94%

Home Savings and Loan – Deposits:

	1987		1986		1985	
	Rate	Amount	Rate	Amount	Rate	Amount
Passbook	4.43%	786,647	5.25%	1,284,310	5.50%	806,497
NOW accounts	5.23%	1,683,922	5.21%	1,583,844	6.46%	912,757
Money market savings accounts	5.51%	4,917,547	5.25%	4,729,911	6.70%	4,518,891
Total demand deposits		7,388,116		7,598,065		6,238,145
Certificates of deposit						
Retail	7.65%	13,768,701	7.21%	13,369,545	8.20%	11,747,546
Jumbo	7.90%	1,275,852	6.16%	719,580	8.80%	1,436,313
		15,044,553		14,089,125		13,183,859
Total deposits		22,432,669		21,687,190		19,422,004
Weighted-average interest rate		6.90%		6.49%		7.70%

Key Economic Indicators of the Real- estate Industry in Arizona 1985-1987
Source: Economic and Business Research Program at *The University of Arizona*

Date		Residential Construction Awards ($000s)	Change from Prior Year	Change (%)	Employment Construction (000s)	Change from Prior Year	Change (%)
1st Quarter	1985	$828,786	($177,879)	-17.7%	315.4	51.0	19.3%
2nd Quarter	1985	1,060,524	12,097	1.2%	336.2	49.0	17.1%
3rd Quarter	1985	944,371	65,294	7.4%	347.0	42.8	14.1%
4th Quarter	1985	894,480	109,762	14.0%	346.7	39.0	12.7%
1st Quarter	1986	884,504	55,718	6.7%	335.2	19.8	6.3%
2nd Quarter	1986	1,134,933	74,409	7.0%	346.8	10.6	3.2%
3rd Quarter	1986	881,318	(63,053)	-6.7%	346.0	-1.0	-0.3%
4th Quarter	1986	760,379	(134,101)	-15.0%	328.7	-18.0	-5.2%
1st Quarter	1987	730,091	(154,413)	-17.5%	307.6	-27.6	-8.2%
2nd Quarter	1987	777,276	(357,657)	-31.5%	312.8	-34.0	-9.8%
3rd Quarter	1987	820,875	(60,443)	-6.9%	313.5	-32.5	-9.4%
4th Quarter	1987	546,404	(213,975)	-28.1%	304.7	-24.0	-7.3%

Date		Units Authorized	Change from Prior Year	Change (%)	Net Migration (000s)	Change from Prior Year	Change (%)
1st Quarter	1985	7,962	(902)	-10.2%	22.785	3.611	18.8%
2nd Quarter	1985	9,068	741	8.9%	22.216	3.150	16.5%
3rd Quarter	1985	8,708	1,945	28.8%	22.310	1.584	7.6%
4th Quarter	1985	6,263	155	2.5%	23.422	1.212	5.5%
1st Quarter	1986	7,795	(167)	-2.1%	24.924	2.139	9.4%
2nd Quarter	1986	10,612	1,544	17.0%	24.252	2.036	9.2%
3rd Quarter	1986	8,458	(250)	.9%	16.076	-6.234	-27.9%
4th Quarter	1986	6,114	(149)	-2.4%	17.335	-6.087	-26.0%
1st Quarter	1987	7,645	(150)	-1.9%	18.375	-6.549	-26.3%
2nd Quarter	1987	8,098	(2,514)	-23.7%	17.858	-6.394	-26.4%
3rd Quarter	1987	6,770	(1,688)	-20.0%	11.207	-4.869	-30.3%
4th Quarter	1987	4,976	(1,138)	-18.6%	12.411	-4.924	-28.4%

Case Document Day Two, Part I:

Evaluation of LSL's Real-Estate Transactions

You have now learned about LSL's business strategy, some of the business processes LSL used to implement its strategy, and some of the risks involved in implementing that business strategy in the economic environment at that time. At this time, you will analyze the two transactions described below using that knowledge and using the measurement criteria set forth in SFAS No. 66 "Accounting for Sales of Real Estate." After completing your analysis, you will evaluate the procedures LSL's auditors used to assess these transactions.

Wescon Transaction

On March 31, 1987, AMCOR, an LSL real-estate subsidiary, sold 1,000 acres of Hidden Valley to West Continental (Wescon) for $14.0 million. AMCOR had acquired this land 12 months earlier for $3.0 million. After closing the sale, AMCOR recorded an accounting gain of $11.0 million. The terms of the sale were that in exchange for the 1,000 acres of Hidden Valley land, AMCOR received from Wescon:

- $3.5 million in cash
- $10.5 million non-recourse note at a 10 percent fixed interest rate.

The non-recourse note required annual payments of principal and interest of $2.4 million over a six-year period. In the event of default, the non-recourse provision restricted AMCOR to repossessing the land. AMCOR could not pursue payment from Wescon or its partners on default on the loan. At the time of the purchase, Wescon had a net worth of $100,000, with approximately $200,000 in total assets—primarily a few home sites. Prior to the purchase, Wescon had participated in a small number of home-building projects and in an occasional development project. The dollar value of its largest development project prior to the purchase from AMCOR was about one-fourth the size of the cost of land it acquired from AMCOR.

To finance the purchase, Wescon received a loan for the $3.5 million down payment from Mr. E. C. Garcia, whose company invested in a number of different projects ranging from auto dealerships to real estate. Garcia's loan to Wescon was secured by a second trust deed (much like a second mortgage) on the Hidden Valley property purchased by Wescon. On March 31, 1987, the same day that Wescon purchased the Hidden Valley property, Garcia received a loan from LSL in the amount of $20.0 million. The loan documents supplied by Garcia suggested that stock in his company constituted adequate collateral for the $20 million loan that would be used to buy out a minority shareholder in his company. Garcia personally guaranteed the $20.0 million loan and also pledged the stock he repurchased in his company as collateral. LSL disbursed the $20.0 million directly to the minority shareholder.

Emerald Homes Transaction

On September 30, 1987, AMCOR bought four pieces of multi-family and commercially-zoned real estate located in the metro-Phoenix area from Emerald Homes (EH) for a total of $14.6

million, of which $6.3 million was paid in cash and $8.3 million in notes payable. On the same date, AMCOR sold two parcels of undeveloped land to EH for a total of $26.1 million, of which $6.5 million was received in cash and the remaining $19.6 million in non-recourse notes. One of these parcels was located in Hidden Valley. The terms of the notes required principal and interest payments due each October for 20 years at a fixed interest rate of 10 percent. AMCOR recorded an accounting gain of $9.6 million on the sale of the two parcels.

In a memo outlining the reasons for the sale of the Hidden Valley portion of the land, Keating stated that he was especially happy to have EH on board with the Hidden Valley development. EH had a well-established track record building and marketing homes in California and Tucson, Arizona. Keating felt that selling land to EH sent a strong signal to other homebuilders that Estrella and Hidden Valley were high-quality properties.

On September 23, 1987, EH received a $25 million loan from LSL. The loan proceeds were used to repay existing debt with other entities ($10 million), for debt repayment over the next year ($5 million) and for working capital ($10 million). To repay this debt, EH expected that in late 1988 substantial cash flows would be realized from sales of homes in another development located just outside of San Diego, CA.

Case Document Day Two, Part II:

Clinical Analysis of the Audit Procedures Applied to LSL

Audit Procedures Applied by LSL's Auditors to Wescon

The audit team concluded that immediate recognition of the entire gain from the Wescon transaction was appropriate under SFAS 66. Work paper documentation and other information indicated that the auditors relied on the transaction's structure to conclude that full profit recognition was appropriate under SFAS 66. The documentation indicated that the down payment was 25 percent of the sales price ($3.5/$14 = 25%), which met the SFAS 66 initial investment criteria, and that the payment terms met the SFAS 66 payback criteria (less than 20 years). The work papers did not address the collectibility of the non-recourse note. However, in a deposition the audit principal stated that the auditors expected Garcia to step in and protect his $3.5 million interest in the property if Wescon could not make the payments.

The auditors explicitly considered whether LSL was indirectly financing the down payment through the $20.0 million loan to Garcia. The stated purpose of LSL's $20.0 million loan to Garcia was for him to repurchase stock from a minority shareholder in his company. The auditors decided that the repurchased stock in Garcia's company and his guarantees acted as *collateral* for the loan, and the work papers included documentation indicating that the loan proceeds were dispersed directly to the minority shareholder. The auditors also received a confirmation from Garcia stating the terms of his $3.5 million loan to Wescon. In determining whether the full gain on the sale of real estate to Wescon should be recognized, the auditors relied on Garcia's confirmation and on the evidence that the proceeds of the $20.0 million LSL loan were dispersed to repurchase stock. The auditors concluded that LSL did not indirectly finance the Wescon down payment via loans from LSL to Garcia and that the gain should be recognized in full.

Audit Procedures Applied by LSL's Auditors to the Emerald Homes Transaction

There appears to have been some confusion on the part of the auditors as to which accounting standard applied to this transaction. The work papers contain a SFAS 66 analysis of the sale but the audit principal stated EITF 86-29, "Accounting for Certain Nonmonetary Transactions," was used for the analysis. Available work papers only mentioned that the EITF was discussing similar transactions at the time of the audit.[5] The auditors' SFAS 66 work papers document that the down payment ($6.5/$26.1= 25%) and terms (payment in less than 20 years), in form, met the SFAS 66 criteria. The work papers also indicate that the auditors explicitly considered the possibility that LSL indirectly financed the transaction via the cash portion of AMCOR's land purchase from EH or via the $25 million loan. As part of the evaluation, the auditors obtained a confirmation from EH stating that neither the proceeds from the loan nor the cash on the sale were used to finance the down payment to AMCOR. The following is taken directly from the confirmation:

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[5] The EITF discussed nonmonetary transactions involving boot in its 86-29 and 87-29 abstracts. The 86-29 abstract was issued at the time of the 1987 audit but the 87-29 abstract was still under discussion.

> While our operating cash is not segregated as to use or source, there was sufficient cash available to Emerald Homes to fund the down payment on this purchase independent of the funds received from the $25M Subordinate Loan from Lincoln Savings and land sales proceeds received from AMCOR investments.

In addition to relying on the confirmation from EH, the auditors' enumerated EH's intended use of the $25 million loan; $15.0 million would be used to retire debt and the remaining $10.0 million for "working capital and possible California land acquisition." The auditors concluded that the $25 million did not constitute an indirect financing because EH did not use any of the money to directly fund the down payment. To determine whether LSL indirectly financed the EH sale through AMCOR's land purchase from EH, the auditors traced the cash to and from escrow. The work papers document that $1.4 million of the $6.3 million transferred by AMCOR to escrow was transferred back to AMCOR as part of the $6.5 million payment by EH. In waiving a proposed adjustment related to the $1.4 million, the auditors added a note to the work papers stating: "Transferred as a means of convenience by the escrow company according to the client."

The auditors received an appraisal of $16.6 million for one of the two parcels sold to EH. The appraisal price gave further evidence of the transaction's validity. This parcel was not part of Estrella or Hidden Valley. The accounting gain from this portion of the sale was $2.3 million. However, the auditors did not obtain an appraisal on the second piece of land that was sold for $9.5 million, a sale that generated a gain of $7.3 million. This second parcel was part of Hidden Valley.

The audit principal stated that they (the auditors) relied on EITF 86-29 "Accounting for Certain Nonmonetary Transactions" to evaluate the appropriateness of revenue recognition on this transaction. EITF 86-29 allows recording transactions at the fair market value of the property exchanged if boot exceeds 25 percent of the fair value of the transaction. In form, the net monetary asset of $11.5 million received in this case, or the boot, was well in excess of 25 percent, thus, meeting the criteria for recording at fair value. According to the deposition of the audit principal, the $25 million loan was not relevant in assessing revenue recognition under EITF 86-29. The auditors concluded that the $9.6 million recorded accounting gain on the sales to EH should be recognized in full.

Additional Audit Procedures Applied by LSL's Auditors to All Real-estate Transactions

In addition to the detailed examinations of the previously discussed transactions, the auditors performed other procedures on LSL's real estate activities that are best described as high-level analytical procedures. For each of the seven LSL sales of Hidden Valley land, the auditors considered whether the accounting for the sales complied with SFAS 66. Also, they compared the selling prices per acre for the seven sales, which ranged from $14,000 per acre to $17,500 per acre. The comparison of the seven sales suggested to the auditors that the selling prices did not appear unreasonable. The work papers do not indicate how the auditors made their determination to rely on these analyses in reaching their conclusions.

The auditors also identified all the parties with which LSL had a large number of transactions in 1987 and determined the dollar amounts of the aggregate transactions for each of these parties.

LSL had multiple transactions with all the companies to which it sold Hidden Valley land in 1987. It was not clear from the work papers how the auditors used this listing. The work papers suggested that the list was prepared after the analysis of revenue recognition on the individual transactions was completed.

Finally, the auditors conducted standard "attention-directing" procedures. These procedures focused on the changes in balance sheet and income statement accounts between years. This fluctuation analysis was used to focus the auditors on areas where significant changes took place. The auditors noted the volume of real-estate sales from this analysis and accordingly planned to review the details of these transactions.