

GAO

United States General Accounting Office
Report to Congressional Committees

July 1991

FEDERAL ASSET
DISPOSITION
ASSOCIATION

No Economic Basis for
Reported Fee Income
Under 1988 Letter
Agreement



Accounting and Financial
Management Division

B-231275

July 29, 1991

The Honorable Donald W. Riegle
Chairman
The Honorable Jake Garn
Ranking Minority Member
Committee on Banking, Housing
and Urban Affairs
United States Senate

The Honorable Henry B. Gonzalez
Chairman
The Honorable Chalmers P. Wylie
Ranking Minority Member
Committee on Banking, Finance and
Urban Affairs
House of Representatives

This report presents the results of our review of a 1988 letter agreement for asset management services between the Federal Asset Disposition Association (FADA) and the Federal Savings and Loan Insurance Corporation (FSLIC). Our review focused on the justification for paying FADA for the services performed under the letter agreement and whether the fees FSLIC paid FADA under the letter agreement were fairly presented in FADA's December 31, 1988, financial statements. This report is addressed to you because of your previous oversight of these entities.

Although these entities have been terminated, the results of our work provide information that should be of interest as you consider deposit insurance reform legislation. The report is especially relevant in considering necessary safeguards in connection with expanded powers for banks. The report points out that related party transactions are subject to abuse, and accounting principles and auditing standards that would help to prevent such abuses are presently inadequate.

Results in Brief

Virtually all of the services FADA performed under the letter agreement were substantially the same as the services that FADA and other private asset managers performed, and were compensated for, under a standard asset management contract with FSLIC. Except for advisory services, we found that the services FADA performed did not justify FSLIC's paying the additional asset management fee under the letter agreement. The letter

agreement served primarily as a means for FSLIC to transfer \$13.2 million to FADA to make up for losses being incurred by FADA.

Corroborating data supporting this conclusion include the statements of other private asset managers that they provided substantially the same services to FSLIC as FADA under the standard management contract and the fact that only FADA was given the letter agreement. Also, FADA's minutes of board of director meetings and other information from former FSLIC personnel indicate that FSLIC set the letter agreement fees to ensure that FADA reported a profit in 1988 and to recapitalize it for prior years' losses.

Substantially all of the additional fees that FADA received under the letter agreement were accounted for as income in its financial statements for the year ended December 31, 1988. Although this accounting treatment reflects the legal form of the agreement, it does not fairly present the reality of the agreement. Recognizing the economic substance of the agreement and treating the amounts received by FADA as contributions to capital would have resulted in a fair presentation of FADA's financial statements. In that case, FADA would have reported a loss of nearly \$9.9 million instead of net income of over \$3.3 million. In concluding on this matter, we found that generally accepted accounting principles are unclear in regard to related party transactions and have resulted in differing views on what is required. In particular, it is not clear that related party transactions are required to be accounted for based on their economic substance when it differs from the transactions' legal form.

Considering the real purpose of the letter agreement, the issuance of an unqualified opinion on FADA's 1988 financial statements by KPMG Peat Marwick and Co., FADA's independent public accountant, results in an inappropriate conclusion that the financial statements are fairly presented. We reviewed the auditor's work and concluded that the auditor failed to follow auditing procedures set forth in Statement on Auditing Standards (SAS) No. 45, which requires that the auditor evaluate the economic substance of related party transactions. However, the applicability of the accounting principle that is the basis for SAS No. 45 is unclear, and, therefore, it is possible that the auditor's opinion does not violate specific technical requirements even though the financial statements are misleading. We recommended in a recent report that the

accounting standard setting bodies clarify the accounting for related party transactions.¹

KPMG Peat Marwick, FADA's independent public accountant; the former Chairman of the Federal Home Loan Bank Board; the former Executive Director of FSLIC; and the former Controller and President of FADA disagreed with our report findings. See the last section of this report, "Comments of Cognizant Officials and Our Evaluation," for their comments and our evaluation. KPMG Peat Marwick's letter is included in appendix III.

Background

In 1985, the Federal Home Loan Bank Board created FADA as a wholly owned subsidiary of FSLIC to assist FSLIC in the management and disposition of acquired assets. FADA's sole purpose, according to its mission statement, was "to help strengthen the financial health of FSLIC by using private sector management and marketing techniques to manage problem assets held by FSLIC at the lowest cost consistent with sound operations and to sell those assets as fast as is consistent with obtaining the best possible return."

FADA provided asset management and disposition services to FSLIC in three ways. First, under contracts with some of FSLIC's liquidating receiverships, it provided asset management and disposition services. Second, under contracts with savings and loan institutions in FSLIC's Management Consignment Program, it also provided asset management services. Third, under contracts directly with FSLIC, FADA provided specified services related to the liquidation process, such as developing a national marketing plan for certain types of assets.

Prior to 1988, FADA and other asset managers operated under individually negotiated contracts. Starting in 1988, FADA's services to FSLIC were provided under a standard asset management contract used for all asset managers and a special letter agreement that provided additional amounts to FADA.

On August 9, 1989, the Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (Public Law 101-73), which required that FADA be terminated. Specifically, Section 501 (a) of the act required that the Resolution Trust Corporation liquidate FADA

¹Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, April 22, 1991).

within 180 days of enactment. FADA was terminated on February 6, 1990, in accordance with the act. In addition, section 401 of the act abolished FSLIC on the date of enactment and provided 60 days for its affairs to be concluded.

Objectives, Scope, and Methodology

Our objectives were to determine (1) whether the asset management fees FSLIC paid FADA for the work FADA performed under the letter agreement for 1988 were justified and (2) whether FADA's December 31, 1988, financial statements fairly presented the funds received from the letter agreement in accordance with generally accepted accounting principles. We performed our work in accordance with generally accepted government auditing standards.

To determine whether the fees FSLIC paid for the work FADA performed under the letter agreement were justified, we

- compared the letter agreement with the standard asset management contract FADA had with FSLIC,
- interviewed various FADA and FSLIC officials that were responsible for drafting the letter agreement,
- examined personal notes and correspondence of FSLIC officials involved in negotiating and drafting the 1988 standard asset management contract and letter agreement,
- examined various FADA and FSLIC internal memorandums concerning the asset management agreements between FSLIC and FADA, and
- interviewed five large private asset management firms about the asset management services they provided to FSLIC receivers under the standard asset management contract.

To address our second objective, we reviewed FADA's December 31, 1988, financial statements and the independent public accountant's workpapers to determine whether the accounting and reporting for the asset management services under the letter agreement were done in accordance with generally accepted accounting principles (GAAP). Also, we assessed whether the independent public accountant's audit was done in accordance with generally accepted auditing standards.

Rationale for the Standard Asset Management Contract and Letter Agreement

Prior to 1988, all contract asset managers individually negotiated their agreements to manage assets for FSLIC. The former FSLIC Deputy Executive Director for Asset Management-Liquidation stated that for 1988, FSLIC decided to have a standard asset management agreement to make the contracting process more efficient to administer. Based on an informal study by FSLIC personnel, it was determined that a standard management fee of 50 basis points (a basis point is one hundredth of one percent) of assets managed was representative of a "market" fee.

In 1988, FSLIC implemented the new standard asset management contract for all entities that contracted with FSLIC to manage the assets of failed savings and loan institutions. The general duties of the contractor under the provisions of the new contract were to take charge of the assets, to prepare business plans for the assets, and to manage and dispose of such assets as provided in the agreement. The new contract, which was approved by the Federal Home Loan Bank Board on March 10, 1988, and made effective for all FADA-managed assets as of January 1, 1988, standardized the asset management fee structure. The contractor's asset management fee depended on the value of the assets managed, with a minimum annual fee of 50 basis points of agreed-upon asset net take-over values—defined as the "dollar amount of the asset on the failed Association's books and records on the receivership date as reduced by any reserves on the Association's books and records on the receivership date."

In addition to the standard asset management contract, FADA also entered into a letter agreement (dated March 14, 1988, retroactive to January 1, 1988) with FSLIC, which provided for an additional 40 basis points of agreed-upon asset net take-over values for certain special internal technical services.

According to a FSLIC memorandum,² the 40 basis point fee was comprised of 10 basis points for advisory services, 20 basis points for legal services, 5 basis points for appraisal services, and 5 basis points for accounting services. The memorandum stated that these services were performed by FADA but were not compensated for within the standard asset management contract.

²This memorandum was from the former Executive Director of FSLIC to the Federal Home Loan Bank Board, dated February 9, 1988, in support of a resolution for adoption of the letter agreement for FADA.

The Federal Home Loan Bank Board resolution which authorized FSLIC to enter into the letter agreement with FADA also authorized FSLIC to enter into similar agreements with other asset managers. Although firms that provided asset management services to FSLIC under the standard contract expressed interest in obtaining the additional letter agreement fees, FSLIC only negotiated a letter agreement with FADA. During our review, representatives of four private asset management firms stated that they approached FSLIC about negotiating agreements similar to the one given to FADA. Each of the four firms stated that FSLIC refused to negotiate any such agreement.

The former Chief Executive Officer of FADA stated that FADA was created because FSLIC management felt that it did not have the corporate resources in the areas of legal review, litigation analysis and avoidance, asset accounting and appraisal, and contracting to provide the general policy evaluation, procedural consistency, and management oversight demanded by its confederate approach to receivership operations. In addition, he stated that FSLIC management felt that FADA, as a wholly owned subsidiary of FSLIC, could provide that support with the best interests of FSLIC in mind. Further, he stated that FADA would have bid under competitive procedures to provide FSLIC asset management services had that been FSLIC management's selected approach. Finally, he believed that FSLIC decided on the services it needed and how to obtain them, based on market studies, comparative cost analyses, and its belief that FADA was a cost-effective way of doing business.

We requested from FADA and FSLIC management any market studies or comparative cost analyses they had done or had done by others that compared FADA to private asset managers to assess whether FADA was the most cost-effective way to manage and dispose of assets for failed savings and loans. FADA management had no such study. FSLIC management stated that an accounting firm, Touche Ross, had conducted a telephone survey of private asset managers where various hypothetical situations regarding the cost to manage and dispose of assets were presented, and the companies were asked to respond as to what they would charge to provide the services described. FSLIC management stated the survey results were incomplete and inconclusive and that they were not used to determine the asset management fees in the letter agreement.

Analysis of 1988 Letter Agreement Services

According to FSLIC and FADA documents, the fees paid to FADA under the 1988 letter agreement were primarily for (1) advisory services as requested by FSLIC, (2) legal services for initial review of loan and real estate files, title analysis and perfection, drafting and reviewing documents, and attendance at real estate sale closings, (3) appraisal services to review appraisals for propriety of assumptions used and valuations, update and maintain an appraiser data base, and provide consulting services regarding marketing strategies, and (4) accounting services that mainly consisted of authorizing and paying receivership bills for subcontractors.

The nature of the services provided by FADA and its mission were substantially the same in 1987 and 1988, while FADA's asset management fee income increased 49 percent from \$20.4 million in 1987 to \$30.4 million in 1988. The fees received under the letter agreement were the principal cause of this increase in reported income in 1988 compared to 1987. FSLIC did not require FADA to document and report the level or nature of services provided under the letter agreement in 1988. FADA's controller stated that no record exists that documents the level of services provided by FADA to FSLIC under the letter agreement for legal, appraisal, and accounting services. However, records were maintained on the level of advisory services.

The following sections present our analysis for each of the types of services included in the letter agreement and the effect of the fees received on FADA's 1988 financial statements.

Advisory Services

From its inception, FADA was used as an advisor to FSLIC for policy and systems development. The letter agreement stated that FSLIC, in its corporate capacity, retained FADA for such advisory services as FSLIC required from FADA for the calendar year 1988. FSLIC agreed to pay FADA a monthly retainer of one-twelfth of the product of (a) 10 basis points and (b) the net take-over value of all receivership assets under FADA's management at the end of each preceding month. The letter agreement also stated that to the extent FSLIC, in its corporate capacity, enters into task orders with FADA pursuant to existing procedures, the fees payable under such task orders shall be applied against the annual retainer and no fees shall be paid to FADA until the retainer is fully exhausted. The letter agreement did not address what FADA should do with any retainer amounts held at the end of 1988 in excess of the fees earned for completing task orders for FSLIC.

We reviewed FADA's documentation for the nature and level of advisory services it performed in 1988 and found that FADA provided advisory services for development of a participation loan data base, property insurance review, and consulting fees on a receivership. FADA's former president and controller identified \$406,000 of advisory services in 1988, which included \$112,000 of costs from subcontractors. However, under the letter agreement, FADA recorded a full retainer of \$3.5 million for these services. Rather than record the unearned retainer as a liability owed to FSLIC as would normally be required by generally accepted accounting principles, FADA recorded approximately \$3.1 million in fee income for advisory services in excess of its fee billings to FSLIC.

FADA was a wholly owned subsidiary of FSLIC. For FSLIC to pay a retainer to an entity over which it had complete control is unusual and seemingly unnecessary. In general, a firm pays an unrelated party a nonrefundable retainer to hold resources available for a specified period. However, FSLIC could have exercised its corporate control to hold FADA's resources available without paying a nonrefundable retainer. Since FADA did not report the unearned retainer as a liability, the only remaining accounting treatment for the \$3.1 million is paid-in capital.

Legal Services

The general duties of each asset manager under FSLIC's standard asset management contract included taking charge of assets, preparing business plans, and managing and disposing of assets. FSLIC personnel responsible for contracting identified the six primary private asset management firms which managed FSLIC receiver assets. We contacted representatives from five of the firms to discuss the duties they performed. The other firm was in bankruptcy so we did not contact it. The five firms generally handled routine legal matters in-house (for example, reviewing documents, helping to develop business plans and negotiation strategies, and documenting asset sales) and referred significant legal issues to outside counsel paid by the receivers. Each firm we spoke with said that handling the routine legal questions in-house was an incidental and necessary part of its function as a FSLIC asset manager. Each firm stated that it maintained in-house attorneys to assist its asset managers in handling these issues, varying from attorneys assigned to asset management teams to attorneys at senior management levels.

In 1988, FADA and the private firms had the same general duties as asset managers for FSLIC receivers. However, the letter agreement provided FADA with additional compensation for performing the same type of general in-house legal services performed by the private asset managers

under the standard asset management contract. Also, FADA, like the private firms, referred the significant legal issues concerning its assigned assets to receivers' outside counsels. For example, a FSLIC review of the legal services paid for under the 1988 letter agreement specifically approved FADA's practice of referring "the more detailed and complex involvement in time-consuming legal areas" to the receivers' counsels.

Based on private industry practices, we would expect that additional compensation for FADA's legal services would be reasonably related to either FADA's additional costs or the amount of legal work done by FADA over that done by private asset managers. Further, FADA appears to have been providing essentially the same type of legal services as other asset managers, and, therefore, any fee for FADA's additional legal work should be marginal in comparison to its asset management fee. However, the additional 20 basis points paid to FADA for legal services under the letter agreement in effect raised its 50 basis point asset management fee by 40 percent. FSLIC documents discussing the amount of the legal services fee stated that FADA had determined in a study that a 20 basis point fee would compensate FADA for its legal services. Although we asked for a copy of this study, neither FSLIC nor former FADA officials provided it to us. After reviewing all of the evidence available to us, we were unable to discern a distinction between the type of legal services provided by FADA and the private asset managers which would justify paying FADA 20 basis points more than the fee provided in the standard asset management agreement.

Appraisal Services

We interviewed five of the six primary private asset managers identified by FSLIC who contracted with FSLIC during 1988 regarding what appraisal services they provided for the assets they managed. Neither FADA nor other private asset managers prepared appraisals for assets held in receivership. Appraisal preparation was contracted for with outside appraisers and paid for by the FSLIC receivers. The asset managers stated that they performed the same types of appraisal services done by FADA at no cost to FSLIC receivers as part of the service they provided under the standard asset management contract. While each of them stated they did not develop a national data base of appraisers as FADA did, the private asset managers stated they identified certified appraisers when needed or used appraisers identified by FSLIC to assist them. Therefore, we were unable to justify the payment of an additional fee of 5 basis points to FADA for appraisal services under the letter agreement.

Accounting Services

Accounting services provided by FADA were primarily authorizing and paying reimbursable costs incurred related to assets managed by FADA for the FSLIC receivers. The five private asset managers we interviewed stated they were responsible for authorizing invoices for payment when they used subcontractors to carry out part of their duties under the standard asset management contract. In mid-year 1988, these duties were taken over directly by the FSLIC receivers. The FSLIC receivers performed these services for non-FADA managed assets and subsequently performed these services for FADA-managed assets as well. FADA's board of director minutes stated that FADA was allowed to pay the subcontractors directly because FADA wanted to have control of this function to ensure that payments were made promptly. However, we can discern no economic basis to justify paying the 5 basis point fee to FADA for performing these services because (1) private asset managers had previously authorized the payments at no extra charge under their asset management contracts with FSLIC receivers and (2) prior to mid-1988, FADA provided accounting services at its own request.

Accounting for the Letter Agreement in FADA's 1988 Financial Statements

FADA's 1988 financial statements include substantial amounts recorded as asset management fee income received as a result of the 1988 letter agreement with FSLIC. Ordinarily, fees received pursuant to a validly executed contract for services, such as the letter agreement purports to be, would be accounted for as income. However, in substance, the letter agreement fees were a capital infusion from FSLIC to its wholly owned subsidiary FADA. FADA received the additional fees while providing substantially the same service as private asset managers, who only received the fees from the standard asset management contract.

The fee income from the letter agreement was the primary reason FADA's 1988 net income increased to \$3.3 million from a net loss of \$7.0 million in 1987. If the \$3.1 million of unearned advisory fees and \$10.1 million for other fees FADA received under the letter agreement were recorded as paid-in capital, FADA's 1988 net income would be reduced from the reported \$3.3 million to a loss of \$9.9 million.

In the course of our review, we found that FADA paid employee bonuses of approximately \$900,000 in 1989 for the year ended December 31, 1988. The former president of FADA stated that a formal bonus plan did not exist and that FADA's board of directors approved the bonuses based on a management presentation to the board. These bonuses were from 2 percent to 20 percent of compensation not to exceed \$20,000 per person.

The former chief executive officer of FADA who signed the letter agreement stated that he excluded himself from bonus consideration and did not receive one. Also, he stated it is doubtful that these bonuses, which were accrued for and expensed in the 1988 financial statements, would have been approved and paid had FADA's financial statements reflected a net loss from 1988 operations.

FADA's 1988 Profit and Other Related Matters

From its inception to December 31, 1987, FADA incurred \$10.6 million in operating losses. As a result of these losses, FADA experienced significant congressional criticism of its operations. Minutes of FADA's board of director meetings (the board included the Acting Director of FSLIC as an ex-officio member) attributed the losses to the level of assets being managed by FADA as lower than what was planned and FADA not being paid for services that it was providing FSLIC as part of its asset management service. According to the minutes, the intent of FADA's 1988 asset management contract was to make it economically viable and ensure that it would operate profitably, and to pay FADA for its special appraisal and legal services. Further, the minutes discuss the reluctance of FADA's Chief Executive Officer designee to accept the position without a contract that would be economically viable and his perception that "in the political arena if FADA made a profit everybody would feel good."

The intent of FADA's board and FSLIC management to ensure that FADA's 1988 contract resulted in FADA showing a profit was further corroborated by a FSLIC official who was directly involved in the negotiation and drafting of the 1988 letter agreement. The official stated that an underlying concern during the 1988 FADA asset management contract negotiations was that FADA needed to be profitable. Further, FADA had to show its critics both in the Congress and in industry that it could do the job and that it was running an efficient ship. Finally, the official stated that there was no historical cost or market basis for the 40 basis point fees in the letter agreement.

When presented with our analysis of the letter agreement services, FADA's former Chief Executive Officer stated that his interest was on cost containment rather than in the significance of the letter agreement, because FSLIC was the sole owner of FADA, and all profits or losses accrued to FSLIC. He stated FSLIC's intent was to acquire FADA's services at cost, and it was through cost reductions under his leadership that FADA benefitted FSLIC. He stated that FADA made a significant turnaround in 1988 with cost reductions and that the 1988 letter agreement did not ensure the profit that was reported. In addition, he stated that had FADA

been managed in the same way as in 1987, prior to his assuming leadership, FADA would have lost money even with the additional income provided by the letter agreement. To support this, he stated that FADA reduced staff from 400 to 250; reorganized its work processes; reduced its lease costs by more than half; and, by dramatically increasing productivity, increased the corresponding disposition fee income paid to FADA for the sale or resolution of receivership assets.

In terms of FSLIC's consolidated financial statements, we agree with the former Chief Executive Officer's statement that the true nature of fees under the letter agreement made no difference. However, the issue in question is whether the fees paid under the letter agreement were in substance a capital contribution or income for reporting in FADA's financial statements. If the intent was to acquire FADA's services at cost, then the contracts with FADA should have been some form of cost reimbursement contracts rather than fee-for-service contracts. The fees received under the letter agreement served to help make up for FADA's prior year losses.

The effectiveness of FADA management's efforts were not apparent from a comparative analyses of costs in FADA's 1988 and 1987 financial statements. This analysis shows (1) operating expenses increased \$3.4 million from \$29.4 million in 1987 to \$32.8 million in 1988, (2) 8 of the 14 operating expenses enumerated in the financial statements increased from 1987 to 1988 with a \$4.1 million increase in compensation being the largest and a \$400,000 increase in occupancy cost being the second largest, and (3) the largest decreases in operating expenses were professional services and executive search fees expense categories seemingly unrelated to the claimed cost reduction effort. While this financial analysis suggests FADA management's actions were not effective in reducing costs in 1988, statements in the FADA board of director's minutes suggest that during 1988 staff was gradually reduced, and some offices were closed.

FADA's 1988 Audit Is Defensible but Statements Are Misleading

In accordance with Federal Home Loan Bank Board regulations, FADA contracted with an independent certified public accounting firm, KPMG Peat Marwick Main & Co., for an audit of its 1988 financial statements. In addition to our review of the 1988 letter agreement, we conducted a review of the auditor's work in accordance with generally accepted government auditing standards. FADA's 1988 financial statements and KPMG Peat Marwick Main and Co.'s opinion thereon are included in this report. (See appendixes I and II.)

In the opinion of KPMG Peat Marwick Main & Co., dated May 25, 1989, FADA's financial statements present fairly its financial position as of December 31, 1988, and the results of its operations and its cash flows for the year then ended, in conformity with generally accepted accounting principles.

Based on our analysis discussed in this report, we believe that FADA's financial statements are misleading. We do not agree with the auditor's opinion that FADA's 1988 financial statements are fairly presented. The financial statements do not reflect that the economic substance of substantially all of the funds FADA received under the 1988 letter agreement was to provide FADA with a capital infusion. Rather, the statements reflect the recording by FADA of the legal form of the 1988 agreement payments as income.

In arriving at its opinion, KPMG Peat Marwick concluded that FADA's financial statements fairly presented the 1988 letter agreement payments in accordance with the disclosure requirements of Financial Accounting Standards Board (FASB) No. 57, "Related Party Disclosures,"³ which is category "a" GAAP.⁴ KPMG Peat Marwick's conclusion assumed that FASB No. 57 was the only accounting rule the auditor was required to consider for related party transactions. However, in conducting our work, we found that some differences of opinion exist among accountants and auditors as to the required accounting for related party transactions. We found that existing GAAP provided very limited guidance for related party transactions. The only specific accounting principle for related parties is FASB No. 57, but it does not address accounting treatment for related party transactions and solely provides disclosure requirements.

In contrast, SAS No. 45 states that "the auditor should be aware that the substance of a particular transaction could be significantly different

³FASB No. 57 for material related party transactions generally provides for a description of the nature of the relationship and the transactions.

⁴In determining whether the financial statements are fairly presented in accordance with generally accepted accounting principles, the American Institute of Certified Public Accountants (AICPA) Professional Standards provide in Statement on Auditing Standards No. 52 for categories a, b, c, and d of established accounting principles. Category "a" principles are those promulgated by a body designated by the AICPA Council to establish such principles, and FASB is the designated body. These principles are considered officially established and are the highest order of GAAP. If the accounting treatment of a transaction is not specified by a pronouncement covered by category "a" principles, the auditor considers, in order, categories "b" and "c," which are also considered official GAAP but less authoritative than category "a" principles. Finally, if a transaction is not covered by the higher orders of GAAP, the auditor may consider category "d," which is the lowest order of GAAP.

from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form." SAS No. 45 cites Accounting Principles Bulletin (APB) Statement No. 4 as the accounting rule that requires such accounting for related party transactions. However, it is uncertain whether APB Statement No. 4, which is category "d" GAAP—the lowest in the hierarchy of GAAP—is applicable. Unlike category "a" GAAP, category "d" is not considered established by a body recognized by the AICPA Council nor is an accountant required to justify departure from a category "d" accounting principle. Because it is unclear whether related party transactions should be accounted for under APB Statement No. 4, it is also unclear whether SAS No. 45 requires that an auditor ensure that related party transactions be recorded based on their economic substance.

We believe the accounting treatment discussed in APB Statement No. 4, in addition to disclosures as provided for by FASB No. 57, should be required. We also believe that the concept of recording transactions, including related party transactions, based on their economic substance when it differs from their legal form is fundamental to accounting if financial statements are to have utility and reliability. The concept of economic substance over legal form is incorporated in parts of category "a" GAAP. Two examples are APB Opinion 21, which requires that interest be imputed to reflect market rates and FASB No. 13, which requires an assessment of whether a lease is a capital or operating lease.

If APB Statement No. 4 and the provisions of SAS No. 45 for related party transactions were clearly applicable, Peat Marwick should have followed the auditing requirements that require the determination of the economic substance of the transaction. In our view, an auditor who followed those requirements should have concluded that FADA's 1988 financial statements were misleading.

In our April 1991 report on failed banks, we cited similar concerns about the lack of clarity in accounting literature regarding related party transactions. Specifically, we found that authoritative guidance is lacking for (1) identifying the nature and legitimacy of related party transactions and (2) determining accounting treatment when their economic substance differs from the transactions' form. Our banking report highlighted the need for clarification of accounting rules for related party transactions because such rules are important to protect the government's interest as insurer of banks. We recommended that the accounting rules and auditing procedures for related party transactions be enhanced to clarify that these transactions are required to be

accounted for and reported based on their economic substance. Such clarification is relevant to any context where transactions occur between affiliated parties.

Conclusions

We found no apparent valid business reason that FADA should have been paid additional amounts for its services in 1988 because FADA provided essentially the same asset management service as other asset managers that contracted with FSLIC. Based on that conclusion and our review of FADA's board of director minutes, we found that the intent of the 1988 letter agreement for asset management services was to recapitalize FADA and to ensure that FADA showed a profit in 1988, rather than to provide payment for additional services. Therefore, the proper accounting for substantially all of the funds FADA received from the 1988 letter agreement would have been to report the funds as paid-in capital rather than income.

We believe that FADA's 1988 financial statements, together with Peat Marwick Main & Co.'s opinion on the financial statements, did not provide the Congress with a dependable basis for evaluating FADA's 1988 financial performance. FADA's 1988 financial statements were misleading. However, the auditor's opinion could be defended on technical grounds because the auditing and accounting rules for related party transactions are unclear. As in the case of FADA, the fact that basically misleading financial statements can receive an unqualified auditor's report and the auditor not be in violation of existing auditing standards, demonstrates the urgent need for improvements in the accounting rules for related party transactions.

Giving effect to the financial statement adjustments that we believe should be made as a result of our review, FADA's 1988 reported net income should be reduced to a net loss of approximately \$9.9 million rather than the \$3.3 million of net income shown in these statements.

Comments of Cognizant Officials and Our Evaluation

We requested comments on the report from KPMG Peat Marwick (FADA's independent public accountant for 1988), M. Danny Wall (former chairman of the Federal Home Loan Bank Board), and Gerald Carmen (former chief executive officer of FADA). Stuart Root (former executive director of FSLIC) and John Wills (former FADA controller and president—he was appointed president after Gerald Carmen resigned) provided unsolicited comments.

Gerald Carmen did not comment on the report. He advised us that his comments on our findings and conclusions as presented to us during our fieldwork had not changed. His views have been considered as appropriate in the report.

KPMG Peat Marwick disagreed with our findings and stated that it believes that FADA's financial statements fairly presented FADA's financial condition in accordance with GAAP and that its audit was done in accordance with generally accepted auditing standards. We disagree with KPMG Peat Marwick. We do not believe the accounting treatment and disclosures regarding the letter agreement resulted in the fair presentation of FADA's financial position. See appendix III for KPMG Peat Marwick's detailed comments and our related response.

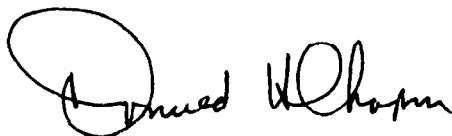
M. Danny Wall did not directly respond but acknowledged that a letter we received from Stuart Root dated December 19, 1990, represented his views on the report. Stuart Root's views on our findings and conclusions as concurred with by M. Danny Wall are (1) FADA's level of legal and appraisal support in its asset management services was significantly greater and more qualitative than any private asset manager, (2) our portrayal of the private asset managers' capabilities is greater than Stuart Root's remembrance of their capabilities based on his 1987 interviews of certain private asset managers, (3) it was necessary for FSLIC to pay FADA for the level of staff it maintained because of the extraordinary service it provided and so that the FADA contract could be used as a benchmark for contracts with private asset managers, and (4) FADA was profitable in 1988 because of effective performance in the areas of cost control and asset dispositions.

The scope of our work did not include an assessment of FADA's qualitative performance nor the need for the number and mix of people employed by FADA and private asset managers. We based our assessment on whether FADA was providing services beyond those required by the standard asset management agreement and those being performed by other private asset managers.

John Wills' comments were consistent with the views expressed by KPMG Peat Marwick and Stuart Root.

We are sending copies of this report to the Director of the Office of Management and Budget, the Secretary of the Treasury, the Director of the Office of Thrift Supervision, the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the Financial Accounting Standards Board, the President of the American Institute of Certified Public Accountants, and the Managing Partner of KPMG Peat Marwick's Washington, D.C., office. We will also make copies available upon request.

This report was prepared under the direction of Robert W. Gramling, Director, Corporate Financial Audits, who may be reached on (202) 275-9406 if you or your staffs have any questions. Other major contributors are listed in appendix IV.

A handwritten signature in black ink, appearing to read "Donald H. Chapin". The signature is fluid and cursive, with a large initial "D" and "H".

Donald H. Chapin
Assistant Comptroller General

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Abbreviations

| | |
|-------|----------------------------------------------------|
| AICPA | American Institute of Certified Public Accountants |
| APB | Accounting Principles Board |
| FADA | Federal Asset Disposition Association |
| FASB | Financial Accounting Standards Board |
| FSLIC | Federal Savings and Loan Insurance Corporation |
| GAAP | generally accepted accounting principles |
| SAS | Statement on Auditing Standards |

Auditor's Opinion

Peat Marwick

Certified Public Accountants

Peat Marwick Main & Co.
2001 M. Street, N.W.
Washington, DC 20036

Board of Directors
Federal Asset Disposition Association

We have audited the accompanying statements of financial condition of the Federal Asset Disposition Association (FADA), a wholly owned subsidiary of the Federal Savings and Loan Insurance Corporation (FSLIC), as of December 31, 1988 and 1987, and the related statements of operations, stockholder's equity, and cash flows for the years then ended. These financial statements are the responsibility of FADA's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our report dated March 30, 1988, we expressed an opinion that the 1987 financial statements fairly presented the financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles, subject to possible adjustments due to the uncertainty inherent in the 1987 asset management fee income estimation process. During 1988, this uncertainty was resolved without material impact to the 1987 financial statements. Therefore, our opinion expressed on the 1987 financial statements referred to above has been changed.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of FADA at December 31, 1988 and 1987, and the results of its operations, and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The accompanying financial statements have been prepared assuming that FADA will continue as a going concern. As discussed in Note 14 to the financial statements, legislative proposals raise substantial doubt about the entity's ability to continue as a going concern in its present form. The financial statements do not include any adjustments relating to the recoverability and classification of reported asset amounts or the amounts and classification of liabilities that might result from the outcome of this uncertainty. Furthermore, as discussed in Note 11 to the financial statements, in April 1989, FADA became a defendant in a lawsuit the ultimate outcome from which cannot presently be determined. Accordingly, no provision for any liability that may result upon adjudication has been recognized in the accompanying financial statements.

Peat Marwick Main & Co.

May 25, 1989



Member Firm of
Klynveld Peat Marwick Goerdeler

Financial Statements

Statements of Financial Condition

DECEMBER 31, 1988 AND 1987

| ASSETS | 1988 | 1987 |
|-----------------------------------------------------------------------------------------------------------------------------------------------|---------------|--------------|
| CASH | \$ 746,184 | 339,026 |
| MONEY MARKET INVESTMENTS | 8,700,000 | 1,214,495 |
| INVESTMENTS IN U.S. GOVERNMENT AND FEDERAL AGENCY SECURITIES (APPROXIMATE MARKET VALUE: 1988, \$2,859,000; 1987, \$4,857,000) (NOTES 2 AND 8) | 3,010,857 | 5,017,314 |
| FEES RECEIVABLE: | | |
| ASSET MANAGEMENT FEES (NOTE 4) | 3,915,945 | 6,607,339 |
| ADVISORY FEES (NOTE 4) | 46,500 | 187,350 |
| REIMBURSABLE EXPENDITURES RECEIVABLE, NET (NOTES 5 AND 8): | | |
| RECEIVERSHIP CONTRACTS | 632,429 | 8,410,104 |
| ADVISORY CONTRACTS | 57,942 | 273,232 |
| ACCRUED INTEREST RECEIVABLE | 36,025 | 45,173 |
| PROPERTY, EQUIPMENT AND LEASEHOLD IMPROVEMENTS, NET (NOTE 6) | 2,748,601 | 3,212,077 |
| LEASED PROPERTY UNDER CAPITAL LEASE, NET (NOTE 7) | ----- | 510,467 |
| FEDERAL HOME LOAN BANK STOCK, AT COST (NOTE 8) | 807,100 | 424,100 |
| PREPAID EXPENSES AND OTHER ASSETS | 434,346 | 570,957 |
| | \$ 21,135,929 | 26,811,634 |
| | ***** | ***** |
| LIABILITIES AND STOCKHOLDER'S EQUITY | | |
| SHORT-TERM BORROWINGS, INCLUDING BANK OVERDRAFT IN 1988, \$509,066; 1987, \$3,192,513 (NOTE 8) | 509,066 | 10,192,513 |
| OTHER LIABILITIES AND ACCRUED EXPENSES | 2,075,869 | 1,339,555 |
| OBLIGATION UNDER CAPITAL LEASE (NOTE 7) | 414,184 | 521,412 |
| DEFERRED RENT PAYMENTS | 393,778 | 333,677 |
| TOTAL LIABILITIES | 3,392,897 | 12,387,157 |
| STOCKHOLDER'S EQUITY (NOTE 12): | | |
| PREFERRED STOCK, NO PAR VALUE | | |
| AUTHORIZED 500,000 SHARES; NONE ISSUED | ----- | ----- |
| COMMON STOCK, NO PAR VALUE, | | |
| STATED VALUE \$1,000 PER SHARE | | |
| AUTHORIZED 500,000 SHARES; | | |
| ISSUED AND OUTSTANDING 25,000 SHARES | 25,000,000 | 25,000,000 |
| ACCUMULATED DEFICIT | (7,256,968) | (10,575,523) |
| TOTAL STOCKHOLDER'S EQUITY | 17,743,032 | 14,424,477 |
| COMMITMENTS AND CONTINGENCIES (NOTES 11 AND 12) | | |
| | \$ 21,135,929 | 26,811,634 |
| | ***** | ***** |
| SEE ACCOMPANYING NOTES TO FINANCIAL STATEMENTS. | | |

**Appendix II
Financial Statements**

Statements of Operations

YEARS ENDED DECEMBER 31, 1988 AND 1987

| | 1988 | 1987 |
|---------------------------------------------------------------------|---------------------|--------------------|
| FEE INCOME: | | |
| ASSET MANAGEMENT (NOTE 3) | \$ 30,441,908 | 20,388,274 |
| ASSET ADVISORY | 470,029 | 1,318,665 |
| FSLIC CORPORATE | ----- | 264,164 |
| DISPOSITIONS | 5,434,151 | ----- |
| TOTAL INCOME | 36,346,088 | 21,971,103 |
| OPERATING EXPENSES: | | |
| COMPENSATION & RELATED BENEFITS (NOTE 9) | 22,205,082 | 18,173,911 |
| OTHER PROFESSIONAL SERVICES | 816,640 | 1,978,396 |
| OCCUPANCY | 2,331,452 | 1,884,601 |
| TRAVEL | 1,262,053 | 1,343,698 |
| DEPRECIATION AND AMORTIZATION | 1,138,695 | 923,952 |
| PROPERTY AND EQUIPMENT RENTALS AND SUPPLIES | 1,201,887 | 886,903 |
| TELEPHONE | 952,585 | 816,142 |
| EXECUTIVE SEARCH FEES | 25,125 | 644,137 |
| SYSTEMS CONSULTING | 598,359 | 598,385 |
| LEGAL SERVICES | 447,897 | 453,820 |
| OFFICE SUPPLIES | 383,789 | 453,679 |
| POSTAGE AND DELIVERY | 370,854 | 366,332 |
| INSURANCE | 299,554 | 255,327 |
| OTHER | 760,535 | 601,602 |
| TOTAL OPERATING EXPENSES | 32,794,507 | 29,380,885 |
| OPERATING INCOME (LOSS) | 3,551,581 | (7,409,782) |
| OTHER INCOME (EXPENSE): | | |
| INTEREST AND DIVIDEND INCOME | 896,749 | 974,983 |
| INTEREST EXPENSE | (622,475) | (544,526) |
| LOSS ON SALE OF INVESTMENT SECURITIES | ----- | (24,522) |
| OTHER INCOME (EXPENSE) | 59,123 | (10,273) |
| LOSS ON DISPOSITION OF FIXED ASSET | (401,473) | ----- |
| INCOME (LOSS) BEFORE INCOME TAXES AND EXTRAORDINARY ITEM | 3,483,505 | (7,014,120) |
| PROVISION FOR INCOME TAXES | 1,347,950 | ----- |
| | 2,135,555 | (7,014,120) |
| EXTRAORDINARY ITEM: | | |
| TAX BENEFIT OF AN OPERATING LOSS CARRYFORWARD | 1,183,000 | ----- |
| NET INCOME (LOSS) | \$ 3,318,555 | (7,014,120) |
| ***** | | |
| SEE ACCOMPANYING NOTES TO FINANCIAL STATEMENTS. | | |

Appendix II
Financial Statements

Statements of Stockholder's Equity

YEARS ENDED DECEMBER 31, 1988 AND 1987

| | PREFERRED STOCK | COMMON STOCK | ADDITIONAL PAID-IN CAPITAL | ACCUMULATED DEFICIT | TOTAL |
|----------------------------------------------------|--------------------|-----------------|----------------------------------|------------------------|-------------|
| BALANCES AT JANUARY 1, 1987 | \$ ----- | 25,000,000 | ----- | (3,561,403) | 21,438,597 |
| LOSS FOR THE YEAR ENDED DECEMBER 31, 1987 | ----- | ----- | ----- | (7,014,120) | (7,014,120) |
| BALANCES AT DECEMBER 31, 1987 | ----- | 25,000,000 | ----- | (10,575,523) | 14,424,477 |
| NET INCOME FOR THE YEAR ENDED DECEMBER 31, 1988 | ----- | ----- | ----- | 3,318,555 | 3,318,555 |
| BALANCES AT DECEMBER 31, 1988 | \$ ----- | 25,000,000 | ----- | (7,256,968) | 17,743,032 |

SEE ACCOMPANYING NOTES TO FINANCIAL STATEMENTS.

**Appendix II
Financial Statements**

Statements of Cash Flows

FOR THE YEARS ENDED DECEMBER 31, 1988 AND 1987

| | 1988 | 1987 |
|--------------------------------------------------------------------------------------|--------------|--------------|
| | ----- | ----- |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| NET INCOME (LOSS) | \$ 3,318,555 | (7,014,120) |
| ADJUSTMENTS TO RECONCILE NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES: | | |
| DEPRECIATION OF EQUIPMENT | 1,138,695 | 923,952 |
| DEFERRED RENT PAYMENTS, NET | 60,101 | 255,184 |
| LOSS ON EQUIPMENT | 401,473 | |
| CHANGE IN ASSETS AND LIABILITIES: | | |
| DECREASE (INCREASE): | | |
| MANAGEMENT FEES RECEIVABLE | 2,604,314 | (5,609,446) |
| ADVISORY AND OTHER FEES RECEIVABLE | 140,850 | (51,606) |
| REIMBURSABLE EXPENSES RECEIVABLE | 7,992,965 | (7,740,459) |
| INTEREST AND OTHER ACCOUNTS RECEIVABLE | 9,148 | (10,089) |
| PREPAID EXPENSES AND OTHER ASSETS | 136,611 | (404,152) |
| INCREASE (DECREASE): | | |
| ACCRUED EXPENSES PAYABLE | 736,314 | 30,001 |
| OBLIGATION UNDER CAPITAL LEASE | (107,228) | 521,412 |
| ALLOWANCE FOR UNCOLLECTABLES | 87,080 | ----- |
| | ----- | ----- |
| NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES | 16,518,878 | (19,099,323) |
| | ----- | ----- |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| PROCEEDS FROM SALE OF MARKETABLE SECURITIES | 2,006,457 | 13,901,192 |
| ADDITIONS TO FURNITURE AND EQUIPMENT, NET | (566,225) | (2,422,864) |
| PURCHASE OF FHLB STOCK | (383,000) | (376,100) |
| | ----- | ----- |
| NET CASH PROVIDED BY INVESTING ACTIVITIES | 1,057,232 | 11,102,228 |
| | ----- | ----- |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| SHORT TERM BORROWINGS, NET | (7,000,000) | 6,200,000 |
| | ----- | ----- |
| NET CASH PROVIDED (USED) BY FINANCING ACTIVITIES | (7,000,000) | 6,200,000 |
| | ----- | ----- |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 10,576,110 | (1,797,095) |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR | (1,638,992) | 158,103 |
| | ----- | ----- |
| CASH AND CASH EQUIVALENTS AT END OF YEAR | \$ 8,937,118 | (1,638,992) |
| | ----- | ----- |

SEE ACCOMPANYING NOTES TO FINANCIAL STATEMENTS

Notes to Financial Statements

December 31, 1988 and 1987

(1) Organization and Significant Accounting Policies

The Federal Asset Disposition Association (FADA), a Federal Savings and Loan Association, whose stock is wholly-owned by the Federal Savings and Loan Insurance Corporation (FSLIC), was chartered in 1985 under Sections 406(a) and (b) of the National Housing Act of 1934 to help financially troubled Thrifts manage and dispose of real estate assets, including loans, pursuant to asset management contracts with these Thrifts or, in most circumstances, the Thrift receivers. As agent serving on behalf of receivers, the FADA does not take title to underlying assets but does have the fiduciary responsibilities inherent in the agency function. The FADA derives substantially all of its income from providing services (primarily asset management, advisory and disposition services) for the FSLIC and various FSLIC receiverships and Management Consignment Programs.

The following accounting policies, together with those disclosed elsewhere in the notes to financial statements, represent significant accounting policies that the FADA follows in preparing its financial statements.

(a) Money Market Investments

The investment in money markets consists of interest bearing overnight deposits with the Federal Home Loan Bank of Topeka.

(b) Investment in Securities

Investment securities are stated at cost, adjusted for amortization of premiums or accretion of discount. Interest and dividends on investment securities include interest earned on investment securities and dividends earned on stock of the Federal Home Loan Bank of Topeka. Amortization of premium or accretion of discount is accounted for over the term of each investment on a straight-line basis.

(c) Investment in Federal Home Loan Bank Stock

As a member of the Federal Home Loan Bank (FHLB) System, the FADA is required to acquire and hold a specified number of shares of the capital stock of the Federal Home Loan Bank of Topeka, Kansas. In addition, the short-term borrowing agreement

(continued)

FEDERAL ASSET DISPOSITION ASSOCIATION
(a wholly-owned subsidiary of the FSLIC)

Notes to Financial Statements

between the FADA and the Federal Home Loan Bank of Topeka (note 8) stipulates that the FADA will purchase additional FHLB stock as short-term borrowings are made. The amount of stock held at December 31, 1988 satisfied both of the requirements as of that date.

(d) Property, Equipment and Leasehold Improvements

Property and equipment are stated at cost less accumulated depreciation and amortization. Purchases of equipment are capitalized to the extent that the expenditures individually exceed \$350, except software for which the amount is \$450. Purchases of equipment between \$100 and \$350 are capitalized in annual pools. Separate pools are established for office furniture and equipment, and computer hardware and accessories. Purchases of supplies are charged to expense as incurred.

Depreciation of office property and equipment is computed on a straight-line basis over the estimated useful lives of the various classes of assets. The period used for depreciation of assets is based on the following table:

| <u>Asset type</u> | <u>Capitalized cost</u> | <u>Estimated useful life</u> |
|------------------------------------------|-------------------------|------------------------------|
| I. <u>Asset individually capitalized</u> | | |
| Furniture - new | \$350+ | 96 months |
| Furniture - used | \$350+ | 60 months |
| Office equipment | \$350+ | 60 months |
| Systems hardware | \$350+ | 60 months |
| Systems software | \$450+ | 36 months |
| II. <u>Assets capitalized in pools</u> | | |
| Furniture - new or used | \$100+ less than \$350 | 60 months |
| Office equipment - new or used | \$100+ less than \$350 | 60 months |
| Systems hardware | \$100+ less than \$350 | 60 months |
| III. <u>Installation costs</u> | | |
| Systems installation | \$1,000+ | 36 months |

(continued)

FEDERAL ASSET DISPOSITION ASSOCIATION
(a wholly-owned subsidiary of the FSLIC)

Notes to Financial Statements

Leasehold improvements are amortized on a straight-line basis over the remaining term of the lease or the estimated useful life of the asset, whichever is shorter. Maintenance and repairs are charged to expense; improvements are capitalized.

(e) Fee Income and Reimbursable Expenses

Asset management and advisory fee income is accrued and billed monthly. As of July, 1988 the FSLIC receivers began paying invoices involving the management of assets which had been paid by the FADA and were then billed to the receivers as reimbursable expenses. These reimbursables were recorded as receivables when paid by the FADA and were billed to receivers monthly. These third-party expenditures are not recorded in the FADA statements of operations.

(f) Collections on Behalf of Receivers

The FADA, through property managers, collects revenues in connection with income producing assets under management. The property managers remit such revenues directly to the receiver. The FADA generally does not collect or process loan payments related to assets under management.

(g) Statement of Cash Flows

During 1988 the FADA adopted Statement of Financial Accounting Standards No. 95, "Statement of Cash Flows" which require a statement of cash flows be presented in place of the statement of changes in financial position. For purposes of reporting cash flows, the FADA includes cash, money market investments and bank overdrafts in cash and cash equivalents.

(h) Reclassifications

Certain of the 1987 financial statement amounts have been reclassified to conform to the 1988 presentation.

(2) Investment in U. S. Government and Federal Agency Securities

At December 31, 1988, the FADA held investment securities issued by the U. S. Government and the FHLB, with maturities as follows:

(continued)

FEDERAL ASSET DISPOSITION ASSOCIATION
(a wholly-owned subsidiary of the FSLIC)

Notes to Financial Statements

| | <u>December 31, 1988</u> | |
|---------------------------------------|--------------------------|-------------------------------------|
| | <u>Book Value</u> | <u>Approximate Market Value</u> |
| <u>Due within one year:</u> | | |
| U. S. Treasury Note, due 2/28/89 | \$ 999,882 | \$ 997,000 |
| <u>Due between one to five years:</u> | | |
| U. S. Treasury Note, due 10/15/93 | 1,010,023 | 920,000 |
| FHLB Bond, due 12/26/91 | <u>1,000,952</u> | <u>942,000</u> |
| Total | <u>\$3,010,857</u> | <u>\$2,859,000</u> |

| | <u>December 31, 1987</u> | |
|---------------------------------------|--------------------------|-------------------------------------|
| | <u>Book Value</u> | <u>Approximate Market Value</u> |
| <u>Due within one year:</u> | | |
| U.S. Treasury Note, due 06/30/88 | \$1,003,921 | \$1,002,000 |
| U.S. Treasury Note, due 11/30/88 | 1,000,863 | 990,000 |
| <u>Due between one to five years:</u> | | |
| U.S. Treasury Note, due 02/28/89 | 999,138 | 986,000 |
| U.S. Treasury Note, due 10/15/93 | 1,012,121 | 933,000 |
| FHLB Note, due 12/26/91 | <u>1,001,271</u> | <u>946,000</u> |
| Total | <u>\$5,017,314</u> | <u>\$4,857,000</u> |

(3) Assets Under Management

At December 31, 1988, the FADA managed real estate assets, including loans and loan participations, on behalf of 41 FSLIC liquidating receiverships and 1 institution in the FSLIC's Management Consignment Program (MCP). The total net book value of managed assets, per receivership and MCP records, was approximately \$3.6 billion at December 31, 1988, (\$4.3 billion at December 31, 1987) which unaudited amounts are not reflected in

(continued)

FEDERAL ASSET DISPOSITION ASSOCIATION
(a wholly-owned subsidiary of the FSLIC)

Notes to Financial Statements

the accompanying statements of financial condition. The unaudited net book values are not intended to be indicative of current market values. These assets are located in all areas of the United States, with major concentrations in Texas, California and Florida. The assets under management include a significant number of assets subject to loan participation agreements. For participations in which the receiver or MCP is not the lead participant, the asset book value includes only the receiver's or MCP's percentage interest in the total asset.

(4) Asset Management Fees

The FADA manages and disposes of receivership and MCP assets for a fee. For the year ended December 31, 1987, this fee was calculated using .75% of the net realizable asset values per annum. For assets subject to participation agreements, asset management fees were calculated on 100% of the asset value in those instances when the receiver or MCP is the lead participant, and on the actual participation percentage when the receiver or MCP is the non-lead lender. Asset values initially assigned for fee calculation purposes were generally the receivership or MCP net book values, although the FADA in certain circumstances assigned a lower value for fee purposes. These values were subsequently adjusted, as were previous billings to receiverships and MCPs, to reflect net realizable values pursuant to appraisals and asset disposition plans, as approved by receivers and MCPs.

As of December 31, 1987, asset disposition plans had not been finalized for all assets under management. For such assets, the FADA generally records fee income on the basis of estimated net realizable values. As of March 1988, management estimated that, of total assets under management at year end 1987 of approximately \$4.3 billion (at unaudited net book value), 27% or approximately \$1.2 billion had approved net realizable values. Approximately \$10,648,000 of FADA's 1987 management fee income was recorded on the basis of estimated net realizable values for assets which did not yet have approved values. As additional net realizable values were determined for assets under management at December 31, 1987, income in 1988 was adjusted to reflect fee income as if the approved values were in place from the inception date of the management contract pertaining to the assets.

(continued)

FEDERAL ASSET DISPOSITION ASSOCIATION
(a wholly-owned subsidiary of the FSLIC)

Notes to Financial Statements

A new FADA/FSLIC asset management contract, with an effective date of January 1, 1988 and signed in March of 1988, changed the FADA asset management fee structure. Management fees depend on the level of services provided, with a minimum base annual fee of .50% of agreed upon asset net take-over values. A letter of agreement also provides for an additional .30% of agreed upon asset values to perform technical services outside the scope of the management contract. An additional .10% of asset values was incorporated in the fee structure to compensate the FADA for non-receiver specific work performed for the FSLIC organization. These values for new assets are to be determined within 60 days after the FADA commences management of the asset.

The FADA was also paid a disposition fee on assets. The amount of the fee is dependent upon how long the FADA managed the asset and ranges from 1.00% to 1.50%. The fee percentage decreases each of the first three years a given asset remains under the FADA management.

A new FADA/FSLIC asset management contract, with an effective date of January 1, 1989, has not yet been signed.

Asset management fees receivable at December 31, 1987 and related management fee income include approximately \$4.4 million due from the FSLIC to compensate the FADA for legal and appraisal services provided by the FADA beyond the scope of the receivership and MCP contracts in force at year end 1987. The entire \$4.4 million was received in March 1988.

(5) Reimbursable Expenditures

In addition to management fees, the FADA is reimbursed by the various receiverships and MCPs for expenditures related to assets it manages. Beginning July 1, 1988 the FADA ceased paying the various vendors for asset related expenditures. This function was assumed by the various receiverships. Such expenditures include all third party payments related to the assets under management, including subcontracted property management fees. Under the 1988 contract with the FSLIC certain third party payments, including business plan preparation costs, which were reimbursable under the old contract, were expensed by the FADA.

At December 31, 1988, the FADA had outstanding reimbursable expenses of \$632,429.

(continued)

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FEDERAL ASSET DISPOSITION ASSOCIATION
(a wholly-owned subsidiary of the FSLIC)
Notes to Financial Statements

(6) Property, Equipment and Leasehold Improvements

Property, equipment and leasehold improvements at December 31 are comprised of the following:

| | <u>1988</u> | <u>1987</u> |
|------------------------------------------------|--------------------|--------------------|
| Computer hardware and software | \$2,589,696 | \$2,437,099 |
| Furniture and fixtures | 1,810,170 | 1,457,402 |
| Leasehold improvements | <u>265,309</u> | <u>256,974</u> |
| | 4,665,175 | 4,151,475 |
| Less accumulated depreciation and amortization | <1,916,574> | < 939,398> |
| | <u>\$2,748,601</u> | <u>\$3,212,077</u> |

(7) Obligation Under Capital Lease

In 1987, the FADA entered into a five-year lease on data processing equipment that has been recorded as a capital lease. At December 31, 1987, the asset is stated at cost of \$589,000 less accumulated depreciation of \$78,533. Depreciation is computed on a straight-line basis over the five year lease period which is equivalent to the estimated useful life.

The following is a schedule by years of future minimum lease payments under capital lease together with the present value of the minimum lease payments as of December 31, 1988:

| | |
|-----------------------------------|------------------|
| Year ending December 31: | |
| 1989 | \$139,068 |
| 1990 | 139,068 |
| 1991 | 139,068 |
| 1992 | <u>46,356</u> |
| Net minimum lease payments | 463,560 |
| Less amount representing interest | <49,376> |
| Obligation under capital lease | <u>\$414,184</u> |

(continued)

FEDERAL ASSET DISPOSITION ASSOCIATION
(a wholly-owned subsidiary of the FSLIC)

Notes to Financial Statements

In January, 1989 the FADA began operating in a time share computer environment out of Dallas. The leased IBM 4381 Mainframe remains in San Francisco. At this time the machine is not being used and an allowance has been established to fully reserve its remaining value.

(8) Short-term Borrowings

Short-term borrowings of \$7.0 million at December 31, 1987 were drawn against a \$50 million open line of credit with the Federal Home Loan Bank of Topeka. The open line of credit is backed by a contract between the FSLIC and the Federal Home Loan Bank of Topeka under which the FSLIC has guaranteed repayment of up to \$50 million of Bank advances to the FADA. Under the terms of the contract, the repayment guarantee applies only to advances used for the purpose of funding operations in which the FADA has a legal agreement with the FSLIC in the FSLIC's capacity as receiver or conservator for an insured institution. Effective January 1, 1989, the open line of credit with Federal Home Loan Bank of Topeka was changed to \$25 million.

Under terms of the borrowing agreement between the FADA and the FHLB of Topeka the FADA is required to maintain qualifying collateral equal to 120 percent of outstanding borrowings. Qualifying collateral includes the FADA's investment securities and reimbursable expenditures and fees receivable. The FADA is required to maintain investment securities, in the possession of the FHLB of Topeka, equal to the greater of 20 percent of outstanding borrowings or 120 percent of such borrowings, as reduced by qualifying reimbursable expenditures and fees receivables.

The FADA's FHLB stock is also pledged as additional collateral for borrowings from the FHLB of Topeka. The line of credit arrangement is reviewed on an annual basis by the lender.

(continued)

FEDERAL ASSET DISPOSITION ASSOCIATION
(a wholly-owned subsidiary of the FSLIC)

Notes to Financial Statements

(9) Incentive Compensation and 401(k) Savings and Investment Plan

The FADA has established an incentive compensation plan for its key officers and managers. In 1988 the plan was expanded to include all employees. The plan is designed to add an incentive element to the compensation packages. Awards under the plan are based on both individual performance and overall corporate performance. The maximum award as a percentage of base salary generally ranges from 2% to 20%. Award amounts must be approved by the Board of Directors. For the years ended December 31, 1988 and 1987, the FADA recorded incentive compensation expense totaling approximately \$900,000 and \$300,000, respectively.

The FADA established a 401(k) Savings and Investment Plan for its salaried employees in October 1986. Employer contributions required under the Plan include a minimum of two percent of each employee's compensation per annum. In addition to the minimum two percent contribution, the FADA matches 100 percent of employee contributions under the Plan, limited to four percent of employee compensation per annum. Employer contributions to the Plan vest with participants over time and become fully vested after three years of service. Compensation and related benefits expense in the accompanying statement of operations includes approximately \$460,000 at December 31, 1988 and \$560,000 at December 31, 1987 relating to the Plan.

(10) Income Taxes

The provision for income taxes consist of the following:

| | <u>For the year ended December 31</u> | |
|-----------------------------------------------------|---------------------------------------|-------------|
| | <u>1988</u> | <u>1987</u> |
| Current: | | |
| Federal | \$ 128,150 | -- |
| State | <u>36,800</u> | <u>--</u> |
| | 164,950 | |
| Deferred | <u>1,183,000</u> | <u>--</u> |
| | 1,347,950 | -- |
| Tax effect of net operating loss carryforward | <u>1,183,000</u> | <u>--</u> |
| Net | <u>\$ 164,950</u> | <u>--</u> |

(continued)

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FEDERAL ASSET DISPOSITION ASSOCIATION
(a wholly-owned subsidiary of the FSLIC)

Notes to Financial Statements

A reconciliation of the statutory federal income tax rates to the FADA's effective income tax rate is as follows:

| | Percent of pretax income <loss> December 31, | |
|------------------------------------------------------|----------------------------------------------------|------------|
| | 1988 | 1987 |
| Statutory federal income tax rate | 34.0% | <40.0> |
| Unused net operating loss deduction | -- | 40.0 |
| State income tax, net of federal income tax benefit. | .7 | -- |
| Other | <.7> | -- |
| Alternative minimum tax | 4.7 | -- |
| | <u>38.7%</u> | <u>-0-</u> |

As of December 31, 1988, the FADA had net operating loss carryforwards for tax purposes of approximately \$5,120,000 which will expire in the year 2002. For financial statement purposes, the FADA has available loss carryforwards of approximately \$5,870,000. The difference between the loss carryforwards for tax and financial statement purposes is primarily the result of timing differences in the recognition of depreciation and compensation expenses.

(11) Commitments and Contingencies

Commitments

At December 31, 1988 the FADA leased office space and equipment in headquarters and regional locations. Future minimum lease payments under the terms of existing noncancelable operating leases in excess of one year are as follows:

(continued)

FEDERAL ASSET DISPOSITION ASSOCIATION
(a wholly-owned subsidiary of the FSLIC)

Notes to Financial Statements

| | <u>Office Space</u> | <u>Equipment</u> | <u>Total</u> |
|--------------------------|---------------------|--------------------|--------------------|
| Year ending December 31: | | | |
| 1989 | \$ 1,764,440 | \$ 481,727 | \$2,246,167 |
| 1990 | 1,871,975 | 455,521 | 2,327,496 |
| 1991 | 1,773,612 | 210,967 | 1,984,579 |
| 1992 | 1,863,320 | 35,862 | 1,899,182 |
| 1993 | 1,099,761 | 2,438 | 1,102,199 |
| Thereafter | <u>192,504</u> | <u>--</u> | <u>192,504</u> |
| | <u>\$8,565,612</u> | <u>\$1,186,515</u> | <u>\$9,752,127</u> |

Contingencies

In its capacity as asset manager for FSLIC receiverships and MCPs, the FADA is a defendant (as is the FSLIC and/or FSLIC receiverships and MCPs) in several pending and threatened litigation matters. Certain of these matters involve substantial claim amounts and were unresolved as of December 31, 1988. Pursuant to terms of the revised asset management contract effective January 1, 1988, the FADA is indemnified by the FSLIC for losses and expenses, if any, unless the FADA acts in a grossly negligent manner. Although the asserted and non-asserted claim amounts are significant, it is the opinion of management, after consultation with counsel, that the resolution of these matters will not have a material adverse impact on the FADA's financial position.

In April, 1989, an individual brought suit against the FADA, the US League of Savings Institutions, et. al. in the United States District Court, District of New Jersey. The complaint served upon the FADA and over 40 other defendants seeks damages of \$25,000,000 plus punitive and treble damages, claiming he has suffered business and personal losses resulting from a conspiracy to deny him the opportunity to purchase distressed assets. He further claims damages from other tortious and illegal conduct allegedly committed by the defendants. Assessment of a potential FADA liability, if any, cannot be made at this time.

The FADA is also involved in various other claims and legal actions arising in the ordinary course of business. In the opinion of management, after consultation with counsel, the ultimate disposition of these matters will not have a material adverse effect on the FADA's financial position.

(continued)

FEDERAL ASSET DISPOSITION ASSOCIATION
(a wholly-owned subsidiary of the FSLIC)

Notes to Financial Statements

Additionally, the FADA is contingently liable under an employee severance plan, whereby, in the event of loss of employment due to the dissolution of the FADA, each employee is entitled to a severance payment if, as a result of the dissolution, the employee is not employed by a successor entity or purchaser of the FADA. The sole purpose of this plan is to allow for continued staffing required to manage the assets assigned to the FADA. The potential impact of this plan is approximately \$6 million.

(12) FHLBB Regulations

Since the FADA is chartered under Section 406 of the National Housing Act, it is considered subject to Federal Home Loan Bank Board (FHLBB) Regulation. Such regulations govern the activities of Thrift Institutions and contain various financial requirements, e.g., that Thrifts maintain levels of regulatory net capital and investment in liquid assets, as defined by regulation. At December 31, 1988, the FADA's regulatory capital and investment in liquid assets exceeded amounts required by FHLBB regulation.

The FADA does not engage in traditional Thrift-oriented activities. The FHLBB has not specified which FHLBB regulations pertaining to Thrifts should apply to the FADA.

(13) GAO Report

During 1988, the General Accounting Office (GAO) issued a report stating an opinion that the FADA should not have been chartered as a Savings and Loan and the employees should be subject to the government pay scales. FHLBB issued a contradictory report stating that the FADA employees were not government employees. The FADA has not been required to take any action as a result of these reports.

(14) Going Concern Considerations

Federal legislation, which is pending in the U.S. Congress, could substantially alter FADA's future operational structure. While no legislative action has been taken, significant uncertainty exists relating to the FADA's ability to continue as a going concern. The probable outcome of this uncertainty cannot be determined.

Comments From KPMG Peat Marwick

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



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December 18, 1990

Mr. Donald H. Chapin
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Chapin:

We have reviewed the General Accounting Office's (GAO) draft report "Federal Asset Disposition Association - No Economic Basis for Reported Fee Income Under 1988 Letter Agreement." The report addresses the Federal Asset Disposition Association's (FADA) 1988 letter agreement with the Federal Savings and Loan Insurance Corporation (FSLIC) and FADA's 1988 financial statements. We appreciate this opportunity to comment on the draft report.

The draft report asserts that the 1988 financial statements were not presented in accordance with generally accepted accounting principles (GAAP) and that KPMG Peat Marwick did not conduct the audit in accordance with generally accepted auditing standards (GAAS). It bases this assertion on a provision in Accounting Principles Board (APB) 4 that financial statements should emphasize the substance of a particular transaction rather than merely its legal form, and GAO's belief that there was not economic substance for certain transactions between FADA and its parent, FSLIC.

We would point out that Statement of Financial Accounting Standards (FAS) No. 57 "Related Party Disclosures," which appears not to have been taken into consideration by GAO, expands upon APB 4. FAS 57 states that the financial statements shall include the following disclosures for material related party transactions:

- a. The nature of the relationship(s) involved
- b. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements
- c. The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period



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See comment 1.

See comment 2.

Appendix III
Comments From KPMG Peat Marwick

KPMG Peat Marwick

Mr. Donald H. Chapin
United States General Accounting Office
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See comments 2, 3, and 4.

Moreover, while not required by GAAS, we considered the business purpose and economic substance of the FADA/FSLIC transaction and concluded that it had no effect on the manner in which the transaction should be recorded. We determined that FADA provided services to FSLIC under a letter agreement signed by both parties. Since the agreement was not a cost reimbursable contract, revenue was not deferred. FADA was paid non-refundable fees for services actually rendered; the income received was not fictitious.

See comment 5.

Furthermore, transactions between parent and subsidiary are very common in the business world. In such situations, a subsidiary company would report revenue on its separate financial statements knowing that the intercompany profits would be eliminated when the financial statements of the parent and the subsidiary are consolidated. In the consolidated FSLIC financial statements the fee expense recorded by FSLIC would be offset against the fee income reported by FADA. The transaction is a wash. Also, it would not be correct for FADA to account for the fee income on FADA's financial statements as either deferred revenue or paid-in capital since services were rendered and income was earned.

Thus, the agreement has both business purpose and economic substance. The fact that FADA reported net income is neither inappropriate nor unusual. The fee arrangement is fully disclosed in note 4 to the financial statements as required by generally accepted accounting principles.

The financial statements of FADA are presented in accordance with generally accepted accounting principles and the audit was conducted in accordance with generally accepted auditing standards.

The conclusions in the draft report regarding the financial statements and audit are incorrect. We, recommend therefore, that the draft report be appropriately modified or not issued.

Very truly yours,

KPMG Peat Marwick

more influential than APB Statement No. 4. Also, FASB stated that the accounting concept of "substance over form" is included in both and noted that Concepts Statement No. 2 states "The quality of reliability and, in particular, of representational faithfulness leaves no room for accounting representations that subordinate substance to form. Substance over form is, in any case, a rather vague idea that defies precise definition." FASB further stated that APB Statement 4 and FASB Concepts Statement 2, while considered to be GAAP, were not included in accounting principles as contemplated in Rule 203 of the AICPA Code of Professional Conduct. FASB acknowledged that transactions, including those between related parties, are normally accounted for and reported based on their legal form, but notes that Rule 203 of the AICPA Code of Professional Conduct states "upon occasion there may be unusual circumstances where the literal application of pronouncements on accounting principles would have the effect of rendering financial statements misleading. In such cases, the proper accounting treatment is that which will render the financial statements not misleading." Finally, FASB stated that it expresses no opinion on the accounting treatment of the letter agreement in FADA's financial statements.

We believe that FASB's views could be used to construct a technical position, especially considering Rule 203, that accounting for the substance of related party transactions is required when accounting for their legal form would result in misleading financial statements. However, such a construction of the rules is difficult and certainly does not constitute a clear standard that could be expected to be consistently followed. Therefore, we believe the accounting standard setting bodies should clarify the accounting rules for related party transactions.

4. Our review of KPMG Peat Marwick's workpapers did not support their assertion that, while not required by generally accepted auditing standards, they considered the business purpose of the letter agreement and its economic substance as presented in the financial statements. We found no evidence to support that the auditors (1) reviewed information concerning the purpose of the letter agreement that was available and in the possession of FSLIC, (2) had discussions with FSLIC personnel involved in the negotiation and drafting of the letter agreement, or (3) determined that the fees FADA received under the letter agreement were earned based on services rendered that were beyond the scope and terms of the standard asset management agreement.

5. KPMG Peat Marwick's comment regarding the consolidated impact of these transactions to FSLIC is not relevant. FADA's financial statements

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Appendix III
Comments From KPMG Peat Marwick

KPMG Peat Marwick

Mr. Donald H. Chapin
United States General Accounting Office
December 18, 1990
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- d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement (paragraph 2)

See comment 3.

FAS 57 also states "Transactions involving related parties cannot be presumed to be carried out on an arm's-length basis, as the requisite conditions of competitive, free-market dealings may not exist" and that representations made in financial statements "shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless such representations can be substantiated." (Paragraph 3)

See comments 2 and 3.

FADA did not represent in its financial statements that the transactions were arm's - length. Instead, it made the disclosures required by FAS 57. All pages of the financial statements and notes thereto contain the heading "Federal Asset Disposition Association (a wholly-owned subsidiary of the FSLIC)." The first paragraph of note 1 of the Notes to Financial Statements clearly describes the relationship of FADA and FSLIC. Note 4 to FADA's 1988 financial statements provides the specific details of the fee arrangements between FADA and FSLIC.

Thus, FADA's financial statements are fairly presented in accordance with generally accepted accounting principles as promulgated in FAS 57.

See comment 4.

With respect to the audit, Statement on Auditing Standards (SAS) No. 45 "Omnibus Statement on Auditing Standards," provides the guidance for auditing related party transactions. This is the guidance we followed in conducting our audit which can be confirmed by a review of our workpapers. Specifically, we:

- a. Obtained an understanding of the business purpose of the transaction.
- b. Examined invoices, executed copies of agreements, contracts, and other pertinent documents.
- c. Determined whether the transaction had been approved by FADA's board of directors.
- d. Tested for reasonableness the compilation of amounts to be disclosed.
- e. Confirmed transaction amounts and terms and other significant data, with the other parties to the transaction.
- f. Inspected sufficient evidence in possession of FSLIC and the related receiverships.

The following are GAO's comments on KPMG Peat Marwick's letter dated December 18, 1990.

GAO Comments

1. Our final report takes into account the lack of clarity in current accounting principles and auditing standards with regard to related party transactions.
2. We disagree with KPMG Peat Marwick. We do not believe FADA's financial statements are fairly presented. GAO did consider FASB Statement No. 57 and found that FADA's disclosures related to fees derived from the letter agreement in FADA's statement of operations and in note 4 were misleading. The footnote states that "A letter of agreement also provides for an additional 30 percent of agreed upon asset values to perform technical services outside the scope of the management contract. An additional 10 percent of asset values was incorporated in the fee structure to compensate the FADA for non-receiver specific work performed for the FSLIC organization." This disclosure suggests that services were performed by FADA that were beyond those required by the standard asset management agreement. We could not find any such services that were performed. Also, we found that fees paid to FADA for non-receiver specific work were far in excess of those justified based on the services rendered.
3. In subsequent discussions on our draft report, representatives of KPMG Peat Marwick stated that paragraph 3 of FASB Statement No. 57 suggests that the accounting concept of economic substance over legal form, when they are different, as prescribed in APB Statement No. 4 and FASB Concepts Statement No. 2, is not relevant to transactions between related entities. Rather, it only applies to transactions between unaffiliated parties. Further, they stated that APB statement No. 4 is not GAAP as contemplated by Rule 203 of the AICPA Code of Professional Conduct and therefore is not to be considered in determining whether financial statements are presented in accordance with GAAP. KPMG Peat Marwick stated that only compliance with FASB Statement No. 57 disclosure requirements is necessary for financial statements to be presented in accordance with GAAP.

As a result of KPMG Peat Marwick's written and oral comments, we requested FASB's views on the accounting issues presented in this report. FASB stated that both APB Statement No. 4 and FASB Concepts Statement No. 2 are included in category "d" of the hierarchy of GAAP established by Statement on Auditing Standards 52 and that FASB Concepts Statement 2 was developed through FASB's "due process" and is considered

were presented on a stand-alone basis and not in the context of the consolidated financial statements of FSLIC.

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