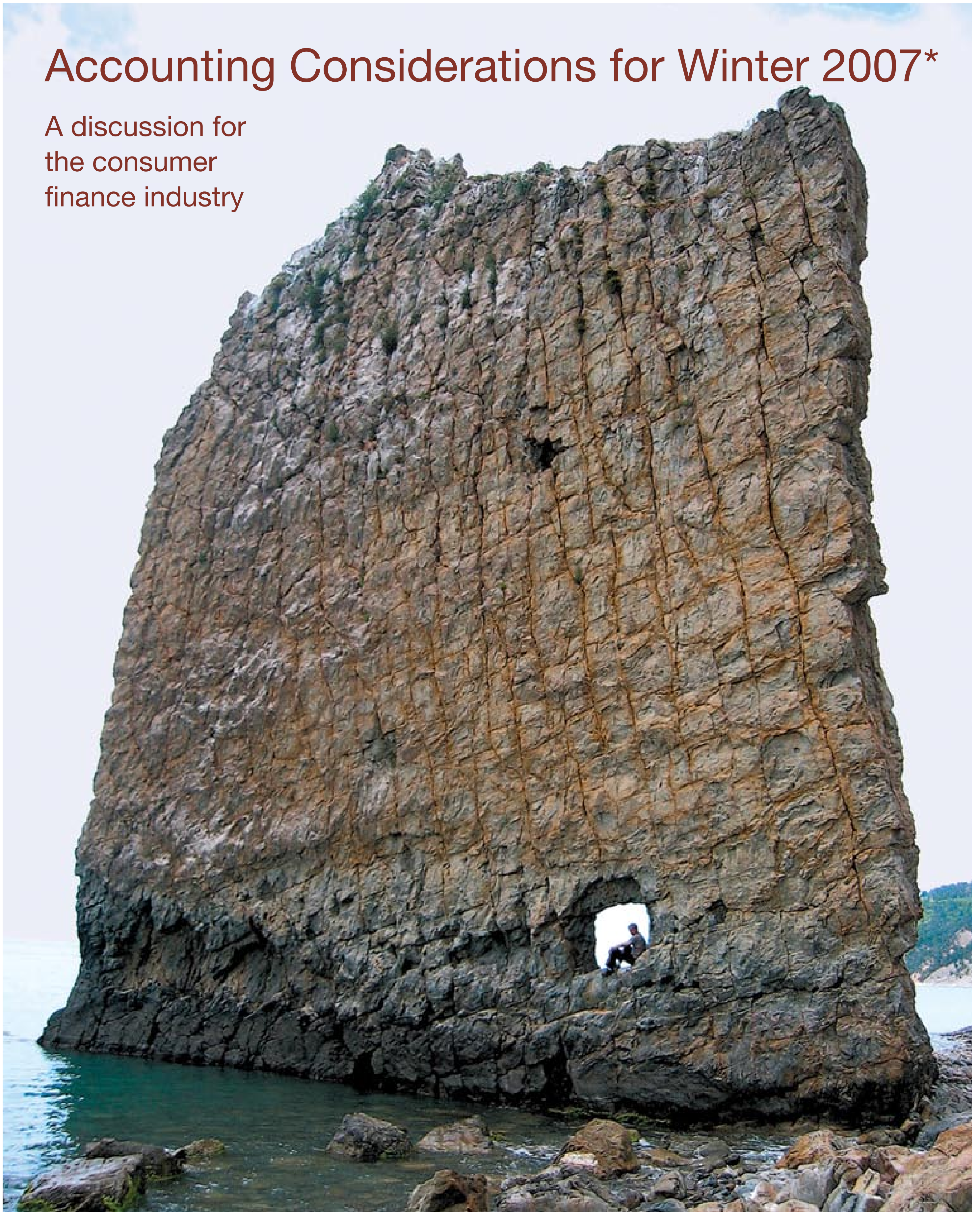
Accounting Considerations for Winter 2007*

A discussion for the consumer finance industry



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Editors' Comments

As we noted in our inaugural addition of this Accounting Considerations publication, we who serve in the accounting profession recognize that the volume and complexity of the accounting and reporting issues that affect your industry continues to increase. As we move closer to the year end 2006 reporting cycle, we thought it prudent to provide an update for certain items we covered in our previous edition of Accounting Considerations as well as to provide some information on additional items that have arisen during 2006.

This winter edition of the PricewaterhouseCoopers Consumer Finance Group Accounting Considerations publication contains a summary of several topical and emerging accounting and reporting technical issues that will most likely be of importance to the financial reporting and accounting staff of consumer finance companies. These topics include the Financial Accounting Standards Board's ("FASB") Fair Value Option Exposure Draft, accounting for reverse mortgages, recent SEC scrutiny over cash flow statements, regulation AB compliance, and FAS 156 and FAS 157 among others. In addition to the technical and financial reporting items that are most relevant to consumer finance companies, we have also included information related to two areas that while not solely consumer finance industry-specific, they are issues that will most likely impact the financial reporting process: changes in pension accounting and income tax accounting.

As with our previous issue of this publication, we hope that you find the collection of issue summaries relevant and helpful as well as timely. The volume of literature and rules changes from standard setters continues to be unprecedented; however, we are both excited and optimistic about these changes. As always, we look forward to being of service to our clients and readers regarding any of the items discussed herein.

Best wishes for success,

The Partners of the
Consumer Finance Group
of PricewaterhouseCoopers LLP

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Update on the FASB's Fair Value Option Exposure Draft

Background

The FASB Fair Value Option ("FVO") exposure draft was released on January 25, 2006 with comments to be received in writing by April 10, 2006. On June 19, 2006 the FASB sponsored a roundtable discussion on the exposure draft. On September 6, 2006 the board met to discuss the current status of the exposure draft and to address some key outstanding items which is the culmination of the first phase of the FASB's broader FVO project. These discussions were scheduled to continue at the October 18, 2006 board meeting. The FASB will commence the second phase once the first phase is issued. The Board's current schedule calls for a release of the final Statement later this year. The proposed Statement will become effective for fiscal years that begin after December 15, 2006. This article will provide a brief overview of the FASB Fair Value Exposure Draft and highlight some of the issues raised in the comments and discussions that may have an impact on the mortgage industry.

Overview

Objectives: The proposed Statement would permit an entity to use fair value as an alternative measurement treatment for many financial assets and financial liabilities. The changes in fair value must be recognized in earnings as they occur. The FASB has stated that its objectives are to:

1. Allow companies to reduce earnings volatility resulting from use of multiple accounting models for related assets/liabilities;
2. Reduce the need for complex hedge accounting;
3. Achieve further convergence with International Accounting Standards Board 39 ("IASB 39"), which has already incorporated a FVO; and
4. Expand the use of fair value measurement for financial instruments, which is considered more relevant to financial statement users.

Scope: The proposed Statement provides all entities with an optional alternative measurement treatment for recognized financial assets and financial liabilities, with some exceptions (including written loan commitments that are not accounted for as derivatives under FAS 133). The scope of the proposed Statement will include bringing loans, debt, and other financial instruments (but not leases, demand deposit accounts or loan commitments not included under FAS 133 as derivatives) into the fair value alternative. Non-financial assets and non-financial liabilities will be covered later in the year under Phase 2 of this project.

Measurement: The election of the fair value option (a) would be made on a contract-by-contract basis, (b) be irrevocable, and (c) require that changes in fair value be recognized in earnings as those changes occur. Concurrent documentation or a pre-existing policy for automatic election would be required to support the use of the fair value option. The election must be made on the date the financial asset or financial liability is initially recognized or upon an event that gives rise to a new-basis accounting at fair value under generally accepted accounting principles. This can include the election of a firm commitment on a financial instrument into the FVO.

Presentation and Disclosure: Reporting these financial assets and liabilities would need to be accomplished in a way that separates the reported fair values from the carrying amounts of assets and liabilities using another measurement attribute on the face of the financials. The reporting objective may be accomplished by either (a) displaying separate line items for the fair value and non-fair value carrying amounts or (b) presenting the aggregate of the fair value and non-fair value amount and parenthetically disclosing the amount of fair value included in the aggregate amount.

An entity must also focus on a few key balance sheet and income statement disclosures:

1. The difference between the carrying amount of any financial liability, reported at fair value due to the election, and the principal amount the company would be required to pay the holders of the obligations at maturity;
2. Sufficient information to allow users of the financial statements to understand the changes in fair value of the items elected under the FVO to include the:
   a. Disclosure of the methods and assumptions to estimate fair value; and
   b. Encouragement to disclose quantitative disclosures of the market risks for those items under level 3 of the FAS 157 fair value hierarchy consistent with their methods of managing those risks (both items added at the September 6 board meeting).
3. Quantitative information by line item on the income statement that indicates where gains and losses are reported that arise from changes in fair value for those items where the FVO has been elected;
4. A description of how interest and dividends are measured and reported on the income statement; and
5. Disclose the impact of a significant change in creditworthiness on liabilities where the FVO has been elected (added at the September 6, 2006 meeting).

Issues Raised

At the close of the comment period the FASB staff developed a summary of the comments received to date (the key source for this commentary). The issues that have been raised are as wide ranging as the potential impact of this exposure draft. However, for the consumer finance industry, the following items may be of the greatest interest.

Written Loan Commitments: The exposure draft does not allow for the treatment of written loan commitments as qualifying for the FVO unless they qualify as derivatives under current FAS 133 guidance. This inclusion was delayed until Phase 2 by the Board as they saw these loan commitments as having "non-financial components" that would impact the determination of fair value. This item had significant comment from about a third of the respondents with nearly two thirds opposing this exclusion. The key objection seems to be due to it's inconsistency with other valuation methods for items within the scope of the exposure draft. For example, the valuation of mortgage loans requires the estimation of a non-financial element—prepayment speeds. Or loan locks that qualify as derivatives under FAS 133 require the estimation of loan fallout/pull-through. Another issue that was raised was the inconsistency of SAB 105 (which excludes the servicing component from loan lock valuations) to the FVO.

Contract by Contract Election: The election of the FVO on a contract basis was commented on by nearly half of the respondents with most reporting some concerns with this approach. Those concerns ranged from the lack of clarity in the exposure draft to issues surrounding the required level of documentation. On the positive side, it was commented that this approach would allow greater flexibility in the determination of the items to include/exclude in the FVO. This could facilitate the "fine tuning" of economic hedging activities. On the concern side, there were those who supported taking a look at the election on an entity-wide or similar asset or liability basis. An entity-wide election could be such that a firm could elect to have all financial assets and liabilities in the FVO. The similar asset model would have all assets (or liabilities) that are similar in nature included in the FVO, e.g., the mortgage loans in the warehouse or specific credit card receivables. In contrast, there were comments that current General Accepted Accounting Principles ("GAAP") allows the election of fair value accounting for a portion of an asset or liability. The key argument here was that risk management activities may not result in all of a particular asset or liability being hedged, and that this election would be consistent with the permission granted in FAS 133 to hedge a portion of an asset or liability. The board discussed this at the September meeting and decided to retain the FVO election at a contract level.

Documentation Requirements: The exposure draft requires that the election be supported by concurrent documentation or a pre-existing documented policy for automatic election. This was uniformly opposed in the comment letters. The Staff summarized these objections in two key points. First, it was suggested that the FVO election be subject to and controlled by the firm's internal control processes not by a requirement in a FASB standard. One respondent supporting this approach focused on the rationale for this requirement—"an anti-abuse provision." In their mind, this should be something that the system of internal controls should be able to manage. The second point lies in the required level of

documentation—will we have a FAS 133-like world of documentation? That would defeat the one objective of the FVO—that of reducing the burden of FAS 133. In September, the board decided not to provide specific guidance on documentation requirements.

Changes in a Liability's Fair Value Due to the Debtor's Creditworthiness: In the FVO as it currently stands, the full change in fair value of debt that is under the FVO will be included in earnings. If a debtor were to have a reduction in their credit quality, this could result in booking a gain from that credit deterioration. This was strongly objected to because a company would be able to "benefit" from deterioration in its credit quality while they would (apart from default) have to pay the full par amount of the debt. Unfortunately, the Staff was not provided with many clear alternatives to this approach. One alternative was to have the change in value due to credit reported in OCI instead of the P&L. Alternatively, it was suggested that the entity elect to only use the change in fair value due changes in market movements—similar to the benchmark interest rate approach in FAS 133. In any event, this potential gain due to the deterioration in the issuer's credit quality could end up being the subject of significant levels of disclosure. At the September meeting, the Board decided to retain the effect of changes in creditworthiness in the issuer's debt.

Delayed Election of the FVO: The timing of the election of the FVO was discussed and comments received focused on several areas. First, there was some concern expressed related to the definition of "initial recognition." Was "initial recognition" as of the trade or as of the settlement date? The Board was asked to clarify this position as it could have ramifications. For example, the recognition of a hedging derivative would normally occur at trade date, but the offsetting asset/liability would have an ambiguous and potentially mismatched initiation of valuations. Additionally, it was discussed whether a change in contractual terms of the instrument should be an "initial recognition" event. Finally, there was commentary on what exactly would be included in the definition of a "new basis" event. One respondent suggested that the change in risk management strategy be considered as such an event. That same respondent also suggested that the termination of the risk management strategy be an opportunity to elect out of the FVO for that item. At the September 6 meeting, the Board concluded that the FVO must be elected at initial recognition or when there is a new basis event. However, they agreed that in the final basis for conclusions there should be a clarification if the transaction is initially recorded at trade date then the FVO should also be at the trade date.

Recognizing Changes in Fair Value in Earnings: There were a significant number of comments on the requirement that the change in fair values be recorded in earnings. Most of those commenting wanted the Board to consider changing the recognition of the changes in fair value into OCI. This was primarily driven by concerns over the potential for earnings volatility that would distort reporting on operating results. They were also concerned that some of this earnings volatility would be attributed to differences in valuation models and not directly related to the financial results. The Board discussed this issue and retained the position that any changes in the fair value of items accounted for under the FVO should be recorded in earnings. Additionally, they concluded that changes in the whole fair value would be used—they rejected the FAS 133 model that would permit the exclusion of certain selected risks from the value measurement.

Effective Date: The proposed effective date of the Standard (for fiscal years that begin after December 15, 2006) was the topic for some comment and discussion. Among the concerns that were raised to support delaying the proposed standard, were the need to have time to make system changes, this is a one time election for existing assets and liabilities, and the effective date should match that of the Fair Value Measurement Standard. The key issue behind the system changes is the need to adjust them to support full fair value measurement. If a system is set up for FAS 133, it is likely that it is geared to measuring the valuation based on the benchmark rate method which is significantly different from the full fair value.

Conclusion

This standard has significant issues and will be the subject of continuing discussion and debate. However, in spite of the complexities, there appears to be significant support for moving forward in the direction that this exposure draft outlines. The key will be how these details are worked out as the final standard takes shape.

Please Welcome FAS 157—The New Fair Value Measurement Standard and Hierarchy

On September 15, 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (the "Statement" or "FAS 157"). FAS 157 addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under GAAP. Many current standards require or permit specific assets and liabilities to be recognized or disclosed at fair value however those standards specify **when** fair value measures should be used. The FASB recognized that there was no single consistent framework within the accounting literature for applying fair value measurements and developing a reliable estimate of fair value. FAS 157 emphasizes the importance that the FASB has placed on the use of fair value in financial reporting, particularly for financial instruments that have readily determinable fair values.

The purpose of this Statement is to increase consistency and comparability of fair value estimates by:

- Defining fair value;
- Establishing a framework for measuring fair value; and
- Expanding disclosures of fair value measurements.

FAS 157 is effective for years beginning after November 15, 2007 (e.g., in 2008 for calendar year-end companies); although earlier adoption is encouraged and permitted so long as no financial statements have been issued for the fiscal year (including interim financial statements). FAS 157's transition provisions require that the standard generally be applied prospectively as of the first interim period for the fiscal year in which it is initially adopted. The Standard must also be applied retrospectively as of the date of adoption for instruments with blockage adjustments, affected by EITF Issue 02-3 *"Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities,"* or subject to the FAS 155 fair value election *"Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140."*

Definition of Fair Value

Paragraph 5 of FAS 157 defines fair value as:

> "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

Paragraph 7 of FAS 157 further defines what is meant by the price for fair value measurement. A fair value measurement assumes that the asset or liability is exchanged or settled in an orderly market transaction at the measurement date. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

FAS 157 indicates that a fair value measure is based on an orderly transaction between market participants in the principal market or, in the absence of a principal market, the most advantageous market for the asset or liability. The principal market is the market with the greatest volume and level of activity for an asset or liability and the most advantageous market is the market where an entity would receive the highest selling price for an asset or pay the lowest price to transfer a liability. These are new concepts that have been introduced by the FASB. FAS 157 clarifies that the most advantageous market could be different for different reporting companies.

FAS 157 clarifies that the term fair value is intended to mean a market-based measure as opposed to entity-specific measures. FAS 157 gives the highest priority to quoted prices in active markets when measuring fair value. Companies that are currently only using entity-specific methods and assumptions to measure for fair value without considering information available from market participants will need to change their practices in order to comply with FAS 157.

The transaction is considered from the perspective of a market participant that holds the asset (seller) or owes the liability (transferor). Therefore, the objective of a fair value measurement is to determine the price that would be received to sell the asset or paid to transfer the liability at the measurement date (an exit price). In addition, FAS 157 clarifies that in measuring the fair value of a liability, a company should take into account the effect of its own credit standing. This requirement could lead to results that do not appear to be logical from the standpoint that as a companies credit quality deteriorates, the company would recognize a gain in the income statement due to the decrease in fair value of the liability. The FASB has reiterated throughout the comment letter process for FAS 157 as well as the Fair Value Option proposed standard that an entity's own creditworthiness is a key component to the overall fair value of a liability.

Valuation Approaches

FAS 157 describes three main approaches to estimating fair value:

- The market approach;
- The income approach; and
- The cost approach.

The Market Approach

The market approach uses observable prices and other relevant information generated by market transactions involving comparable assets or liabilities. Some potential sources for market values are:

- Exchange markets;
- Dealer markets;
- Brokered markets; and
- Principal to principal markets.

Valuation techniques consistent with the market approach include use of market multiples derived from a set of comparables or matrix pricing. Matrix pricing refers to a mathematical technique used to value debt securities without relying exclusively on quoted prices but rather the securities' relationships to other benchmark quoted securities.

The Income Approach

The income approach uses valuation techniques to convert future cash flow amounts to a single present value amount. Those valuation techniques may include the following:

- Present Value of Expected Future Cash Flows;
- Option Pricing Models (i.e., Black-Scholes/Binomial models);
- The multi-period excess earnings method, which is used to estimate fair value of certain intangible assets.

The Cost Approach

The cost approach is based on the amount that currently would be required to replace the service capacity of an asset considering utility and obsolescence. Service capacity is often referred to as current replacement cost.

The Fair Value Hierarchy

FAS 157 establishes a fair value hierarchy to prioritize the inputs used in valuation techniques to increase consistency and comparability in fair value measures. The hierarchy is used to evaluate significant inputs to the valuation process, rather than valuation techniques used to value an asset or liability at fair value.

The valuation inputs range from external market sources (observable inputs) and internal entity sources (unobservable inputs). The hierarchy is focused on transparency and using market based information that is readily available to all parties. The selection of appropriate valuation techniques may be affected by the availability of inputs that are relevant to the asset or the liability, as well as the relative reliability of the inputs.

There are three broad levels to the fair value hierarchy of inputs:

Level 1: Quoted prices: Prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

- If the entity holds a large position (block) of a financial instrument that has a quoted price in an active market, the fair value of the position is a Level 1 estimate and computed as the quoted price for an individual trading unit multiplied by the quantity held. The quoted priced should not be adjusted for the size of the position relative to trading volume (use of a blockage factor);
- Emphasis is on the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market; and

- Emphasis is also placed on whether the reporting entity has the ability to access the price in that market at the measurement date.
- Companies that hold a large number of similar assets and liabilities oftentimes will use an alternative pricing methodology when a quoted price in an active market not be available, such as matrix pricing. Matrix pricing is a mathematical technique that is a very common approach to valuing bond portfolios and as specified in FAS 157, use of matrix pricing would be considered a Level 2 input.

Level 2: Inputs other than quoted prices included in Level 1 that are observable either directly or indirectly:

- Quoted prices for similar assets or liabilities in active markets;
- Quoted prices for identical or similar assets or liabilities in markets that are not active, that is, markets in which (1) there are few transactions for the asset or liability; (2) the prices are not current; (3) price quotations vary substantially either over time or among market makers (e.g., some brokered markets); or (4) little information is released publicly (e.g., a principal-to-principal market);
- Inputs other than quoted prices that are directly observable for the asset or liability; and
- Inputs that are derived principally from or corroborated by other observable market data through correlation or by other means (market-corroborated inputs). Significant adjustments to Level 2 inputs may cause the fair value measurement to move down to Level 3.

An example of a Level 2 input would be the LIBOR swap rate.

Level 3: Unobservable inputs:

- Unobservable inputs reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing; and
- The reporting entity's own data (adjusted if information is reasonably available without undue cost and effort to reflect market based assumptions).

Examples of Level 3 inputs include historical default and returns for an entity's portfolio.

By distinguishing between inputs that are observable and those that are unobservable, the hierarchy is a useful indicator of the relative reliability of the estimates. FAS 157 requires that the estimate of fair value maximize the use of observable inputs and minimize the use of unobservable inputs, which may change current practice for some entities. In some cases, inputs for valuation techniques that are used to measure fair value may fall within different levels of the fair value hierarchy. FAS 157 states that the **lowest level** of significant input determines the placement of a fair value measure in the hierarchy.

Disclosures

An important concept about the hierarchy is the expanded disclosures that will be required when measuring fair value subsequent to initial recognition. The requirements differ depending on whether you are measuring on a recurring or non-recurring basis and at what Level in the hierarchy the inputs fall into. The objectives of the disclosures are to inform the reader of the types of instruments valued in accordance with the fair value hierarchy.

Expanded disclosures are required for Level 3 inputs that include a reconciliation of the beginning and ending balances including total gains and losses (realized and unrealized) for the period, except for derivative assets and liabilities which may be presented net. These expanded disclosures are meant to provide users with information to assess the quality of reported earnings by segregating the unrealized gains and losses recorded in the income statement that relate to Level 3 inputs.

Conclusion

FAS 157 has addressed the fair value challenge by establishing a framework for measuring fair value and expanding disclosures regarding fair value measurements. The fair value framework does not however, eliminate the complexity and judgment required to estimate fair value. For example, given the proliferation of complex financial instruments that have unusual features, the determination of fair value will remain judgmental and may not always conclude in a consistent result.

Nevertheless, this Statement does provide a single definition of fair value, a consistent framework to measure fair value and expanded disclosures that will help increase transparency to investors.

Is There Some Relief for Accountants?

In March 2006, the FASB released Statement of Financial Accounting Standard No. 156, an amendment to Statement No. 140 for the accounting for servicing of financial assets[1]. In addition, the FASB recently issued a proposed statement of financial accounting standards for "The Fair Value Option for Financial Assets and Liabilities.[2]" The announcement of FAS 156 is already showing its effects. Many companies have early adopted the standard as it relates to mortgage servicing rights and the fair value option project could have a similar and significant impact on the accounting for mortgage loans held for sale. Indeed, the FASB could be offering relief to companies who are attempting to achieve hedge accounting under FAS 133 for their mortgage servicing rights and loans held for sale.

Historical Accounting Framework

Under the current accounting framework governing mortgage servicing rights ("MSR") and mortgage loans held for sale ("LHFS"), there is a challenge for companies that are trying to hedge the changes in the fair value of their MSRs and LHFS against changes in interest rates using derivative financial instruments. Under FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, companies are required to record MSRs at LOCOM. Likewise, under FAS 65, companies are required to record LHFS at the LOCOM. Because these assets are recorded at LOCOM and the derivatives used to hedge the change in fair value of these assets are recorded at fair value, a challenging accounting situation exists.

Instead of accepting the volatility in their income statement, many companies have decided to seek to hedge accounting under FAS 133 for their MSR and LHFS. For companies that have tried to achieve or are trying to achieve hedge accounting under FAS 133 for their MSRs or LHFS, the process is difficult. The application of hedge accounting requires complex systems to track derivatives and to aggregate assets into similar assets in order to designate the derivatives as hedges for FAS 133 purposes, after which the Company must then assess the effectiveness for each of its hedge relationships.

FAS 156: Statement on the Accounting for Servicing of Financial Assets

On March 6, 2006, the FASB released FAS 156 which includes an option that permits investors in servicing assets to elect either fair value or the amortization method ("LOCOM") as the subsequent measurement attribute for each class of servicing that is separately accounted for under GAAP. The new standard should be adopted as of the first fiscal year beginning after September 15, 2006. Companies may early adopt, unless they have already released interim financial statements. Under FAS 156, servicing rights recognized as a result of transfers of financial assets accounted for as sales are initially measured at fair value rather than an allocation of the previous carrying amount between the assets sold and the retained interests based on their relative fair values. For companies

1 Statement of Financial Accounting Standards 156: "Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140," issued March 6, 2006, available at www.fasb.org

2 Proposed Statement of Financial Accounting Standards: "The Fair Value Option for Financial Assets and Financial Liabilities. Including an amendment of FASB Statement No. 115," issued January 25, 2006, available at www.fasb.org

electing fair value measurement as the subsequent measurement attribute, subsequent changes in the fair value of servicing assets for the applicable class of servicing will be recognized in earnings. This guidance is to be applied prospectively to all new servicing assets recognized after the election. Existing servicing assets on the date the election is made should be marked to fair value through a cumulative effect adjustment to beginning retained earnings. The election must be made separately on each major class of servicing rights. Classes of servicing rights should be identified based on the availability of market inputs used in determining fair value or a company's method for managing risk or both. The election is irrevocable and must be made at the beginning of a company's fiscal year.

In taking up the project to reconsider the accounting for servicing assets, the FASB recognized that the accounting for MSRs was complex. The FASB also appears to have noted the difficulties associated with the application of hedge accounting for MSRs, for accounting purposes, in accordance with FAS 133. Achieving hedge accounting under FAS 133 is complicated by the fact that the fair value of MSRs does not move linearly with interest rates due to the nature of prepayment behavior, which causes MSRs to lose value faster when interest rates decline than the rate at which MSRs gain value when rates rise. A primary objective of allowing an election for fair value accounting is therefore to simplify the accounting for MSRs by avoiding the difficulties in obtaining hedge accounting treatment under FAS 133. In addition, fair value accounting provides relief from the substantial recordkeeping needed to support hedge accounting under FAS 133.

Of equal importance, widespread election of fair value accounting would improve the transparency and comparability of MSR portfolios and financial results among those companies that make the fair value election. Historically under FAS 140, the comparability of financial results across companies was impacted by companies' decisions made with respect to several factors:

- LOCOM accounting;
- Whether or not FAS 133 hedge accounting is applied;
- The risk management approach taken towards MSRs;
- How the MSR is fair valued (models and assumptions);
- MSR amortization measurement techniques;
- MSR stratification methodology; and/or
- Other than temporary impairment measurement techniques.

The complexity of the historical accounting model was such that users of financial statements did not always understand the interrelationships among these factors as evidenced by recent examples of companies with temporary impairments being penalized by the financial markets compared to those with FAS 133 write-downs. Widespread adoption of fair value accounting would improve transparency and increase the ability of investors to assess the true drivers of financial results.

In terms of earnings volatility, arguments can be made that the adoption of fair value accounting could increase or decrease volatility of reported earnings, depending on the company's risk management strategy. Fair value accounting for MSRs would enable a write-up of the asset in the event of an increase in fair value, providing at least a partial offset to mark-to-market losses on derivatives contracts used to hedge the asset. This may reduce volatility of reported earnings for companies hedging the MSR asset using derivative instruments. On the other hand, volatility of reported earnings may increase for companies that would be marking-to-market the MSR under the fair value option and either do not hedge, or who use investment securities classified as available for sale as economic hedges of MSRs. In this situation, the securities are marked-to-market through other comprehensive income on the balance sheet, rather than through earnings.

Further, companies who no longer seek to claim hedge accounting under FAS 133 may find the need to make additional disclosures and provide additional commentary on hedge performance. This is explicitly highlighted in FAS 156 by the FASB as a recommendation, but is not required. Assuming that investors and analysts will still require support for and explanation of the hedge strategy and its economic effectiveness, such detail will no longer be available through disclosures previously made in accordance with the requirements of FAS 133.

In terms of implementing fair value accounting, the mortgage industry already employs fair value methods in the current accounting model and has proven methods in place to derive fair value estimates. Operational and systems concerns that were once problematic for the industry are less common today. As a result, it seems that fair value accounting would not impose significant new difficulties on reporting entities from the perspective of deriving valuations for MSRs.

In addition to providing companies an election for fair value, the FAS 156 provides entities with the ability to make a one-time transfer of securities used to economically hedge MSRs from available for sale to trading in accordance with FAS 115 without "tainting" the remaining portfolio. This is an important benefit to companies using securities to provide economic hedges of MSRs as a trading classification, as it will alleviate revenue recognition timing differences. The one-time transfer will result in the reclassification of any gains or losses that are carried in other comprehensive income to retained earnings as a cumulative effect adjustment. The carrying amount of reclassified securities and the effect of reclassification on the cumulative effect adjustment are required to be disclosed.

Many members of the mortgage industry – including most of the top 10 sevicers— embraced the standard and early adopted FAS 156 prior to the release of their first quarter's 10Q. In the following months, many of the large players in the industry elected the fair value option. While this has improved transparency as described above, the industry is still working out a couple of kinks. Some notable unresolved issues are how companies are defining a "class of separately recognized servicing assets" and how companies structure their roll-forward disclosures.

As it pertains to roll-forward disclosures, FAS 156 only provided captions to disclosure changes in fair value as either changes due to “changes in inputs or assumptions” and “other changes.” Preliminarily, most companies who have elected the fair value option have decided to use the “other changes” categorization for disclosing fair value runoff. While companies have defined fair value runoff in their disclosures, the definition and calculation has not been consistent across the industry. It does appear that fair value runoff in many cases is being isolated, so that changes in the asset which are being hedged (due to inputs and assumptions) are easily identifiable.

Conclusion

As discussed above, the mortgage accountant’s headache may be relieved from the FAS 133 burden with the combination of the implementation of FAS 156, for servicing assets and the FASB’s anticipated fair value option project. However, we recognize the potential for the start of a migraine as more scrutiny is placed on fair values and required disclosures to the users of the financial statements. Get ready!

FAS 155 Reminder

In February 2006, the FASB issued FAS 155, *Accounting for Certain Hybrid Financial Instruments*. FAS 155 nullifies the guidance from the FASB's Derivatives Implementation Group ("DIG") in Issue D1, *Application of Statement 133 to Beneficial Interests in Securitized Financial Assets*, which deferred the application of the bifurcation requirements of FAS 133 for certain beneficial interests until the FASB considered whether beneficial interests in securitized financial assets (1) met the definition of a derivative under FAS 133, (2) contain an embedded derivative, or (3) were eligible for the scope exception described in paragraph 14 of FAS 133 related to interest-only or principal-only strips. FAS 155 does the following:

- Provides a fair value measurement option ("FVO") for certain hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation;
- Clarifies that only the simplest separations of interest payments and principal payments qualify for the exception afforded to interest-only strips ("IOs") and principal-only strips ("POs") from derivative accounting under paragraph 14 of FAS 133 (thereby narrowing that exception);
- Requires that beneficial interests in securitized financial assets be analyzed to determine whether they are freestanding derivatives or whether they are hybrid instruments that contain embedded derivatives requiring bifurcation;
- Clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives; and
- Allows a qualifying special-purpose entity ("QSPE") to hold passive derivative financial instruments that pertain to beneficial interests that are or contain a derivative financial instrument;

Note: The FASB recently approved proposed guidance limiting the scope of the certain aspects of the above guidance. The Board directed the FASB Staff to prepare an exposure draft for a 30 day comment period with the expectation that final guidance in the form of a SFAS 133 Implementation Issue will be issued in the first quarter of 2007, before reporting deadlines for periods ending December 31, 2006. See further commentary within the meeting minutes of the October 25, 2006 FASB meeting.

The new guidance is effective for all instruments acquired, issued or subject to a remeasurement (new basis) event occurring after the beginning of the first fiscal year that begins after September 15, 2006.

As companies are thinking through the implementation aspects of this new standard, PwC strongly believes engaging your accounting firm in an early dialogue around implementation issues associated with the new standard is essential.

SEC Scrutiny Over Cash Flows

Introduction

The statement of cash flows has become a recent topic of interest with the SEC of late. This additional scrutiny has resulted in earnings releases being withheld past scheduled press release dates, decreased investor confidence in the reliability of reported cash flows, and has frustrated all levels of numerous organizations from the financial reporting department all the way up to the Boards of Directors.

Historically, certain professional judgment has been exercised in determining the classification of cash flows between operating, investment, and financing activities with the end user of the financial statements in mind. The SEC has made it clear that the classification of cash flows between operating, investing, and financing activities is important to the reader of the financial statements requiring presentation and disclosure within the cash flow statement to reflect similar priorities as in the balance sheet and income statement. This is further highlighted by the fact that there are two FASB standards regarding the statement of cash flows. See the commentary throughout the remainder of this article for further discussion regarding the challenges consumer finance companies have faced pertaining to the cash flow statement.

Operational Issues

Consumer finance companies, like the broader industry, are facing increasing regulatory scrutiny over the cash flow statement. Some of the more common challenges consumer finance companies have struggled with include: how to appropriately reflect cash received from the sale of loans originally acquired with the intent to hold them for the foreseeable future (i.e., loans held for investment), how to reflect the sale of loans for any retained interests held in those loans, how to record cash received on retained interests that are classified as available for sale or held to maturity securities, and how to record the capitalization of servicing rights within the cash flow statement.

In order to aid the conversation around the appropriate accounting treatment of certain loan-related cash flow topics, the below commentary from the 2005 AICPA National Conference on Current SEC and PCAOB Developments held on December 5, 6, and 7 of 2005 was reviewed (specifically commentary regarding the "Cash Flow Statement"). It was clear that the SEC recommended that registrants take a "fresh look" at the statement of cash flows, in its entirety, including routine and non-routine transactions. Some of the specific topics identified were discontinued operations, dealer floor plan financings of inventory, proceeds from insurance claim settlements, loans held for sale and retained interests in securitized loans. While all of the topics discussed at "the conference" are considered significant, the remainder of this discussion will focus on loan classification and retained interests in securitizations as they directly relate to the consumer finance industry.

Loan Classification

The SEC staff commented on the recent growth in the asset-backed securities market, remarking that there is a question of when loans and trade receivables should be classified as loans that are held for investment ("LHFI") instead of loans that are held for sale ("LHFS"). The SEC staff noted two pieces of applicable literature: (1) FAS 65, Accounting for Certain Mortgage Banking Activities, the scope of which includes mortgage banking enterprises that purchase or originate mortgages and (2) SOP 01-6, which includes in its scope finance companies, as well as non-finance companies that engage in lending or financing activities. The SEC staff believes that SOP 01-6 is relevant to most companies with loans and trade receivables and noted that issues have arisen when non-finance companies have failed to apply the SOP's requirements. The SEC staff has observed cases in which a company has cash flows that indicate the company routinely sells loans, but the company makes no disclosures about whether it accounted for the loans as LHFS.

Under SOP 01-6, loans should be classified as LHFI when management has the intent and ability to hold the loans for at least the foreseeable future, otherwise the loans should be classified as LHFS. Once a company has decided to sell loans that were previously classified as LHFI, such loans should be transferred to the LHFS category at the lower of cost or fair value. The SEC staff reminded companies to disclose (1) how they determine their loans' classification, (2) the method they used to determine the lower of cost or fair value, and (3) that they plan to sell certain loans or trade receivables.

In addition, transfers of loans from LHFS to or from LHFI may create classification issues within the cash flow statement if not properly tracked within the loan inventory system. As the classification between operating and investment cash flows within the cash flow statement is determinant based on the loan classification at the time the cash flows were received. The process in which loans are transferred (in the event a loan was originated or purchased with the intent to sell and was subsequently transferred to loans held for investment) consists of the loan being transferred at the lower of cost (i.e., basis, which includes previously deferred fees and costs) or market value ("LOCOM") on the date of transfer. Any difference between the carrying amount of the loan and its outstanding principal balance on the date of transfer shall be recognized as an adjustment to yield over the life of the loan in accordance with the interest method. No retroactive amortization catch up from the date the loan was funded to the date of transfer is required.

Likewise, if a loan was originated or purchased with the intent to hold for investment purposes and subsequently transferred to loans held for sale, the transfer shall be recorded at LOCOM on the date the decision to sell is made. The associated deferred fees and costs are no longer amortized and are rolled into the cost basis of the loan for the purposes of the LOCOM analysis and eventually recognized in the overall gain of sale calculation upon disposition. No correcting entry for amounts previously amortized into income while the loan was held in the HFI portfolio is required.

Generally, classification in the statement of cash flows depends on the initial classification of the loans (i.e., as LHFS or LHFI). Under FAS 102, if the loans are acquired specifically for resale (i.e., LHFS), cash receipts and payments should be classified as operating

activities. If the loans are acquired as investments (i.e., LHFI), cash receipts and payments should be classified as investing activities. Under FAS 102, if a LHFI is reclassified as LHFS on a later date because of a change in the purpose for holding the loan, its cash flows should continue to be classified as investing activities.

As consumer finance companies routinely buy and sell loan portfolios, it becomes increasingly important to track the changes in classification of these loans in order to appropriately reflect the cash flow streams within the cash flow statement. The process to track and correct this at year end can be extremely burdensome in the event servicing and loan inventory systems aren't designed to track such activity. Given the typically large volume of loan transfers and sales activity within a consumer finance organization, this may require significant resource needs to identify the loan sales, any changes in loan classification, and the resulting accounting impact.

Retained Interest in Securitized Loans

When companies sell loans or trade receivables, they might retain an interest in the sold loans. The SEC staff noted instances in which companies have incorrectly treated the receipt of a retained interest as a cash inflow, rather than as a non-cash activity.

In addition, the SEC staff noted that subsequent cash inflows should be driven by the method that the company uses to account for the retained interest. As mentioned above, pursuant to FAS 102, principal payments should be recognized as operating inflows if the retained interest is accounted for as though it were a trading security; otherwise, principal payments should be recognized as investing inflows. Similarly, cash outflows should be determined by whether the loan was classified as LHFI or LHFS. When the retained interest for a LHFS is accounted for as an available-for-sale security, there will be negative operating cash flows because the cash flows from the loan acquisition and sale are classified as operating cash flows, but the cash flows from the retained interest are classified as investing cash flows.

This is ever prevalent within the securitization market as loans are often sold with the transferor retaining certain interests. When considering the appropriate classification of cash flows, one may need to evaluate each class of transaction rather than an overall accounting policy for the retained interest portfolio as a whole.

Summary

The above commentary is meant to provide guidance for companies to put preventative measures in place necessary to avoid scrutiny over liquidity and certain cash flow presentation challenges. While more and more items are taken in the literal sense rather than, as may be viewed in some cases, the practical sense, it becomes increasingly important for management to know and understand the cash flow classification challenges that lie ahead of them.

Correction of an Error—
Newly Issued SAB 108

Introduction

As the financial services industry becomes more complex with ever changing business models, regulations, and accounting principals, the potential for financial statement errors has increased within organizations. Management is left fighting an up hill battle of finding, correcting, and then preventing these errors from occurring again in the future. With the recently issued Staff Accounting Bulletin 108, there is even more to consider.

The SEC Staff has recently issued *Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements ("SAB 108")*, which addresses the method in which companies assess and evaluate the materiality of known errors within their financial statements. Similar to procedures followed in the past, the "iron curtain" and "rollover" methods of assessing materiality are still recommended. However, recent guidance within SAB 108 requires both methods to be evaluated including the effect any correcting entries may have on the overall financial statements. Not only are both methods required to be considered, but the greater result of the two methods must then be assessed for materiality. In the event the error was material under either method, management must then assess the impact of making the necessary correction to the financial statements. In addition, prior period financial statements may need to be restated for immaterial prior period corrections if such corrections relate to material current period errors.

This article will discuss how SAB 108 guidance affects the method in which errors are evaluated, assessed for materiality and eventually recorded within the financial statements.

Rollover versus Iron Curtain Method

Over the past several years both, the "iron curtain" and "rollover" methods of accumulating and assessing known errors for financial statement adjustment have been followed. Both methods have their shortcomings.

The rollover method may result in the balance sheet being materially misstated over time if adjustments are only assessed using this methodology. This is possible as the rollover method of correcting a misstatement originates within the income statement of the financial statements and focuses primarily on the impact the error has on the income statement, potentially ignoring balance sheet effects.

An example of such a situation would be an error in which an incorrect accrued expense was incorrectly accrued each reporting period for a number of periods resulting in the accrued liability building up over time in the wrong amount within the balance sheet. The rollover approach would only correct for the current period accrued expense leaving an accrued liability in the balance sheet potentially indefinitely. This method may result in large misstated amounts remaining in the balance sheet as the amount assessed for

materiality under the rollover method is quantitatively small for the current period as that amount is based on the income statement impact rather than the balance sheet. See the example below of such a fact pattern with corresponding correcting entries under both the rollover and iron curtain methods.

As the rollover method has its problems, the iron curtain method approaches the known error from the opposite side. Rather than focusing on the income statement as is the case with the rollover method, the iron curtain method focuses on the balance sheet impact of any misstated amount. While this may seem to be a better approach, it sometimes results in the income statement being misstated for the current period. This is possible through the correcting entry necessary to accurately reflect the balance sheet. As shown within the example below, the iron curtain method of correcting the entry properly reflects the balance sheet, however, through recording the correcting entry, the current year income is understated as shown in the example below. See the facts of the situation and corresponding correcting entries for both methods below. Also see the short-falls of each method as illustrated below. Note that this example was obtained from the Staff Accounting Bulletin No.108 guidance.

Example Situation

During the course of preparing annual financial statements, a registrant is evaluating the materiality of an improper expense accrual (e.g., overstated liability) in the amount of $100, which has built up over five years, at $20 per year. The registrant previously evaluated the misstatement as being immaterial to each of the prior year financial statements (i.e., Year 1 through Year 4). For the purpose of evaluating materiality in the current year (i.e., Year 5), the registrant quantifies the error as a $20 overstatement of expenses.

Year 1 Entry		
Expense	$20	
Accrued Liability		$20

Year 2 Entry		
Expense	$20	
Accrued Liability		$20

Year 3 Entry		
Expense	$20	
Accrued Liability		$20

Year 4 Entry		
Expense	$20	
Accrued Liability		$20

Year 5 Entry (today)		
Expense	$20	
Accrued Liability		$20

Rollover Method Correcting Entry		
Accrued Liability	$20	
Expense		$20

Rollover Method Remaining Misstated Amount

The amount of $80 in the accrued liabilities would potentially remain misstated indefinitely.

Iron Curtain Method Correcting Entry		
Accrued Liability	$100	
Expense		$100

Iron Curtain Method Remaining Misstated Amount

The current year income statement would be misstated by the amount of $80.

As illustrated above, both the rollover and iron curtain methods of quantifying and correcting known errors have shortcomings. SAB 108 is intended to minimize such shortcomings and better reflect correcting entries within the financial statements as well as reduce varying methods of correcting such misstatements. See further commentary below regarding the specific requirements of SAB 108.

Staff Accounting Bulletin 108 Requirements

Given the previously discussed shortcomings of the rollover and iron curtain methods of quantifying misstatements and the divergence in practice of applying each method, SAB 108 now requires both the rollover and iron curtain methods to be considered. Once this is done, the larger amount of the two results must be assessed for materiality in the current period. In the event the aggregated known error is material to the current period financial statements, an adjusting journal entry is required to correct that error. Then the remaining financial statement effect (i.e., remaining income statement being understated by $80 under the iron curtain method as illustrated above) of that adjusting journal entry must be assessed for materiality.

In the event the remaining effect is material to the current period financial statements, and it relates to prior reporting periods, the prior period financial statements should be corrected, even though such revision previously was and continues to be immaterial to the prior period financial statements. During the period of adoption of SAB 108, any prior period correction would not require previously filed reports to be restated, but correction may be made the next time the registrant files the prior period financial statements. However, this would not apply to periods subsequent to adoption of SAB 108 requiring the prior period financial statements to be restated.

The requirements mentioned above are meant to create unison in the method in which known misstatements are quantified and corrected. While the balance sheet versus income statement focus is now driven by materiality of error, the underlying problem of remaining balance sheet or income statement error must be assessed. This develops a more comprehensive materiality assessment to more accurately reflect the overall financial statements rather than the balance sheet or income statement alone.

Conclusion

While there may not be one perfect method of evaluating accounting errors, SAB 108 is intended to come as close as possible to that ideal scenario as well as help reduce diversity in practice of quantifying financial statement misstatements. The above guidelines help to accomplish that goal by requiring an organization to consider additional financial statement impact inherent in recording adjusting journal entries and the manner in which known errors are evaluated for materiality. In addition, the concept of correcting prior period errors for immaterial amounts relevant to those periods is something of a new development that may impact companies industry wide. Lastly, it is this author's opinion that as SAB 108 will require additional effort in accurately correcting known errors within the financial statements, it is a step in the right direction as far as the transparency and quality of financial statements issued and used by readers thereof. As this article is meant to be a brief summary of SAB 108, please refer to more in-depth discussion within PwC Datalines 2006-22 and 2006-23 for further commentary and explanation of implementing SAB 108.

Accounting for Reverse Mortgages

The growing baby boom population and their need for resources to finance home improvements, pay healthcare expenses, or take a retirement trip to dream destinations, is resulting in many older Americans turning to "reverse" mortgage products. This product allows the homeowners to convert equity in their homes built up over time into either a lump sum payment received at closing or a monthly payment without selling their homes or taking on additional monthly bills. In general, the "reverse mortgage" allows the borrower to receive money from the lender without the requirement to repay as long as they are alive or have not relocated from their home.

Various mortgage institutions have considered expanding their product mix and have begun to offer their customers this product. When doing so, these institutions are faced with the accounting challenges to value and appropriately account for these products in accordance with GAAP. These products are very similar to traditional mortgages with respect to overall prepayment behavior, response to current interest rate environment, future collateral value of the underlying property, and expected term (life expectancy) of the borrower. However, there are key attributes that should be considered when applying appropriate accounting guidelines. These factors include but are not limited to the following:

- The mortgage may be subject to origination fees and closing costs as well as servicing fees during the life of the loan;
- Interest is compounded continuously to the total amount outstanding and may be based on fixed or variable rates;
- The loans may be subject to nonrecourse provisions that prevents the borrower from owing more than the value of their home; and
- Actuarially assumptions used for life expectance projections.

The primary authoritative guidance when considering accounting for reverse mortgages is based on a memo by the Securities and Exchange Commission ("SEC") dated October 1, 1992 entitled *Accounting for Pools of Uninsured Residential Reverse Mortgage Contracts* ("SEC Memo"). In summary, the SEC memo provides the following guidance:

- The holder will be required to recompute an effective yield at each reporting period based on the re-estimation of cash inflows and outflows. Investment income is recognized each period by applying the effective yield both retroactively and prospectively to the net investment in the contracts. Current income for the period should be computed by utilizing the cumulative income to date as the revised effective yield method has been applied since the inception of the pool/contract. This can create significant income statement volatility in changing rate environments given the need to recast the effective yield each period;

- Cash projections used to value the assets should include the projection of outflows to the borrower on an actuarial basis including any incremental direct costs. The projection of inflows to the holder is based on either contractual balance or expected proceeds from sale of collateral less selling expenses; and
- The expected value of collateral underlying the contract is considered from current market value, periodically adjusted in accordance with an appropriate index.

The SEC memo describes in detail the factors needed to be considered by any holder when calculating the expected cash flows and inflows and thus determining the effective yield at each reporting period. The market value for these products is primarily driven by the life expectancy of the borrowers and the property value. The SEC's recommendations indicated that the holders of such products are to use simulation models to statistically estimate the value of the houses. This data combined with life expectancy data based on actuary results should allow holders to estimate the value of these products and calculate an internal rate of return for accounting and economic purposes.

Additionally, the SEC Memo requires a number of disclosures in the notes to the financial statements, including but not limited to, description of accounting policy and methods, actuarially estimated future cash payments, significant actuarial and statistical assumptions, income or loss recognized in the period as a result of re-estimated cash flows due do to changes in actuarial assumptions.

The market for these products is largely untapped and expected to continue to grow. As more institutions enter the market, new intricacies to the products will likely develop which will bring additional complications to the operation and accounting for these products.

Postretirement Benefits and Related Pension Accounting and Accounting for Uncertainty in Income Taxes

While postretirement benefits and income taxes are not consumer finance industry issues per se, there has been a lot of activity in these areas both from a standard setter perspective as well as in the broader public space. This article will explore, at a high level, certain aspects of these two issues.

Postretirement Benefits Considerations

Tremendous focus in the marketplace has been placed recently on postretirement benefits and in particular, the role of the defined-benefit pension plan. It's well documented that many companies are moving away from providing their employees with defined-benefit pension plans and replacing them with defined-contribution plans. The reasons for this are numerous and unique to each company's particular situation but one thing is clear from this change and that is the shifting of investment risk from employers to employees. This shift of risk has caused the most debate in terms of how well individuals are prepared to manage their own investments and in turn how will this impact the ultimate amount of retirement benefits aggregated over time.

On top of all this debate within the marketplace, the FASB has proposed significant changes to the way that postretirement benefit obligations are to be accounted for and disclosed in companies' financial statements. The FASB's stated objective of the project it undertook around postretirement benefit obligations was to comprehensively reconsider guidance in FASB Statements No. 87, *Employers' Accounting for Pensions, No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions*, and No. 132(R), *Employers' Disclosures about Pensions and Other Postretirement Benefits*, in order to improve the reporting of pensions and other postretirement benefit plans in financial statements by making information more useful and transparent for all financial statement users. The FASB issued an Exposure Draft on this topic in March of this year and later issued FASB Statement No 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, on September 29, 2006. This was an amendment to FASB Statements No. 87, 88, 106, and 132(R). Calendar year-end public companies will be required to apply the new standard for the 2006 year end reporting cycle. Based on this timing, companies that are impacted should begin preparing to implement the final standard now. Non-public companies will be required to apply the new standard as of the end of the fiscal year ending after June 15, 2007.

The standard requires recognition on the balance sheet of the overfunded or underfunded status of a defined benefit postretirement plan measured as the difference between the fair value of plan assets and the benefit obligation. Key to this aspect of the final standard will be for companies to engage those who perform valuations (i.e., actuaries, etc.) early in the process to provide the required information. Another point of interest on this topic is from a major SEC publication of June 16, 2005, *Special Report: Report and Recommendations*

Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entitles and Transparency of Filings by Issuers, that suggests that approximately $414 billion in net pension liabilities currently are off-balance sheet obligations and $121 billion in other postretirement benefit liabilities are also off-balance sheet. A staggering amount of such off-balance sheet liabilities would need to be recorded on the balance sheets of applicable companies as a result of this standard.

In addition, the standard eliminates the provisions in existing guidance that permit plan assets and obligations to be measured as of a date not more than three months prior to the balance sheet date. This requires all companies to measure their plans as of the date of the financial statements. This change will require companies to ensure they coordinate the receipt of this information from their actuaries at the appropriate time to ensure that the standard's requirements are met and the information received with enough time to process within the financial records. The effective date for the provision in the Standard is fiscal years ending after December 15, 2008.

Given the magnitude of the changes in FASB 158, companies should begin preparing to adopt this standard now. In addition to assessing the potential balance sheet impact, companies should consider the development of communication strategies to the users of financial statements as well as begin a dialogue with their auditors and actuaries to effectively prepare for implementation.

Accounting for Uncertainty in Income Taxes Considerations

Similar to pension accounting, the volume of statutory, regulatory and interpretive guidance on the application of income tax law is voluminous and very complex. Therefore, it is frequently unclear whether a position taken on a company's tax return will ultimately be sustained or result in additional payments in later periods. The related accounting for uncertain tax positions has historically lacked explicit, authoritative guidance and as a result substantial diversity in practice has developed in this complex area. To address this issue and to clarify the accounting, the FASB has released FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes- an Interpretation of FASB Statement 109* ("FIN 48").

FIN 48 prescribes a comprehensive model for how a company should recognize or derecognize, measure, present and disclose in its financial statements uncertain tax provisions that the company has taken or expects to take on its tax return. FIN 48 substantially changes the applicable accounting model and is likely to cause greater volatility in the income statement as more items are recognized within income tax expense.

The following represents an overview of the significant elements of the new guidance within FIN 48:

- A tax benefit may be recognized in the financial statements only if it is "more likely than not" that the company will be able to sustain the tax return position;
- A tax benefit should be measured as the largest amount of benefit that is cumulatively greater than 50% likely to be realized;
- A taxpayer is required to accrue interest and penalties on the unrecognized tax benefit when it's expected that, under relevant tax law, the taxpayer would be regarded as having incurred;
- FIN 48 requires qualitative and quantitative disclosures within the footnotes to the financial statements; and
- FIN 48 is effective as of the beginning of fiscal years that start after December 15, 2006.

Companies should begin to asses the impact that FIN 48 adoption will have on any tax positions taken or expected to be taken and may require that companies obtain updates of current legal opinions on pre-existing tax positions.

Reg AB is Here to Stay: What Does this Mean for Servicers?

Background

The Securities Exchange Commission ("SEC") issued final rules for the Asset Backed Securities ("ABS") industry on December 22, 2004[3] entitled "Regulation AB," which became effective on January 1, 2006. Regulation AB is a set of new and amended rules and forms to address comprehensively the registration, disclosure and reporting requirements for ABS under the Securities Act of 1933 and the Securities Exchange Act of 1934. The final rules are intended to accomplish the following:

- Update and clarify the Securities Act registration requirements for ABS offerings, including expanding the types of securities that may be offered in delayed primary offerings on Form S-3;
- Consolidate existing positions which allow modified Exchange Act reporting that is more relevant to ABS;
- Provide disclosure guidance and requirements for Securities Act and Exchange Act filings involving ABS;
- Streamline existing positions that permit the use of written communications in a registered offering of ABS in addition to the statutory registration statement prospectus; and
- Establish a consistent servicing standard that is used as the basis for measuring each Servicer's performance.

The entire set of requirements are enumerated § 229.1100 though 229.1123. The section of Regulation AB that is of primary importance to Servicers is the annual assertion and accountant's attestation report. These requirements, and the associated servicing standard are described in § 229.1122.

Where the ABS Industry has been

Uniform Single Attestation Program ("USAP"): The existing modified reporting system did not require audited financial statements for the issuing entity in the annual report on Form 10-K, but has instead generally required an assertion by the servicer and an attestation by an independent public accountant regarding compliance with servicing criteria. This longstanding framework was developed based on the recognition that one of the most important elements affecting an investor's assessment of a particular ABS is the performance of the servicer—and that an independent third party checking some aspect of the servicing function provides a certain level of assurance and transparency regarding the servicer's performance. However, the types of assessments and attestations, and the criteria that servicing compliance was assessed against, historically have varied significantly. The most common example involves an assertion on and disclosure regarding compliance with criteria set forth in the Uniform Single Attestation Program for Mortgage Bankers, or USAP, developed by the Mortgage Bankers Association.

3 Securities Act Release No. 8518 (Dec. 22, 2004) [70 FR 1506] (the "ABS Adopting Release"), available on the Web at http://sec.gov/rules/final/33-8518fr.pdf

The Mortgage Bankers Association ("MBA") first issued the Uniform Single Attestation Program ("USAP") in 1983. The most recent revision to the USAP was issued in January 1995[4]. The accountant's report attesting to the assertion under the USAP is prepared in accordance with SSAE No. 10 (Statement on Standards for Attestation Engagements issued pre-PCAOB). The servicer's assertion as to compliance and the accompanying accountant's report are commonly referred to as a "USAP Report." The servicing criteria enumerated in the USAP program were developed for Residential Mortgage Servicers. The principal objective was to establish a standard set of servicing criteria for the residential mortgage backed securities industry. This would allow investors, banking institutions and regulators to evaluate Servicers based upon a uniform compliance requirement. Also, by establishing industry standard servicing criteria, residential mortgage servicers would likely be subject to less extensive third party audit requirements.

The ABS industry quickly adopted the USAP servicing criteria as the "industry standard" for many asset types (e.g., commercial mortgage, auto, credit card, etc.). Given the focus of USAP on residential mortgage ABS transactions, there were numerous criteria, which were wholly or partly inapplicable to other asset classes.

The USAP criteria largely focused on cash management and investor reporting aspects of the Servicing process. There were minimal criteria, which evaluated Servicers asset management responsibilities, such as:

- collateral monitoring and surveillance;
- loss mitigation or recovery actions (e.g., loan modifications & restructuring, foreclosures/repossessions, etc.);
- administration of pool assets (asset replacements, loan defeasance, etc.); and
- maintenance of credit enhancements.

4 Mortgage Bankers Association of America, Uniform Single Attestation Program for Mortgage Bankers (last rev.1995), Available on the web at http://store.mortgagebankers.org/ProductDetail.aspx?product_code=PB2-110119-BK-P

Further, USAP did not require the evaluation of periodic reporting required to third parties (e.g., reports filed with the SEC for public transactions). With this in mind, the USAP criteria did not comprehensively cover the full servicing responsibilities associated with ABS transactions.

Implementation Challenges

The ABS industry has been challenged with several implementation issues related to Reg AB disclosure and the attestation requirements. These challenges include:

- Management Oversight: Participants in the ABS market have invested considerable time in amending and updating the required disclosures and the related offering and trust administration documents pursuant to the requirements of Reg AB. Institutions have heavily involved both their in-house and external legal counsel to understand and interpret the disclosure requirements associated with the securities registration process, changes to periodic reports filed with the SEC and/or investor and disclosure of static pool data. One of the challenges of servicers is to redirect the focus of their oversight

committee to drive compliance with the servicer attestation requirements. This change in focus will likely also require changes or additions to the existing committee members. Generally, senior executives from the servicing and/or trustee business would be expected to participate in the oversight committee.

- Compliance Monitoring: Given the increase in servicing compliance requirements, institutions have been challenged with developing a comprehensive monitoring process to track compliance throughout their organization. Compliance monitoring can be a benefit to management to facilitate ongoing review of their operations and also to allow for early identification of any potential servicing issues.

- Disclosure of Material Non-compliance: Management and the auditor must evaluate and assess all instances of non-compliance and determine which exceptions must be disclosed in management's assertion. The Reg AB guidance does not provide a model for the evaluation of exceptions or examples of material non-compliance. Management will need to use quantitative and qualitative methods of evaluating exceptions when identifying material instances of non-compliance. We expect there to be judgment and skepticism applied when evaluating exceptions. The servicer must be prepared to provide detailed evidence supporting their methodology for assessing exceptions and any related qualitative or quantitative analysis supporting management's conclusions surrounding disclosure of exceptions.

- Responsible Party: Servicers continue to evolve in the process to identify all material parties participating in the servicing process (as defined by Reg AB). This presents a risk in the compliance process since late notification of parties who must comply with the servicer attestation requirements of Reg AB could jeopardize the timely completion of their respective accountant's attestation report.

- Material Outsourced Activities: As required by Item 1122(a) (ii); Servicers must institute policies and procedures to monitor all material servicing activities outsourced to third parties. Management must implement an effective monitoring process to identify vendors servicing a material component of the transaction at the platform level. This process may prove to be difficult and require a deal level analysis to identify all third parties who participate in the servicing process.

- Platform Definition: The industry continues to evaluate the appropriate definition of "platform," which is most appropriate for their respective business. The SEC recently gave guidance that allows asserting parties some flexibility in their definition of platform. See the "Recent SEC Guidance" section below.

- Pool Assets: Servicer's must identify all pool assets in scope based upon management's definition of platform. Depending upon the servicer's degree of automation and use of systems, it may be an onerous process to identify all assets that support the platform.

- Waterfall Testing: Item 1122 (d) (3) (ii) requires that Servicer's accurately calculate distributions made to investors. Institutions are focused on developing new deal modeling controls or enhancing existing controls to comply with this requirement. In particular, as the calculation of these distributions is based upon the waterfall calculation, the auditor must reperform the waterfall calculation in order to evaluate the accuracy of payments to investors. This requirement is a significant change from USAP and will require significant attention on both the part of management and the auditor. Accounting firms will likely use structured finance specialists to perform such testing.

- Static Pool Data: The "Sponsor" of the transaction is responsible for making the materiality judgment on the inclusion of static pool data in the disclosure documents. Most CMBS Sponsor's have determined that static pool data is not material for their asset type. Sponsors also continue to ask whole loan sellers to provide static pool data upon the sale of a pool. For those sellers that sell all of their loans on a servicing released basis, static pool data is frequently not available. During the first half of 2006, securitization sponsors are continuing to buy these pools of loans, but are dividing the loans into multiple securitization transactions in order to manage the resulting concentration percentage to a minimal level.

Recent SEC Guidance

In December 2005 and August 2006, the SEC issued interpretations of Regulation AB and the related rules. The full list of interpretations can be found on the SEC website under the "telephone interpretations" section. The items below represent the new key interpretations that relate to the assertion and attestation report required by section 1122:

- Defining the Servicer's Platform (How much flexibility does the asserting party have when defining their Platform?)

  Interpretation 17.04 allows the asserting party to include only those ABS transactions subject to Regulation AB. Interpretation 17.03 allows the asserting party to define their platforms geographically or based on the computer system on which the information is maintained. The SEC said that it was important for the definition of Platform to remain consistent from period to period and that the platform should never be artificially designed and should mirror actual servicing practices of the asserting party.

- Modification of servicing criteria enumerated in Item 1122 (may the Servicer modify the description of the servicing criteria in their written assertion on compliance?)

  The SEC clarified the Servicers may not modify the servicing criteria pursuant to Item 1122. Rather, if the servicer's process is different than the criteria, this should be disclosed as material non-compliance.

- Who is responsible for the accuracy and completeness of aggregated pool asset data provided by multiple Servicers or parties?

  The SEC clarified that the party who prepares the data is responsible for the accuracy and completeness of their information. The party who is the "data aggregator" is responsible for the completeness of the aggregated data based upon the underlying details. This could fall to one or more parties. At a minimum, a Servicer's assessment of the various criteria under section 1122(d)(4) should include the accurate aggregation and conveyance of such information. See interpretation 11.03 for more detail.

- Will some criteria require the use of experts?

  The SEC clarified that the accountants will not be required to make a legal determination, therefore the use of experts will not be required (e.g., perfection of security interest, loan defeasance) See interpretation 11.04 for more detail.

- Is there any other guidance on materiality?

  Interpretation 17.05 makes clear that noncompliance with respect to the Item 1122 servicing criteria, materiality is to be assessed at the platform level. By contrast, for purposes of the Item 1123 servicer compliance statement, materiality is to be assessed in relation to the individual transaction for which such compliance statement relates.

The Road Ahead

It is expected that 2006 may be among the final years of USAP servicer compliance. Investors will increasingly demand the Reg AB servicer compliance report as the "new" industry standard surrounding servicing compliance. The MBA has previously communicated that while market participants may continue to utilize the USAP program, the MBA will no longer support the USAP program.

While there is a significant penalty assessed to issuers for non-compliance with the filing and reporting requirements pursuant to Reg AB, there is no direct penalty assessed by the SEC for material instances of non-compliance identified in the Servicer's assertion and the related accountant's attestation report. It is unclear how the market will react to exceptions identified in the Servicer's attestation reports. There are many market participants who believe there may be an up tick in re-appointments of Servicers if unfavorable information is contained in a Servicer's report on compliance with Item 1122 of Reg AB.

Servicers must evaluate the legal implications associated with non-compliance with either their transaction agreement or their servicing agreement(s). For example, the Servicer should evaluate if any exceptions constitute a breach of their servicing contract which may subject the Servicer to certain financial or other penalties. Market practices and SEC interpretations relating to the implementation of Reg AB will continue to evolve over the remainder of 2006. The SEC has stated that it intends to review the disclosures in the registration filings and the compliance statements associated with the 10-K filing in more detail during 2006 and 2007. Market participants may not be able to fully determine their compliance with the SEC intentions until the results of these reviews are communicated to the market.

International Markets Update

Rising interest rates and talk of a housing bubble bust in the United States have put pressure on the mortgage industry to continue high volumes amidst an origination slowdown. In an environment which seems to be saturated and slowing one might ask: are there any untapped resources? In addition to innovative domestic products, mortgage companies could also consider expansion into growing economies such as Mexico and China, where mortgage markets are waiting to be penetrated. Entering a new market doesn't come without its risks, but if managed correctly; the rewards may outweigh any potential loss.

When a company is determining 'if' it should enter a new market, it should equally consider 'when'. New markets are more apt to have unexpected volatility, a well-timed entry to a market is vital for a sustainable profit. Factors such as cultural tendencies, market conditions, existing competitors, default history, prepayment statistics, and common mortgage products should be contemplated.

Mexico

Cultural: Companies should consider the cultural differences when entering an international market. Traditionally, Mexican residents have a deep attachment to their community. Their home is one of their most prized possessions and living in the same home for nearly one's entire life is not uncommon. This tradition results in a vast untapped home equity loan market as approximately 13% of homes currently carry mortgage debt in Mexico. Another significant difference from the U.S. market is a majority of homeowners in Mexico do not have property insurance. Thus, foreign lenders should contemplate the effects of unexpected damages to property and the ability or willingness of borrowers continued payment in their pricing, execution and potential real losses sustained at the occurrence of an event. Foreign lenders evaluating Mexico could also consider the young married couple emerging market. The primary purchasers of homes in Mexico are young married couples after renting for the first few years of marriage.

Market Conditions: While Mexico is considered a developing country, in 2005 the World Bank classified the country as the 10th largest economy in the world. The greatest demand for housing is in large urban cities such as Mexico City, Monterrey, Guadalajara, and Puebla. However, recent growth trends have also shifted toward midsized cities in tourist areas and regions bordering the U.S. In 2005, interest rates fell to historically low levels along with the required down payments, now at 10% of cost. In 2005, the inflation rate was at a historic low at 3.3% and is expected to increase slightly this year to 3.6%. The large growth in the real estate market can also be attributed to Mexico's macroeconomic stability, increased governmental regulation, and the North American Free Trade Agreement. All in all, these factors contributed to an 80% increase in Mexican mortgage loans since last year. Industry experts anticipate this trend will continue in the near future.

Current Market Leaders: In Mexico, federally funded institutions control a majority of the mortgage market. Currently, INFONAVIT, a public sector-institution, originates approximately 70% of the mortgages. In 2006, INFONAVIT plans to grant 750,000 loans, an increase of 250,000 from 2005. During the next five years (2006-2010), they intent to issue 3.49 million loans compared to the 3.61 million loans issued since they were founded in 1972. This institution has increased growth through the establishment of new programs using SOFOLES. SOFOLES are non-bank financial institutions licensed to lend to particular sectors or for specific types of activities (i.e., small business lending, housing, or automobile finance). The SOFOLES allow a lender to lend in a niche market without the regulations and stipulations required of big Mexican lending institutions. The primary difference between SOFOLES and banks is SOFOLES are prohibited from acquiring assets through deposits. Mexico's second largest mortgage lender is Hipotecaria Su Casita ("HSC"), a limited purpose financial corporation. They are also planning for a significant increase in originations from 2005.

Credit History, Default Rates, Prepayment Rates: Borrowers' credit histories, market default rates, and prepayment rates are all key components in determining the reliability of new borrowers. Since Mexico's mortgage market is developing, this information is not as readily available as it is in the U.S. In 1995, the Buró de Crédito was created. While the institution was established over 10 years ago, it wasn't until the reforms of 2001, 2002 and 2004 that the centralized credit system was able to provide dependable, accurate and reliable credit information. In addition, the development and implementation of the Global FICO score is expected to be a further aid to lenders in Mexico. The Global FICO score ranks individuals by risk level and is intended to be used in conjunction with a lender's origination decisions based on local credit scores. The use of the dual system is estimated to improve the percentage of 'good' loans by nearly 43% compared to using one traditional credit system.

Defaults and prepayments of mortgagors within Mexico have also improved. During the financial crisis in the mid 1990s, Mexico's mortgage defaults soared. However, due to reforms and additional regulation, the rate of defaults has decreased significantly. Earlier this year, INFONAVIT reported a current weighted average LTV of 83%. Historical trends show, mortgages tend not to default until the LTV reaches about 125%. Traditionally, mortgage prepayment rates have been low. This is likely related to the prepayment penalties that are common during the first three years of the mortgage loan. Further, Mexico's high mortgage to annual income does not leave much disposable income for prepayment. Lastly, the current increasing interest rate environment is also slowing prepayment speeds.

Products and Mortgage Structures: It is imperative to understand the specificities of products in order to be competitive in the foreign marketplace. Foreign lenders should consider the following characteristics in Mexico's markets; (1) mortgage loans mature on an average at five years, (2) mortgage loans are often denominated in multiples of inflation units ("UDI"), rather than currency; UDIs are used because of Mexico's historical high inflation periods that have made the value of the Mexican Peso volatile; (3) INFONAVIT and FOVISSSTE utilize the method of valuing mortgage loans through multiples of minimum wages. The minimum wages multiple is reset once per year in January. (4) SOFOLES originate the majority of its loans in UDI denomination while monthly payments are indexed to the minimum wage. (5) Due to the utilization of the indexed values, loan values often reflect negative amortization. Innovative products for consideration in the Mexico market include cash liquidity loans for up to 30% of the value of the property, home equity loans which provide an alternative to consumer credit where rates can exceed 32%, zero "enganche" (down payments) mortgage credits as the inability to afford a down payment is one of the biggest challenges for consumers trying to obtain mortgages and rent to own programs. These emerging products should aid in increasing the volume of residential mortgages issued in Mexico.

China

Cultural: The desire to own a home in the Chinese culture is strong. Ancient philosophers believed the concept of owning a home related to enjoying peace of mind and that philosophy continues to hold true today. China's home ownership, specifically in the major metropolitan areas, approximates 80%. In comparison, home ownership approximates 52% in the U.S. China is currently experiencing a demographic shift in the mortgage industry. The shift is due to the single-child generation coming of age, smaller family sizes, and the expansion of the urban middle class. Prior to the housing reform in the 1990s, the Chinese lived with their extended family in small, rundown housing. However, the recent growth in income levels has resulted in an ability to afford larger, newer dwellings. Due to the influx in buying power, China struggles to meet the demand for housing. As a result, prices continue to rise. There is an economic concern that if demand continues to increase at the current rate, development will not be able to meet future needs.

Market Condition: The dynamic economy in China has set the foundation for a solid mortgage industry. The long term growth prospective for Asia is high, especially considering the current mortgage market where real estate per capita is extremely low on the global scale. The relatively low amount of mortgages is a direct result of government control over the industry until the late 1990s. The Chinese government first allowed banks to introduce mortgages in 1998. Ever since, real estate development has thrived which is apparent by the construction of many new residential and commercial high rise buildings. Foreign banks contemplating the China market should fully understand mortgage regulation and the complicated taxation system before entering the marketplace.

Current Market Leaders: China Construction Bank ("CCB") originates approximately 66% of all mortgages. After a turbulent past, CCB plans to increase its residential mortgage loans by 20% in 2006. HSBC, Bank of China, Standard Chartered and Hang Seng Bank, which account for approximately 70% of the lending in Hong Kong are also significant originators. In February, China Merchants Bank began offering fixed-rate mortgages nationwide at rates of 5.91%, 6.03%, and 6.39% for 3-, 5-, and 10-year loans respectively. The loans are offered in US dollars and Hong Kong dollars. These loans are only applied to the first purchases of new houses. The interest rates offered for HK dollar loans are between 6.25% and 7.25%. For US dollar loans, they are approximately 6.75%. With these competitive rates, China is expected to see a greater foreign bank presence in the mortgage industry in the near future.

Credit History, Default Rates, Prepayment Rates: China lacked a centralized credit system until January 2006. Now, the credit information system, established by the People's Bank of China, includes information such as: individual's name, identity certificates, family address, employer, and information about bank borrowings and credit cards. At this time, only commercial banks are allowed to directly use the system for the purposes of lending. However, individuals are able to apply to the credit administration for personal reports and may distribute it to other lending institutions. China's individual credit information databank is now the largest in the world, covering nearly 486 million people as of January this year.

Historically, China has a record of low defaults despite the fact that the average Chinese mortgage is eight times the average household's annual income (the international average is about three to five times annual income). This can be attributed to significant down payments. China's average initial payment for home loans was up to 37% as of June 2006. This rate has even been rumored to be up to 50% for luxury homes and investment properties in the future. These large down payments create a greater risk of equity loss for the borrower upon default. Banks, such as the People's Bank of China, are ensuring default rates stay low by implementing penalty policies requiring a fine of 30-50 basis points for overdue mortgages. The Chinese market experienced high prepayment rates in 2005, estimated at 35%. However, the increasing interest rate environment is expected to promote lower prepayment rates in the near future.

Products and Mortgage Structures: As China is a developing mortgage market, product diversification is not as prevalent as it is in the U.S. Most mortgage loans are variable rate interest; however, fixed rate mortgages began to emerge in late 2005. Chinese mortgages have an average original maturity of 15 years. Unlike in the United States, 76% of all mortgage loans in China are for apartments rather than single family homes. The Chinese market now offers a mortgage loan that requires payments every two weeks rather than once per month. This product will reduce borrowers' interest expense on the loan and shorten the period of total repayment compared to a traditional monthly payment product. Another emerging product in the industry benchmarks interest rates to the Monetary Authority's composite rate. These loans are lower risk to investors as the composite rate is more stable than the Hong Kong interbank offered rate ("HIBOR"). This is also important as the volatility of the composite rate is less than the prime rate, making the rate more attractive to mortgagors.

Summary

The current market conditions in both China and Mexico if navigated correctly outweigh any potential roadblocks. Because the markets are new, mortgage indicators may not be fully reliable. However, the housing demand, in both Mexico and China, is rapidly growing which has created an opportune market. Recent industry trends point to favorable entry for U.S. mortgage lenders. As the housing bubble in the U.S. looms above the domestic industry, international entry could be the next logical step.

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About our Consumer Finance Group

The PricewaterhouseCoopers Consumer Finance Group is a national business advisory and audit practice of over 100 fully dedicated professionals across the country solely dedicated to serving clients in the mortgage banking, credit card, home equity, student loan, manufactured housing and other related consumer finance industry sectors. We focus on enhancing the core competencies of these companies such as exceptional customer service, a comprehensive package of service offerings, efficiencies of scale, interest rate risk management, cash management, risk management and controls assessment, effective utilization of technology, accounting and auditing, and asset quality management.

Consumer Finance Group Partners

Steve Davies, Co-Chair
646.471.4185
steve.t.davies@us.pwc.com

Mike Seelig, Co-Chair
704.344.4390
mike.seelig@us.pwc.com

Mike English
646.471.7357
michael.english@us.pwc.com

David Guy
646.471.2561
david.a.guy@us.pwc.com

Martin Hurden
703.918.3250
martin.hurden@us.pwc.com

Alan Lee
703.714.3814
alan.l.lee@us.pwc.com

Maryann Murphy
703.918.3892
maryann.murphy@us.pwc.com

Michael Stork
612.596.6407
michael.stork@us.pwc.com

Brian Williamson
617.530.7528
brian.d.williamson@us.pwc.com

Contributors

Jivka Batchvarova

Casey Crews

Stephanie Fenz

Wade Hampe

Bryan Heft

Thomas Kelly

LaWanda Morris

Maria Nizza

Jason Roos

Jessica Roos

Abby Thompson

For questions regarding this publication, please contact Michael Stork at 612.596.6407 or at michael.stork@us.pwc.com, or Thomas J Kelly at 312.298.4241 or at thomas.j.kelly@us.pwc.com.

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