A Cautionary Tale Of Flawed Debt Accounting And SEC Fines

By **Kevin Toomey, Robert Azarow and Paul Nabhan** (September 18, 2023)

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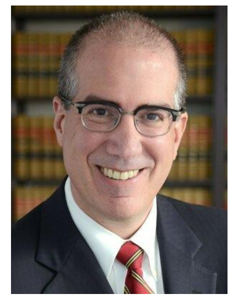

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The U.S. Securities and Exchange Commission recently announced it had settled cease-and-desist proceedings against Malvern Bancorp Inc. and its former chief financial officer.

In its Aug. 15 order, the SEC found that Malvern failed to properly account for certain troubled debt restructurings, or TDRs; loan impairments and charge-offs; and impairment of other real estate owned — the effects of which resulted in Malvern materially overstating its income in several periods between 2017 and 2021, including in an offering and sale of Malvern's common stock.[1]

The SEC also found that Malvern's books and records with respect to such loans were inaccurate, in part due to Malvern's failure to devise and maintain an effective system of internal controls over financial reporting, or ICFR.

This article provides some details about the order and highlights issues to which all publicly traded institutions will want to be alert.

The Order

The Malvern matter involved three commercial real estate, or CRE, loans that the order states should have been accounted for as TDRs or impaired — and in several instances were only corrected upon review by Malvern's primary banking regulator. The order explains that Malvern's former CFO reviewed and approved:

- Inputs and facts in Malvern's accounting analyses that he knew or should have known were not true;
- Inputs and facts in Malvern's accounting analyses and valuations that were unsubstantiated and without support; and
- Valuation methods that were not permitted or substantiated by Malvern's accounting policies.

As such, the SEC found the former CFO willingly and repeatedly overrode Malvern's accounting policies with his own beliefs, including when there was no support or even contradictory evidence, and caused an overstatement as to the credit quality of the loans in question and an overstatement of net income due to inadequate valuation and reserves.

As a result, the SEC found that Malvern violated rules governing periodic reports, books and records, accounting controls, and the SEC's anti-fraud rules that govern public offerings of securities, with the former CFO liable for causing Malvern's violations.

The Loans

The sole tenant of the property underlying the first of the three commercial real estate loans, or Loan A, declared bankruptcy, and the borrower did not have any other sources of operational cash flow. The borrower refused to repay the loan until it received payment relief from Malvern through a modification.

Malvern eventually approved a loan modification and an interest rate reduction, but did not reclassify Loan A as a TDR. Malvern eventually reported the loan as a TDR after a review by Malvern's primary banking regulator and determined it was a collateral-dependent loan.

However, inconsistent with its own policy, Malvern then did not timely obtain an appraisal of the underlying property, delaying an impairment of Loan A and again misstating Loan A's value, even though its CFO knew the appraisal used for Loan A's collateral was outdated.

Once Malvern obtained an updated appraisal, Malvern probability-weighted the fair value estimate, assigning a large probability to a favorable scenario where a new tenant leased the property, even though Malvern and its CFO knew such a potential tenant was no longer interested. Malvern nonetheless waited until the following quarter to take the full impairment charge.

Malvern then relied on this appraisal for over two years, a period which spanned the COVID-19 pandemic, and Malvern failed to discount the outdated appraisal per its own accounting policy and consider the impact of a signed letter of intent to sell the property in estimating the property's fair value, resulting in another delayed impairment charge on its financial statements.

The sole tenant of the property underlying the second commercial real estate loan, or Loan B, was the same as that of Loan A, declaring bankruptcy, and here too the borrower refused to repay the loan until it received a modification, which Malvern ultimately approved.

Malvern's TDR analysis for Loan B suffered the same faults as with Loan A and likewise was not reported as a TDR until after a review by Malvern's primary banking regulator, causing Malvern to have materially misstated the loan on its financial statements.

Unlike Loan A, however, Malvern did not consider Loan B to be a collateral-dependent loan because of a limited guarantee, but after a few years, the guarantee had reduced to zero, with Loan B about to reset with a higher interest rate.

Malvern attempted to restructure Loan B to obtain a new limited guarantee, but in determining the corresponding impairment amount, Malvern equally weighted two scenarios, one of which was the borrower accepting the proposed restructuring plan.

Malvern attributed the probability-weighing to the fact that the guarantor had recently died, though the guarantor had actually died over a year prior — a fact that some Malvern employees knew, but was never shared with the CFO. After a review by Malvern's primary banking regulator, Malvern determined that Loan B was collateral-dependent, and restated its financial statements accordingly, though without a corresponding Form 8-K indicating nonreliance on the prior filing.

Finally, the mixed-use property underlying the final commercial real estate loan, Loan C, began experiencing cash flow issues because of difficulties finding tenants. Malvern initially did not classify the loan as collateral-dependent because of the strength of the guarantor.

When the COVID-19 pandemic struck in March 2020, however, Malvern granted the borrower three consecutive 90-day deferrals, during which time the borrower refused to provide Malvern with any updated financial information about either itself or the guarantor. Malvern and its CFO knew that the borrower was having financial difficulties, but nonetheless issued an earnings release showing no impairment of Loan C.

Only after the earnings release did Malvern notify investors that it was evaluating Loan C to determine if it was collateral-dependent, and not until the next calendar quarter did Malvern notify investors that they should not rely on the prior earnings release. This episode also caused Malvern to disclose it had a material weakness in its ICFR.

Considerations for Financial Institutions

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation each have identified CRE as one of the top areas of risk for financial institutions in their most recent semiannual risk assessments.

We anticipate that accounting for expected credit losses related to CRE loans will be a high priority for bank examiners and the staff of the SEC.

The accurate measurement of expected credit losses requires a bona fide evaluation of borrowers' credit, the timely ordering of refreshed appraisals and other valuations, and objectivity in selecting and weighing different appraisals and relevant scenarios — all of which must also be obtained pursuant to an entity's accounting policies and ICFR.

In addition, the Malvern order demonstrates that the SEC will investigate smaller community banks, including matters involving relatively small dollar amounts, particularly given concerns over the state of the CRE market.

Financial institutions should consider the following precautionary actions and other takeaways from the order:

First, objectively evaluate borrowers' credit, utilizing current information and inputs — including recent appraisals and valuations when required — and recognizing losses when they actually occur to avoid the appearance of delaying such recognition to improve earnings.

Second, prepare for heightened SEC and federal banking regulator scrutiny and enforcement activity given recent economic uncertainty, particularly with respect to valuation and disclosures related to CRE loans.

Third, proceed with caution and in a balanced fashion when challenging regulatory examiners on loan classifications and their resulting allowance calculations and allocations.

A disagreement with a banking regulator over the classification or treatment of loans is generally not an acceptable reason to delay recognition of losses, and the SEC may view the public disclosure of increased credit reserves due to regulatory downgrades of loan classifications as a red flag indicative of delayed loss recognition.

Finally, although not present in the Malvern Order, prepare for the SEC to enforce the clawback of executive officers' compensation under the Sarbanes-Oxley Act and the recently issued Rule 10D-1 in addition to monetary fines should they be found to have engaged in accounting practices that manipulated income or expense recognition.

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[1] https://www.sec.gov/files/litigation/admin/2023/33-11223.pdf.