Freddie Mac
We make home possible ®

To:

PwC

From:

Gregory Metz

Michael Culhane

Tracy Mitchell

cc:

Rob Mailloux

Mary Beth Perdue

Stephen Lewis, FHFA

Effective Date:

June 30, 2012

Subject:

2Q 2012 Valuation Allowance Assessment

**EXECUTIVE SUMMARY**

The purpose of this memo is to document the assessment made for the need of a valuation allowance against all or a portion of Freddie Mac's deferred tax assets as of June 30, 2012.

Consistent with 1Q 2012, we determined that it was more likely than not that a portion of our deferred tax assets would not be realized.

FASB ASC 740 (Accounting for Income Taxes) requires establishment of a valuation allowance against deferred tax assets when based on the weight of available evidence it is more likely than not that they will not be realized. All available evidence, both positive and negative, must be considered with the appropriate weight given based on the extent to which it can be objectively verified. At June 30, 2012, we considered all available positive and negative evidence in performing our assessment as to the need for a deferred tax asset valuation allowance.

The negative evidence that we considered included 1) Freddie Mac's cumulative loss position under the general guideline of summing the pre-tax book income and permanent differences for three years, 2) Freddie Mac's estimated cumulative tax net operating loss carryforward (after consideration to all carryback potential including regular tax, alternative minimum tax and the impact of FIN 48 liabilities for each open tax period), and 3) difficulty predicting unsettled circumstances.

Freddie Mac considered positive evidence including the future reversals of existing taxable temporary differences and positive income from uncertain tax benefits recorded for prior and current year tax periods. We also considered management's intent and ability to hold the available for sale securities until unrealized losses can be recovered.

As of June 30, 2012, after consideration <D0> $34.7 billion valuation allowance, we had a net deferred tax as<D0> $3.1 billion representing primarily the tax effect of unrealized losses on our available-for-sale securities. Management believes the deferred tax asset related to these unrealized losses is more likely than not to be realized because of our intent and ability to hold our available-for-sale securities until any temporary unrealized losses are recovered.

A summary of the 2Q 2012 valuation allowance activity is summarized below:

Valuation Allowance Rollforward

| *(in millions)* | | Continuing Ops | AOCI | R.E. | APIC | Total |
|---|---|---|---|---|---|---|
| Valuation Allowance 1Q 2012 | <PQ> | (35,564) | (128) | (2) | 66 | (35,628) |
| 2Q Activity | <D0> | 948 | 5 | - | 4 | 957 |
| Valuation Allowance 2Q 2012 | | (34,616) | (123) | (2) | 70 | (34,671) |

It is important to note that this assessment is based on all available information as of June 30, 2012 and this conclusion is subject to reassessment at each relevant measurement date, in our case, quarterly.

**FACTS**

*Economic Environment*

We continue to operate under the conservatorship that commenced on September 6, 2008, conducting our business under the direction of FHFA as our Conservator. During the conservatorship, the Conservator delegated certain authority to the Board of Directors to oversee, and to management to conduct day-to-day operations so that the company can continue to operate in the ordinary course of business.

We had net worth at June 30, 2012 as our assets exceeded our liabili FS $1.1 billio FS $1.1 billion equity includes our total comprehensive income of $2.9 billion and our dividend payn FS $1.8 billion to Treasury on the senior preferred stock in June 2012.[1]

FHFA, as Conservator, will not submit a draw request on our behalf to Treasury under the Purchase Agreement.

*Balance and Nature of Deferred Tax Assets and Liabilities:*

As of June 30, 2012, DTLs were estim <D1> $4.9 billion primarily for basis differences related to assets held for investn <D1> $4.7 billion.

The temporary difference related to basis differences related to assets held for investment is primarily driven by the Section 475 "Mark to Market" election that was made in January 2010 for newly acquired LIA Loans. The Deferred tax assets and liabilities are the same character (ordinary). The deferred tax liabilities do not include any liabilities on indefinite-lived intangible assets.

The DTA related to available-for-sale securities increa <D0> $128 millio <D0> $2.73 billion as of March 31, 2 <D0> $2.86 billion as of June 30, 2012 attributable primarily to unrealized losses on our mortgage-related securities.

[1] Freddie Mac Form 10-Q draft distributed 7/30/12, Executive Summary, page 1.

[redacted]

*Cumulative Losses in Recent Years*

Considering the current year forecast and activity from the last two years, Freddie Mac was in a cumulative loss position as interpreted per guidance from the Big 4 accounting firms as generally being the sum of pre-tax income and permanent differences of the current year and the two preceding years. The following table depicts the three-year cumulative loss:

<D3 56-65>

| *(dollars in millions)* | **Actual 2010** PY | **Actual 2011** PY | **Forecast 2012** | **Cumulative 2010-2012** |
|---|---|---|---|---|
| Pre-tax Income (Loss) | (14,883) | (5,666) | 7,013 | (13,536) |
| Permanent Differences (excludes credits)* | (579) | (524) | (454) | (1,557) |
| Total | (15,462) | (6,190) | 6,558 | (15,093) |

*Permanent differences for 2010 are per filed tax return, 2011 and 2012 permanent differences from Analysis of Tax Provision schedule.

*Impact of Carryforward and Carryback of Net Operating Loss and Tax Credits Opportunities on the 2012 Projected Income*

<D3 56-65> Our June 30, 2012 tax provision estimate of the year's taxable income/loss includes taxable income of $6.6 billion. Taxable income can be entirely offset by the available NOL carryforward. It is likely that the company will be in an Alternative Minimum Tax (AMT) position for 2012. The 2012 AMT credit carryforward can be carried forward indefinitely, and the 2012 LIHTC not utilized in 2012 can be carried forward 20 years.

*Mark-to-Market of Available for Sale Securities*

Consistent with prior quarters, we maintain available for sale securities in our portfolio that are accounted for in Other Comprehensive Income. Management intends to hold these securities until such point that the unrealized losses previously recorded reverse.

During 1Q 2012 Freddie Mac sold its last two commercial mortgage-backed securities (CMBS) issued by LaSalle Bank after becoming the directing certificateholder due to significant credit deterioration. In 2011 management concluded that our intent changed from "intent to hold until recovery" to "intent to sell" the remaining two CMBS, and thus the deferred tax assets associated with these securities were written off. Because these LaSalle CMBS bonds exhibited characteristics, such as significant credit deterioration and severely depressed pricing, that were atypical of the wider CMBS portfolio, our actions with respect to the LaSalle CMBS do not change Freddie Mac management's assertion over the remainder of the CMBS portfolio (i.e. that we have the intent and ability to hold the securities until the point in time in which substantially all of the unrealized losses reverse).

**ISSUE**

Is a valuation allowance needed against all or a portion of Freddie Mac's deferred tax assets as of June 30, 2012?

**CONCLUSION**

Considering the significant negative evidence of our cumulative three year loss and other positive and negative evidence, we determined that it is more likely than not that a portion of our deferred tax assets would not be realized. A valuation allowance was recorded against the majority of net deferred tax assets other than the deferred tax asset attributable to unrealized losses on the available for sale securities recorded in Accumulated Other Comprehensive Income. Additionally, a valuation allowance was not recorded on approxi<D0>$197 million of LITHC credits carried forward (and generating a deferred tax asset), for which, should the uncertain tax position not be sustained, would otherwise be utilized in the 2007 tax year as a result of the 2009 FIN 48 liability decreasing the estimated 2009 NOL to be carried back to 2007.

**RELEVANT ACCOUNTING GUIDANCE AND ANALYSIS**

FASB ASC 740 requires that a valuation allowance be established for deferred tax assets when it is more likely than not that they will not be realized.[2] In other words, "a deferred tax asset could be recognized based on a presumption that it would be realized, subject to an impairment test (i.e., valuation allowance), or it could be recognized based on an affirmation belief as to realizability." [3]

FASB ASC 740-10-30-17 states, "All available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, a valuation allowance is needed. Information about an enterprise's current financial position and its results of operations for the current and preceding years ordinarily is readily available. That historical information is supplemented by all currently available information about future years."

*Sources of Positive Evidence*

The realization of deferred tax assets is dependent on the existence of taxable income of the appropriate character during the carryback and carryforward periods.[4] FASB ASC 740-10-30-18, provides the following four sources of taxable income available under the tax law that provide positive evidence to realize a tax benefit for deferred tax assets (listed in the order of most objective to the most subjective):[5]

- Taxable income in prior carryback years if carryback is permitted under the relevant tax law (including FIN 48 Liabilities).
- Future reversals of existing taxable temporary differences (including FIN 48 liabilities).
- Tax-planning strategies.
- Future taxable income exclusive of reversing temporary differences and carryforwards.

[2] FASB ASC 740-10-30-5.
[3] Deloitte & Touche FAS 109 guidance, FASB 109, 20-1
[4] FASB ASC 740-10-30-18
[5] PwC Guide to Accounting for Income Taxes (2011), sec. 5.3

*Sources of Negative Evidence*

A significant piece of negative evidence is the existence of a significant cumulative loss in recent years. Other examples of negative evidence include (but are not limited to) the following:

- A history of operating loss or tax credit carryforwards expiring unused.
- Losses expected in early future years (by a presently profitable entity).
- Unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels on a continuing basis in future years.
- A carryback, carryforward period that is so brief that it would limit realization of tax benefits if: (1) a significant deductible temporary difference is expected to reverse in a single year or; (2) the enterprise operates in a traditionally cyclical business.[6]

FASB ASC 740 does not define "cumulative losses" or "recent years." Guidance published by the Big 4 accounting firms suggests that while arbitrary, three years (the current and two preceding years) is a common benchmark. While all firms also agree that cumulative losses mean the sum of recent years (i.e., the current year and two preceding years) equals a net loss, there is some disagreement as to what type of "losses." E&Y and KPMG state that "losses" mean pre-tax losses. D&T and PwC, on the other hand, state that "losses" means pre-tax losses adjusted for permanent differences. [7]

*FASB ASC 320 Mark-to-Market of Available-for-Sale Securities*

Securities classified as available-for-sale are reported at fair value with changes in fair value included in AOCI, net of taxes. Only upon sale or recognition of impairment loss are the losses recognized in earnings. Our intent, as well as our ability, is to hold investments until a point in time at which recovery of the unrealized loss can be reasonably expected to occur.[8]

There are two acceptable views to assess the need for valuation allowances against deferred tax assets related to unrealized losses on securities classified as available-for-sale[9]:

- View A: The Company's intent and ability to hold the securities with unrealized losses until maturity can be considered akin to a tax planning strategy. This tax planning strategy is specific only to available for sale securities with the demonstrated intent to hold until maturity or such time that the unrealized losses reverse. Under this view, a valuation allowance would not be necessary for the applicable deferred tax assets even in situations where there is significant negative evidence related to the realizability of other deferred tax assets.

- View B: Recovery of deferred tax assets related to unrealized losses should not be assessed differently than other deferred tax assets. Under this view, a valuation allowance would be necessary for the applicable deferred tax assets in situations where there is significant negative evidence related to the realizability of other deferred tax assets.

Currently, both View A and B are acceptable accounting policies that should be followed consistently. In 2008, we received pre-clearance from the SEC to discretely treat the tax effect of the unrealized losses on

[6] FASB ASC 740-10-30-21

[7] D&T FASB 109 Audit Manual (December 2007), p. 243; E&Y Financial Reporting Developments – Accounting for Income Taxes (June 2007), p. 79; KPMG Accounting for Income Taxes – An Analysis of FASB Statement 109 (September 2007), para. 4.025; PwC Guide to Accounting for Income Taxes (November 2007), p. 92, sec. 5.1.3.1.

[8] 2007 Annual Report [DRAFT 2-14-08], Note 1: Summary of Significant Accounting Policies – Investments in Securities; Note 4: Retained Portfolio and Cash and Investments Portfolio

[9] See Ernst & Young Technical Line No. 2008-14, dated December 3, 2008.

our available-for-sale securities portfolio in assessing the need for a valuation allowance against our deferred tax assets.

*Weighing of Available Evidence*

FASB ASC 740-10-30-21 states that negative evidence such as cumulative losses in recent years is difficult to overcome. FASB ASC 740-10-30-23 also states the following with regard to weighing available evidence, "An enterprise shall use judgment in considering the relevant impact of negative and positive evidence. The weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified. The more negative evidence that exists the more positive evidence is necessary; and the more difficult it is to support a conclusion that a valuation allowance is not needed for some portion or all of the deferred tax asset."

In order to support a conclusion that a valuation allowance is not necessary, the more likely-than-not criterion requires objective and verifiable positive evidence sufficient to counteract the negative evidence.[10] Forecasts become more difficult to be used as positive evidence when there are cumulative losses. Future income projections following a cumulative loss are inherently subjective since a return to profitability often involves a turnaround plan that has not yet been demonstrated.[11] Actual results achieved to date under an existing turnaround plan will presumably be given much more weight than projected results under a pending plan.[12]

Cumulative Loss Table above (pg. 3)

The cumulative book loss position (adjusted for permanent differences) as of June 30, 2012 of $15.1 billion and unsettled circumstances as to future operations and profit levels and our continuing or emergence from conservatorship are significant negative evidence that, in our opinion, cannot be overcome by any existing positive evidence. Thus, we determined that it is more likely than not that the net deferred tax assets (excluding the DTA attributable to available-for-sale securities and positive income related to UTBs discussed above) will not be realizable in the future.

In 2008, we received pre-clearance from the SEC to discretely treat the tax effect of unrealized losses on our available-for-sale securities portfolio in assessing the need for a valuation allowance against our deferred tax asset (View A discussed above) and have applied this accounting policy consistently. After assessing events in 2Q 2012, no changes will be made to the accounting policy previously elected and thus for 2Q 2012 we have not recorded a valuation allowance against the deferred tax asset related to unrealized losses on our available for sale securities portfolio.

[10] Deloitte and Touche Guidance Q&A FASB 109 23-3
[11] PwC Guide to Accounting for Income Taxes 5.1.3.1 (2009 edition)
[12] Deloitte and Touche Guidance Q&A FASB 109 23-3