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Disclosure Implications of Fair Value Accounting and the Subprime Mortgage Crisis

In November of 2007, the Financial Accounting Standards Board ("FASB") put into effect Statement of Financial Accounting Standards No. 157, Fair Value Measurements ("FAS 157").[1] The goal of this pronouncement was to define the term "fair value" and establish a standard framework for making fair value measurements. It also required additional disclosures by companies to enable investors to assess the valuation methods used in calculating fair value. Under FAS 157, companies are required to determine the value of assets and liabilities according to the price that would be paid for the asset or liability in an orderly transaction between market participants.

Subsequent changes in the market for collateralized debt obligations ("CDOs"), as a result of the subprime mortgage crisis, have led to complaints about the functioning of FAS 157. Essentially, since the market for CDOs has collapsed, companies have been forced into speculative estimation methods in valuing these instruments.

All valuation techniques are imperfect, especially for complex financial instruments, and the numbers obtained often have resulted in large write-downs that affected profit statements. According to some parties, however, the measurement methods prescribed by FAS 157 require companies to show losses that would never be realized, which has resulted in an unnecessary hit to investor confidence.[2] This has aggravated an already precarious economic situation. As a result, detractors of FAS 157 have recommended that the fair value rules be suspended or modified, at least until the economic climate has improved. The Institute of International Finance, a global association of financial institutions, has also advocated a modification of various fair value rules in times of financial distress, claiming that the values derived under such rules

[1] Fair Value Measurements, Statement of Financial Accounting Standards No. 157 (FASB 2008), *available at* http://www.fasb.org/pdf/fas157.pdf. In February 2008, the FASB approved a one year deferral of the adoption of FAS 157 as it relates to non-financial assets and liabilities with the issuance of FASB Staff Position FAS 157-2, *Effective Date of FASB Statement No. 157*.
[2] *See, e.g.*, Francesco Guerrera & Jennifer Hughes, *AIG Urges 'Fair Value' Rethink*, FINANCIAL TIMES, Mar. 13, 2008, http://www.ft.com/cms/s/0/1a0328fe-f12d-11dc-a91a-0000779fd2ac.html; Jennifer Hughes & Gillian Tett, *An Unforgiving Eye: Bankers Cry Foul Over Fair Value Accounting Rules*, FINANCIAL TIMES, Mar. 13, 2008, http://www.ft.com/cms/s/0/19915bfc-f137-11dc-a91a-0000779fd2ac.html.

do not provide an accurate picture of a firm's financial position when markets are highly illiquid.[3]

Despite these complaints, FAS 157 remains unchanged. Both the FASB and the SEC continue to be supportive of the standard,[4] and thus companies must come to grips with how to deal best with its requirements. In the main, recommendations for this challenge focus on additional disclosures in financial statements and other communications to investors.

I. General Requirements Under FAS 157

The purpose of FAS 157 was to create uniform standards for fair value measurements. The main focus of the pronouncement was to specify that the representative transaction used to price the instrument was not a "fire" or liquidation sale, but rather an "orderly transaction between market participants."[5] FAS 157 also has a number of other definitional requirements that govern the way valuation should be measured. For instance, it requires that the representative transaction take place either in the principal or most advantageous market for the asset or liability and that the participants in the transaction be independent, knowledgeable, and able and willing to partake in the transaction. It further permits the use of the market, income or cost valuation approach (or any combination of the three) to measure fair value.[6]

The source of much concern surrounding FAS 157 is the categorization of the types of information used to formulate the valuation models. When creating a valuation model, it is necessary to make certain assumptions about the market in which the product would be sold, such as what the demand would be for the product and, what price would correspond to that level of demand. Under the pronouncement, these assumptions are referred to as "inputs" and are separated into three distinct levels, ranging from most favored to least favored.

Most favored, or Level 1, inputs are "quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access."[7] For an example, the stock of a publicly traded company would be valued using Level 1 inputs (the price of the stock on the stock market). Prior to the subprime crisis, there were active markets for CDOs and other asset-backed securities, and, as such, they were priced fairly easily using Level 1 inputs.

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[3] *See* Institute of International Finance, Interim Report of the IIF Committee on Market Best Practices, 15-18 (April 2008), *available at* http://www.iif.com/download.php?id=SDzcEc8juCI=. Although IIF remains committed to the "fundamentals of fair-value accounting," the Committee's proposals aim to minimize the negative effects associated with fair value accounting in unstable economic climates. *Id* at 17.

[4] In March 2008, when much of the debate surrounding this issue began, the chairman of the FASB stated that there were no plans to reevaluate the fair value accounting rules. Guerrera & Hughes, *supra* note 2. The SEC has also declined to comment on FAS 157 other than through the issuance by its staff of a form letter detailing additional disclosures a company may make if it believes that the fair value standards do not accurately represent its financial picture. *See* SEC, Sample Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair value Measurements), (March 2008), *available at* http://www.sec.gov/divisions/corpfin/guidance/fairvaluetr0308.htm.

[5] FAS 157, *supra* note 1, ¶ 5.

[6] *Id.* ¶¶ 18-20.

[7] *Id.* ¶ 24.

Level 2 inputs are "inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly."[8] Essentially, assets measured with Level 2 inputs have inputs based on an observable price, but the asset itself does not have a directly observable price. Level 2 inputs have not substantially factored into the debate over FAS 157.

Level 3 inputs are "unobservable inputs for the asset or liability."[9] They are only used to the extent that observable inputs are not available and thus usually involved only in those situations where there is no active market for the asset or liability. Level 3 inputs are developed based on the best information available to the company, even if the company was the party gathering the data in question. Once the market for CDOs and other asset-backed securities disappeared, many companies were confronted with using Level 3, versus Level 1, inputs to value these assets.

II. Concerns about FAS 157

In March of 2007, AIG and other companies publicly raised the idea of suspending the requirements under FAS 157.[10] The complaints arose from large write-downs that companies were forced to take during the last year as a result of the collapse of the subprime mortgage market. AIG, for example, took write-downs amounting to $11 billion as a result of its mortgage-related holdings. FAS 157 was seen as the cause.

Essentially, the argument is that when there is no market for the asset, and companies are forced to use Level 3 inputs in their valuation techniques, the numbers calculated are unreliable. This was viewed as especially true in the case of the valuations done for CDOs at the time of the subprime market collapse. Up until that point, most companies were using market prices to value their CDOs and other asset-backed securities. Because there were no formal valuation models in place, when the market for those securities fell apart, companies had to move quickly to develop their own valuation models, often using conservative estimates in an effort to limit the potential for litigation. Many companies now believe that these valuations never represented their financial situations and forced them to factor in losses that will never occur.[11]

Parties arguing against fair value accounting also worry about the market's depressed state. With investor confidence in the market already low, critics see companies that are taking large write-downs as a result of FAS 157 as exacerbating an already negative situation. Thus, even assuming the FASB's good intentions in instituting the fair value accounting standards, many believe the new standard has had unintended negative consequences that have further injured investor confidence in the market and the economy.[12]

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[8] *Id.* at ¶ 28.
[9] *Id.* ¶ 30.
[10] *See* Guerrera & Hughes, *supra* note 2.
[11] *See* Michael R. Young, Fair Value Accounting and Subprime, 1 (Mar. 7, 2008), http://www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C2566%5CFair%20Value%20Accounting%20and%20Subprime.pdf; *see also* Hughes & Tett, *supra* note 2
[12] *See* Institute of International Finance, *supra* note 3, at 15.

Companies also worry about the threat of increased litigation. Unlike many other accounting regulations, the fair value accounting standards leave much in the hands and judgments of those preparing the financial statements. This is especially the case when it comes to evaluating those instruments that have no Level 1 or 2 inputs available. Valuation techniques using Level 3 inputs are by their nature a judgment call on the part of the company preparing the financials.[13] The more discretionary the decisions made by companies are, the more those decisions are susceptible to second-guessing by investors. This, combined with a downturn in the economy, increases the potential for litigation. Thus, companies holding large amounts of instruments that must be valued using Level 3 inputs are wary about the risk of investor suits over the valuation of these instruments.

A variety of suggestions have been made for how to modify FAS 157 to deal with these issues. Some advocate permitting companies to keep their holdings at book value, or relatively close to book value, and take the losses gradually over time.[14] This would prevent any sudden shocks that may result in a run on the company's stock. Others support an idea where companies and auditors would be allowed to estimate the maximum losses they are likely to incur and only recognize those.[15] All other unrealized losses would be recorded on the balance sheet, but not included in profit reports. Finally, at least one commentator has advocated creating two sets of financial statements, one without the fair value numbers and one clearly illustrating all of the fair value assets.[16] Any of these changes, however, would require the approval of the FASB and the SEC before adoption.

III. Support for FAS 157

Most supporters of FAS 157 advocate that it is the best way to get an accurate fair value picture of a company's financial condition. It is true that the system may overvalue instruments in certain situations and undervalue them in others, but, over time, any such extremes should even out. Any valuation system is going to be imperfect, and while many companies are arguing for the use of historical cost for these assets, that valuation technique also leads to the possibility of abuse and the potential for misleading investors.[17] Although some of the asset-backed securities held by companies may rebound at some point after the credit crunch has passed, there is no guarantee that they will reach their former levels.

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[13] *See* Antonio Yanez Jr., *Fair Value Roundtable: A Litigator's Perspective*, J. ACCT., June 2008, http://www.aicpa.org/pubs/jofa/jun2008/fair_value.htm.
[14] *See* Eugene H. Flegm, *The Role of Fair Value Accounting in the Subprime Mortgage Meltdown: The Need for Reliability in Accounting*, J. ACCT., May 2008, http://www.aicpa.org/pubs/jofa/may2008/ in_my_opinion.htm; *see also* Daniel Gross, *The Mark-to-Market Melee: Did an Obscure Accounting Rule Cause the Credit Crunch?*, NEWSWEEK (Apr. 1, 2008), *available at* http://www.newsweek.com/id/130029.
[15] *See* Guerrera & Hughes, *supra* note 2.
[16] Gordon Goodman, *Fair Value Roundtable: Assessing the Quality of Reported Earnings*, J. ACCT., June 2008, http://www.aicpa.org/pubs/jofa/jun2008/fair_value.htm.
[17] *See* Paul B.W. Miller, *The Role of Fair Value Accounting in the Subprime Mortgage Meltdown: The Capital Markets' Needs Will Be Served*, J. ACCT., May 2008, http://www.aicpa.org/pubs/jofa/may2008/in_my_opinion.htm; Nicolas Véron, *Fair Value Accounting Is the Wrong Scapegoat for this Crisis*, Bruegel Policy Contribution 2 (May 2008).

Others say that, eventually, losses may have to be taken. FAS 157 is a fair value accounting standard that allows outside investors the ability to see the volatility of the market on a real time basis, rather than limiting such information to the insiders of the companies until they are forced to make it public.[18]

Supporters also point out that fair value accounting is nothing new.[19] Many companies used fair value accounting on at least some or all of their holdings. Trading businesses, like Goldman Sachs, have always used fair value accounting to price their holdings.[20] The purpose behind FAS 157 was simply to unify the calculations that were being done and to require the companies to disclose more to investors about how the numbers were obtained.

Essentially, the argument for FAS 157 is that more information in the hands of the investors is better than less, even if the information raises concerns. Companies should trust investors to be able to evaluate all the information that is given to them without overreacting. Moreover, nothing prevents companies from supplementing the fair value measures with additional disclosures, such as with more information in the footnotes to the financial statements or in other documentation given to investors.

IV. Recommendations

Despite the outcry against fair value accounting under FAS 157, Robert Herz, the FASB Chairman, has publicly stated that there are no plans to reevaluate the rules. The SEC has also declined to comment beyond issuing a letter detailing possible disclosures a company could elect to make. Since both the FASB and the SEC would have to approve any modification or suspension to the fair value accounting rules, companies should expect that they will have to continue to comply with the requirements of FAS 157, at least in the near term.

On July 10, the SEC held a roundtable on fair value accounting. While some in attendance still expressed concern over FAS 157 and the difficulties in valuing instruments in illiquid markets, the overall tenor of the discussion indicated an acceptance that fair value accounting is the best option currently available. Many participants expressed a belief that investors are capable of evaluating the financial information given to them by companies. In fact, some of the investors present stated that they would not feel comfortable investing with a company that did not provide fair value accounting information.

The focus of the roundtable was how to improve disclosure. Much of the literature on fair value accounting has also focused on this goal. Disclosure is the main tool available to companies, both to deal with the possibility of litigation and to mitigate damage caused by low fair value estimates. In the current climate of increased litigation, companies will benefit from being more

[18] *See* Young, *supra* note 11, at 5.
[19] *See* Jonathan Weil, *Don't Blame Mark-to-Market for Banks' Problems*, Bloomberg.com, Mar. 17, 2008, http://www.bloomberg.com/apps/ news?pid=newsarchive&sid=aJFrPa3rqhHw.
[20] *See* Hughes & Tett, *supra* note 2.

transparent in the preparation of their financial statements, especially for valuation of instruments with little to no active market.[21] The more information that is made available, the harder it becomes for investors to allege the fraud necessary to have a successful claim.[22] Additional disclosure also presents an opportunity to provide investors with more information that the company believes more accurately represents the financial picture of the company. Robert Herz has recommended that companies should make additional disclosures if they think assets are likely to recover value and provide greater cash flows than the fair value numbers indicate.[23]

Such disclosures could take many forms. The best place to start is the recommendations made by the SEC. In March 2008, the SEC staff circulated a sample letter about MD&A disclosures relating to FAS 157.[24] In the letter, the SEC made various suggestions for disclosures that could be made to minimize the negative affects of the fall in value from using Level 3 inputs to evaluate the company's financial instruments. Specifically, the SEC encourages disclosure of the following information:

- The amount of Level 3 assets and liabilities as a percentage of the total assets and liabilities measured using fair value;

- The amount and reason for a material change in the Level 3 assets or liabilities;

- The reasons for moving assets or liabilities from Level 1 or 2 into Level 3 and the effects that it may have on the estimates of their value;

- How changes in Level 3 assets or liabilities have affected operations and whether or not the company believes that the fair values accurately represent what the company anticipates receiving for the asset or liability; and

- The nature and type of assets that are underlying any asset-backed security and any expected changes to the ratings of those assets.

A point of discussion at the SEC roundtable focused on better versus more disclosure. Better organization of the disclosures may be more helpful than adding to the voluminous disclosures that are already made. Companies should consider consolidating fair value disclosures into a single section in the MD&A, with references to other sections such as critical accounting estimates and risk factors. This would permit investors to obtain all the information about the fair value accounting of the company in a more direct and clear fashion, and improving the level of transparency regarding financial risks could help in counteracting the instability in the financial markets.[25] That said, there

[21] *See* Weil, *supra* note 19; *see also* Secretary Henry J. Paulson, Jr., Remarks on Recommendations from the President's Working Group on Financial Markets (Mar. 13, 2008) (commenting on the need for greater transparency and disclosure to deal with complex financial markets).
[22] *See* Yanez, Jr., *supra* note 13.
[23] Robert Herz, *Fair Value Roundtable: Dynamic Assets Don't Fit in Passive Vehicles*, J. ACCT., June 2008, http://www.aicpa.org/pubs/jofa/jun2008/fair_value.htm.
[24] *See* SEC, *supra* note 4.
[25] *See* Véron, *supra* note 17, at 5.

is no blanket list of disclosures all companies should make. Rather, companies should consult their accounting and legal advisors to determine what disclosures are necessary, taking into account the types of assets they hold and the models they are using to value those assets.

In addition to disclosures about the assets themselves, details about the models used to calculate the fair value measurements, and any changes to those models, should also be discussed. The SEC recommends that companies be open and honest with the valuation techniques that they use, listing not only general descriptions but also how specific models and valuation techniques were chosen, and how sensitive the measurements are to the inputs used to form the model.

Sensitivity analyses were also highly recommended by both panels at the SEC roundtable.[26] Many who spoke stated that this was the key missing piece in much current disclosure. By providing investors with information on the range of values that may be appropriate for the fair valued assets and liabilities, companies allow those investors to use their own judgment to evaluate the fair value estimates.

Companies will need to keep up to date on developments in this area and revise their internal procedures in response to this evolving issue. Thomas J. Linsmeier, board member of the FASB, has stated that the FASB continues to work on the details of FAS 157.[27] Congress has also announced an intention to hold hearings regarding the oversight of the financial markets, which may include discussion of fair value accounting.[28]

V. Conclusion

While there have been significant objections to FAS 157 by the business community, the SEC and the FASB seem committed to requiring fair value measurements for financial statements under this standard. This may be nothing more than part of a conviction that fair value accounting holds the high ground from a policy standpoint. Or, it may also be a determination that FAS 157's measurement principles are better than other problematic methods. In either case, the best option for companies to mitigate any negative effects stemming from potential questions raised under FAS 157 is through additional disclosures. This would include those disclosures recommended by the SEC and any additional disclosures based on a company's special circumstances that are helpful in giving investors a more complete financial picture of the company.

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[26] At least some of the comments posted after the roundtable also supported the use and disclosure of sensitivity analyses. *See* Olu Sonala et al., *Fair Value Disclosures: A Reality Check*, FITCHRATINGS June 26, 2008, at 10-11, *available at* http://www.sec.gov/comments/4-560/4560-8.pdf.
[27] Thomas J. Linsmeier, Board, FASB, Comments at the SEC Roundtable on Fair Value Accounting Standards (July 10, 2008).
[28] Press Release, House Committee on Financial Services, Frank Announces Hearings on Financial Market Regulatory Restructuring (June 12, 2008), *available at* http://www.house.gov/apps/list/press/financialsvcs_dem/press061208.shtml.
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