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Financial Reporting After The Subprime Crisis: New Challenges For Audit Committees – Part I

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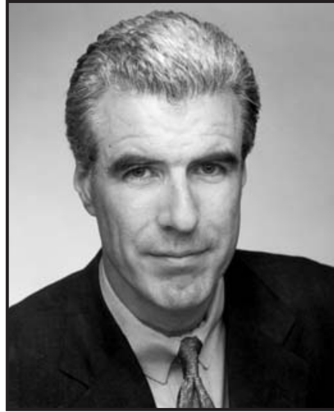

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Introduction

Though it may not have been apparent at the time, in some ways the subprime crisis can be seen as ushering in a new era of financial reporting. It is hard to think of an earlier time when public companies so quickly accumulated, processed, and made available to the public the details behind reported assets as well as the volatility of changing asset values. Nor is it easy to recall a time when financial markets reacted with such broad-based severity. Some might understandably wonder, in the aftermath of a significant recession, whether such a system is best. But if one assumes that the objective of financial reporting is to fairly report current financial information, in fundamental ways the reporting system did its job.

For better or for worse, there's probably no turning back. The accounting principle at the center of the crisis – fair value accounting – is no doubt here to stay. Indeed, as FASB and the IASB continue to head toward accounting "convergence," fair value accounting will likely become more, not less, of a force in financial reporting. At the same time, the pressure to get bad news to investors fast – one of the driving forces in the subprime crisis – can only be expected to increase.

Many investors have been seeking such changes, and therefore will greet these developments as good news. But for those charged with responsibility for financial reporting, the reactions may be more mixed. For the crucible of today's financial markets – and in particular the prevalence of derivative instruments – poses new challenges for everyone with some level of responsibility for public company financial reporting. Among those are the system's overseers, public company audit committees.

This article talks about those challenges. It starts with the subprime crisis itself, the challenges it posed for financial reporting, and how financial reporting systems sought to meet them. It then talks about the consequences for audit committees going forward.

The Subprime Crisis

For many, the events that unfolded into the subprime crisis seemed to start in the summer of 2007. It was then that newspaper headlines riveted attention on two Bear Stearns hedge funds in trouble, with one result being increased investor focus on an esoteric financial instrument known as a "CDO." As investors tried to understand CDO structure and prevalence, they quickly encountered complexity and confusion. Seemingly overnight, key markets for mortgage-related financial instruments froze.

Behind the scenes, this freezing of markets had an impact that at first only the accountants would appreciate. Under a new "principles-based" accounting standard, FAS 157, the disappearance of trading markets meant that the accounting approach to reported asset valuation had to change. In particular, it needed to change from reliance on the now-nonexistent markets to more judgmental valuation approaches. Those judgmental approaches often looked for help to sophisticated valuation models.

Unfortunately, in important instances such sophisticated valuation models were not in place. This was, in context, completely understandable: While the markets had been active and observable, such valuation models had not been needed. And it was just as companies were trying to come to grips with this dilemma that another challenge of the financial reporting system kicked in. This was the desire to get the best possible information about sudden valuation declines to investors fast.

For those faced with responsibility for financial reporting, the dilemma was acute. The financial community understandably wanted fast, updated information. But the financial reporting system – just as understandably – was not in a position easily to deliver it. Adding still another layer of difficulty, when presented with updated information to be presented to investors, outside auditors wanted to be satisfied. Among other things, they wanted to see that, to the extent possible, updated information to be reflected in audited financial statements could be objectively supported.

As it turned out, the system found a way to cope. Through sometimes extraordinary effort, sophisticated valuation models came to be put in place. Enough data was found, often in analogous markets, so that sufficiently objective reliability could be established. And accompanying disclosure came to be drafted allowing investors to judge for themselves how numbers were being put together and whether they did, or did not, want to use the newly-derived information. In hindsight, while there may have been exceptions, overall it is remarkable how well the system met the obstacles.

Still, the process was painful for almost everyone involved. And it is thus that, today, many audit committees find themselves in a tough spot. On the one hand, the evolution of financial reporting has given rise to new demands and opportunities for fast, updated information. On the other hand, the ability of financial reporting systems to deliver that information may not be completely in place.

While it is still fresh in everyone's mind, it is a good idea to look back and focus on the challenges of the crisis. It is just as good an idea to think about how those challenges may affect audit committee oversight of financial reporting going forward. Breaking them down, the main topics are: (1) the accounting regime of "fair value accounting"; (2) increased investor expectations for faster financial information; (3) the broader evolution from accounting rules to principles; (4) implications of these developments for the practice coming to be known as "accounting engineering"; (5) new features of auditor and audit committee interaction; and (6) the audit committee's role in the oversight of risk management.

Challenges For Audit Committees

Fair Value Accounting – Recent controversy notwithstanding, the concept of fair value accounting is actually not that new. As far back as the early 1990s, fair value accounting was already playing a prominent role in financial reporting, and the gradual trend since then had been for its use to increase. That is not to say that everyone was enthusiastically embracing this approach, which basically posits that market value, rather than cost, is the best way to value certain assets. Still, a consensus had seemed to develop that, on balance, for certain assets and in certain circumstances, fair value accounting made sense.

What was new in the subprime crisis was not an extended use of fair value accounting, but the consistency and discipline with which fair value accounting was applied. This was largely owing to the new accounting standard, FAS 157, which, while not extending fair value accounting into new areas, did seek to bring more consistency to how fair values would be determined and the accompanying explanations about how and where fair value was being used. The basic idea behind FAS 157 was to divide valuation approaches into three "levels" depending on the data inputs through which market value would be derived. At "Level 1," fair value was derived through the observation of active markets for the asset in question. At "Level 2," fair value was derived essentially through analogous markets. At "Level 3," which assumed the absence of active, observable markets, fair value was derived through other means such as valuation models. The overall principle behind the standard was fairly straightforward: Assets should be reported at the price at which they could be sold. In the language of FASB, that was referred to as the "exit price."

For audit committees, oversight of the system where fair value can be determined through Level 1 inputs isn't that tough. Valuation can be as simple as looking up the price in *The Wall Street Journal*. It is when active, observable markets disappear – as they did during the subprime crisis – that things can get much more difficult.

The main difficulty is to have in place a system that can derive the hypothetical "exit price" when the valuation needs to be at Level 3. Anyone who has sought to estimate the value of his home when nothing in the neighborhood is selling can understand the problem. When it comes to public company financial reporting, the downsides of getting it wrong can be much more severe. They may include, for example, the potential for SEC investigation and penalties. In particularly egregious circumstances, they may include interest by the Department of Justice.

There's only so much an audit committee can do, but a good starting place is to seek an understanding as to which assets are being "fair valued" pursuant to FAS 157 and at which of the three levels asset valuation is taking place. Where the valuation is at Level 1, the committee can breathe a sigh of relief. But where the valuation is at Level 3, a few follow-up questions may be useful. These may include questions about the valuation inputs, their objectivity, the use and reliability of financial models, and the extent to which the values thereby derived can be supported by objective market data. No one should expect an average audit committee member to be an expert in the mathematics of Level 3 valuation. But a search for system weaknesses is often something even a layman can undertake.

One potential weakness in particular may be a useful topic of inquiry. That is the potential for influence on the objectivity with which valuation judgments are made. The key point here is that, at Level 3, the role of judgment can be significant. The audit committee will want to keep in mind that the objectivity of valuation judgments can be influenced from all sorts of directions – pressures for performance, compensation, the arguments of others (like counterparties), and simply the constraints of the valuation methodology. Even small influences on judgment, moreover, can have enormous consequences for valuation as the numbers play through the system. The math may be too much for those other than the quants. But inquiry directed to the objectivity of the judgment calls can pay great dividends.

Part II of this article, in which the discussion of changes in financial reporting continues, will appear in the August issue of The Metropolitan Corporate Counsel.

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