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Fair Value Accounting & Subprime

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A proposition creeping its way into the discussion about the financial market dislocations arising from subprime loans is that it's really our accounting system that is to blame. The argument is that new accounting rules are requiring writedowns that actually exaggerate losses and that financial markets are thereby being driven to levels that are artificially low. A consequence, as summarized by *The Wall Street Journal*, is a "rebellion" by those who are "blaming accounting rules" for exaggerated losses and calling for new rules that would, in essence, dampen financial market volatility.

That is certainly one way of looking at it. And, no doubt, the billions of dollars in writedowns of mortgage-backed instruments and accompanying volatility in financial markets since this past summer have been no fun. Still, we should be slow to blame the accountants or new accounting standards for the subprime meltdown. To the contrary, some observers may be expected to point out that the aftermath of the subprime difficulties has put to the test a financial reporting system that has responded as it should.

Behind the Scenes: FAS 157

For those inclined to blame the accounting, the real culprit in the subprime mess is a fairly new standard, "Statement of Financial Accounting Standards No. 157" or "FAS 157." Issued in September 2006 and scheduled to take effect this past November, FAS 157 speaks to the valuation of certain kinds of assets, namely assets that should be recorded at fair value. Applicable to, among other things, financial instruments of the sort relevant to subprime loans, the standard specifies that such assets are to be recorded at the price for which they could

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be sold, that is, "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." Among accountants, this concept is referred to in shorthand as the "exit price."

In speaking to the proper valuation of assets, FAS 157 is the latest contribution to one of the oldest debates in accounting. That is whether assets are better recorded at "cost" or at their "fair" (or market) value. The issue is one that has been vigorously debated for years, one of the reasons being that each side has had excellent arguments to support its position. Advocates of the "cost" approach assert that cost is the best, most reliable, and most objective indication of "fair value" at the time a transaction takes place. The existence of an invoice or a contract typically makes the evidence supporting the asset value all but irrefutable. Making the valuation even more reliable, such concrete evidence can be independently examined by an outside auditor of the financial statements. Accordingly, under the cost approach, there is comparatively little need for judgment and, therefore, little opportunity for blunders or the manipulation of financial results.

But that is only one side of the argument. The other is that historical cost, while objectively reliable at the moment a transaction takes place, can become outdated fairly quickly. That is particularly so for assets that are traded in active markets—such as financial instruments. What is the logic, the fair value adherents assert, of keeping a share of stock on the books at its purchase price when the price has increased or decreased in market trading thereafter? More broadly, insistence upon cost as the ultimate measure of asset value can lead to reported results that make no sense. A FASB member made this point at one meeting through the example of an office building. Under GAAP, the building would be recorded at cost and then, over the succeeding quarters and years, depreciated. The result would be that, for financial reporting purposes, its reported value would go down. At the same time, the economic reality may be that its value was actually increasing. Hence, the "cost" approach would have two results. The first is that the information would be objectively reliable. The second is that it would be completely wrong.

The present détente in this debate is an approach to accounting that seeks to acknowledge the good points made by each side. The approach is to require certain assets to be recorded at fair value and other assets generally to be recorded at cost. Among those assets to be recorded at fair value are certain kinds of financial instruments, the thinking being that financial instruments are often traded in active markets with an observable price. It is hardly an insurmountable challenge, the logic goes, to look up the price each time the financial statements are updated.

While that may be true in many or most cases, though, it is not true all the time, and then things start to get a little tricky. FAS 157 acknowledges that there may be instances in which assets will have to be recorded at fair value but in which an observable market price in an active market does not exist. FAS 157 deals with this through the adoption of an approach that focuses attention on the methods used to estimate fair value. Basically, FAS 157 puts in place a "fair value hierarchy" that prioritizes the inputs to valuation techniques according to their objectivity and observability. At the top are "Level 1 inputs," which are defined as "quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date." Next down in the hierarchy are "Level 2 inputs," which are inputs "other than quoted prices included within Level 1 that are observable for the asset or liability" such as quoted prices for *similar* assets or quoted prices for identical or similar assets or liabilities in markets that are not active. Lowest on the list are "Level 3 inputs" which are simply "unobservable," i.e., there really are no active markets. Under Level 3, inputs are to be "developed based on the best information available in the circumstances." Often that will mean, in the absence of an active market, preparers will have to resort to models that seek to figure out what the price to be received in a hypothetical sale of the asset would be.

When a draft of FAS 157 was circulated to the financial community for public comment, not everyone was enthusiastic about its three-level

approach, and thoughtful commentators were understandably concerned about the reliability of hypothetical values that would result from the use of Level 3 inputs. Still, the standard seemed to be the best available resolution to a knotty problem. Some large financial institutions even adopted FAS 157 earlier than required. As they implemented its approach, overall things seemed to go okay. Among those areas where FAS 157 seemed to be working satisfactorily were financial instruments related to subprime loans.

Market Dislocations

That changed this past summer. We're all too familiar with what happened. Two Bear Stearns funds ran into problems, and the result was increasing uncertainty among members of the financial community about the value of mortgage-backed financial instruments, particularly collateralized debt obligations or "CDOs." As investors tried to delve into the details of the value of CDO assets and the reliability of their cash flows, the extraordinary complexity of the instruments provided a significant impediment to insight into the underlying financial data. Financial markets can deal with bad news, but an information vacuum is another thing altogether. The problem with CDOs was not disappointing value. The problem was that the value of the underlying assets could not be figured out.

As a result, the markets seized up. In other words, everyone got so nervous that active trading of many instruments all but stopped. Largely unnoticed behind the scenes was the fact that, with the disappearance of active markets, much CDO valuation was no longer eligible for "Level 1" treatment under FAS 157. For that matter, often there was not even sufficient analogous market activity so that CDOs could be valued under Level 2. So financial officers and accountants quickly found themselves needing to cope with Level 3. That meant they were faced with the need to resort to financial models that would somehow recreate what the price received in a hypothetical sale would be.

But they quickly encountered a problem. Because CDOs to that point had been valued based on Level 1, established models for valuing the instruments at Level 3 were not in place. Just as all this was happening, moreover, another well-intended aspect of our financial reporting system kicked in: the desire to report fast-breaking financial developments to investors quickly. For those with financial reporting responsibility, therefore, the circumstances were exceedingly uncharitable. To their credit, they wanted to get updated value information on their subprime instruments to financial markets fast. But historical approaches to valuation were suddenly unavailable.

What to do? Come up with the best possible models under Level 3 as the circumstances would allow. But that was no easy feat. Models valuing subprime investments might conceivably want to take into account such imponderables as the future of housing prices, the future of interest rates, and how homeowners could be expected to react to such things. One way or another, well-meaning preparers found a way to come up with their best estimates and report them to investors. Not all investors seemed to appreciate, though, the extent to which the reported declines in value, presented numerically and thereby suggesting a level of precision that numerical presentation often implies, were necessarily based upon financial models that relied upon predictions about an inherently unknowable future.

It is hardly surprising, therefore, that in some instances asset values had to be revised either because models were being adjusted or because predictions were being updated as things seemed to get worse. To some, particularly to those who never liked fair value accounting to begin with, this was all evidence that fair value accounting is a folly. According to one managing director at a risk research firm, "All this volatility we now have in reporting and disclosure, it's just absolute madness."

The frustration is understandable. But defenders of fair value accounting would point out that keeping financial assets on the books at levels well above that for which they could be sold is not exactly a model of transparency in financial reporting. The point is that it is a function of financial reporting to tell people what is going on. And while the news has not been particularly pleasant for anyone, one benefit to fair value

accounting—and FAS 157 in particular—is that it has given outside investors real-time insight into market gyrations of the sort that, under old accounting regimes, only insiders could see. True, trying to deal with those gyrations can be difficult, and the consequences are not always desirable. But that is just another way of saying that ignorance is bliss.

But What About Litigation?

Whatever one thinks of fair value accounting, though, one feature of the subprime aftermath has the potential to be completely counterproductive. It is the extent to which our system of litigation and regulatory oversight results in unjustified assertions of "fraud" against those who were doing their best under circumstances that were exceedingly difficult.

In this regard, the aftermath of the subprime mess may be a harbinger of things to come. For the very aspects of fair value accounting that make it susceptible to second guessing—the absence of concrete data, the need for judgment, the importance of predictions—are likely to increasingly become more prominent features of financial reporting generally. That is particularly so as the United States seeks to evolve beyond a preoccupation with detailed rules into a more principles-based system.

At issue in the aftermath of the subprime valuation challenges, therefore, is going to be the extent to which our system of litigation and regulatory oversight puts in place legal penalties in situations where there is no practical alternative to making tough judgments. If it does turn out that financial statement preparers and auditors are to be penalized where good faith judgment calls turned out to be wrong, then continued progress in financial reporting—at least in the highly litigious environment of the United States—will foreseeably be frozen in its tracks. No responsible accountant or auditor will want to make difficult judgment calls when doing so is almost necessarily a career-terminating event. The subprime crisis, therefore, may present the opportunity for us to come to grips with a much bigger question. That is the extent to which we are to permit our present system of litigation and regulatory second-guessing to impede continued evolution in financial reporting.

Stays of Derivative Actions

BY WARREN R. STERN & C. LEE WILSON

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Dealing with tag-along litigation is an important aspect of securities fraud litigation. Some plaintiffs' counsel view tag-along litigation as litigation opportunities for plaintiffs' firms unable to secure an appointment as lead counsel in the primary securities class action. Some see it as an opportunity for plaintiffs and their counsel to attempt to avoid the strictures of the Private Securities Litigation Reform Act of 1995 (PSLRA), such as lead plaintiff and counsel provisions, discovery restrictions, and heightened pleading standards.[1]

Tag-along litigation usually involves class actions under the Employee Retirement Income Security Act of 1974 (ERISA)[2] or shareholder derivative suits. Shareholder derivative suits may be perceived as a particularly appealing option by some plaintiffs because they can generally be brought in either state or federal court. Further, derivative actions are exempt from the Securities Litigation Uniform Standards Act of 1998 (SLUSA), which bars class action complaints alleging fraud "in connection with the purchase or sale" of securities from being filed in state court.[3] Derivative suits are, however, subject to strict demand requirements.

Tag-along litigation raises significant problems of litigation management. Defendants, for example, must consider: (1) whether to seek, if possible, to consolidate the various actions at least for pre-trial purposes; (2) whether, in the alternative, to attempt to stay certain actions in light of