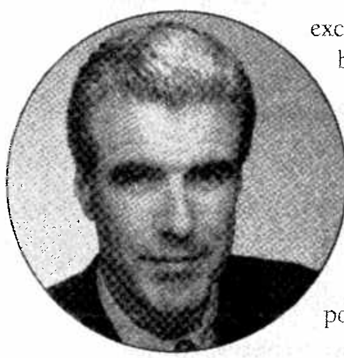
The Role of Fair Value Accounting in the Subprime Mortgage Meltdown

As the credit markets froze and stocks gyrated, investors and pundits naturally looked for someone, or some *thing*, to blame. Fair value accounting quickly emerged as an oft-cited problem. But is fair value really a cause of the crisis, or is it just a scapegoat? And might it have prevented an even worse calamity? On the following pages, the *JofA* presents three views on the debate.

Both Sides Make Good Points

by Michael R. Young



How often do we get to have a raging national debate on an accounting standard? Well, we're in one now.

And while the standard at issue—FASB Statement no. 157, *Fair Value Measurements*—is fairly new, the underlying substance of the debate goes back for decades: Is it best to record assets at their cost or at their fair (meaning market) value? It is an issue that goes to the very heart of accountancy and stirs passions like few others in financial reporting. There are probably two reasons for this. First, each side of the debate has excellent points to make. Second, each side genuinely believes what it is saying.

So let's step back, take a deep breath, and think about the issue with all of the objectivity we can muster. The good news is that the events of the last several months involving subprime-related financial instruments give us an opportunity to evaluate the extent to which fair value accounting has, or has not, served the financial community. Indeed, some might point out that the experience has been all too vivid.

What Happened

We're all familiar with what happened. This past summer, two Bear Stearns funds ran into problems, and the result was increasing financial community uncertainty about the value of mortgage-backed financial instruments, particularly collateralized debt obligations (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.

As a result, the markets seized. In other words, everyone got so nervous that active trading in many instruments all but stopped.

The practical significance of the market seizure was all too apparent to both owners of the instruments and newspaper readers. What was largely missed behind the scenes, though, was the accounting significance under Statement no. 157, which puts in place a "fair value hierarchy" that prioritizes the inputs to valuation techniques according to their objectivity and observability (see also "Refining Fair Value Measurement," *JofA*, Nov. 07, page 30). At the top of the hierarchy are "Level 1 inputs" which generally involve quoted prices in active markets. At the bottom are "Level 3 inputs" in which no active markets exist.

The accounting significance of the market seizure for subprime financial instruments was that the approach to valuation for many instruments almost overnight dropped from Level 1 to Level 3. The problem was that, because many 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.

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To those unfamiliar with the underlying accounting literature, the result must have looked like something between pandemonium and chaos. They watched as some of the most prestigious financial organizations in the world announced dramatic write-downs, followed by equally dramatic write-downs thereafter. Stock market volatility returned with a vengeance. Financial institutions needed to raise more capital. And many investors watched with horror as the value of both their homes and stock portfolios seemed to move in parallel in the wrong direction.

To some, this was all evidence that fair value accounting is a folly. Making that argument with particular conviction were those who had no intention of selling the newly plummeting financial instruments to begin with. Even those intending to sell suspected that the write-downs were being overdone and that the resulting volatility was serving no one. 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."

Is Fair Value Good or Bad?

So what do we make of fair value accounting based on the subprime experience?

Foremost is that some of the challenges in the application of fair value accounting are just as difficult as some of its opponents said they would be. True, when subprime instruments were trading in active, observable markets, valuation did not pose much of a problem. But that changed all too suddenly when active markets disappeared and valuation shifted to Level 3. At that point, valuation models needed to be deployed which might potentially be influenced by such things as the future of housing prices, the future of interest rates, and how homeowners could be expected to react to such things.

The difficulties were exacerbated, moreover, by the suddenness with which active markets disappeared and the resulting need to put in place models just as pressure was building to get up-to-date information to investors. It is hardly surprising, therefore, that in some instances asset values had to be revised as models were being refined and adjusted.

Imperfect as the valuations may have been, though, the real-world consequences of the resulting volatility were all too concrete. Some of the world's largest financial institutions, seemingly rock solid just a short time before, found themselves needing to raise new capital. In the aftermath of subprime instrument write-downs, one of the most prestigious institutions even found itself facing a level of uncertainty that resulted in what was characterized as a "run on the bank."

So the subprime experience with fair value accounting has given the naysayers some genuine experiences with which to make their case.

Still, the subprime experience also demonstrates that there are two legitimate sides to this debate. For the difficulties in financial markets were not purely the consequences of an accounting system. They were, more fundamentally, the economic consequences of a market in which a bubble had burst.

And advocates of fair value can point to one aspect of fair value accounting—and Statement no. 157 in particular—that is pretty much undeniable. 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.

For fair value advocates, that may be their best argument of all. Whatever its faults, fair value accounting and Statement no. 157 have brought to the surface the reality of the difficulties surrounding subprime-related financial instruments. Is the fair value system perfect? No. Is there room for improvement? Inevitably. But those favoring fair value accounting may have one ultimate point to make. In bringing transparency to the aftermath of the housing bubble, it may be that, for all its imperfections, the accounting system has largely worked.

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Fair value accounting limits bubbles rather than creates them.

The Capital Markets' Needs Will Be Served

by Paul B.W. Miller

With regard to the relationship between financial accounting and the subprime-lending crisis, I observe that the capital markets' needs *will* be served, one way or another.

Grasping this imperative leads to new outlooks and behaviors for the better of all. In contrast to conventional dogma, capital markets cannot be managed through accounting policy choices and political pressure on standard setters. Yes, events show that markets can be duped, but not for long and not very well, and with inevitable disastrous consequences.

With regard to the crisis, attempts to place blame on accounting standards are not valid. Rather, other factors created it, primarily actors in the complex intermediation chain, including:

- Borrowers who sought credit beyond their reach.
- Originators who wrote subprime mortgages to collect fees.
- Investment bankers who earned fees for bundling and selling vaporous bonds without adequately disclosing risk.
- Institutional investors who sought high returns without understanding the risk and real value.

In addition, housing markets collapsed, eliminating the backstop provided by collateral. Thus, claims that accounting standards fomented or worsened this crisis lack credibility.

The following paragraphs explain why fair value accounting promotes capital market efficiency.

"Markets can be duped, but not for long and not very well, and with inevitable disastrous consequences."

The Goal of Financial Reporting

The goal of financial reporting, and all who act within it, is to facilitate convergence of securities' market prices on their intrinsic values. When that happens, securities prices and capital costs appropriately reflect real risks and returns. This efficiency mutually benefits everyone: society, investors, managers and accountants.

Any other goals, such as inexpensive reporting, projecting positive images, and reducing auditors' risk of recrimination, are misdirected. Because the markets' demand for useful information will be satisfied, one way or another, it makes sense to reorient management strategy and accounting policy to provide that satisfaction.

The Prescription

The key to converging market and intrinsic values is understanding that *more* information, not less, is better. It does no good, and indeed does harm, to leave markets guessing. Reports must be informative and truthful, even if they're not flattering.

To this end, all must grasp that financial information is favorable if it unveils truth more completely and faithfully instead of presenting an illusory better appearance. Covering up bad news isn't possible, especially over the long run, and discovered duplicity brings catastrophe.

Supply and Demand

To reap full benefits, management and accountants must meet the markets' needs. Instead, past attention was paid primarily to the needs of managers and accountants and what they wanted to supply with little regard to the markets' demands. But progress always follows when demand is addressed. Toward this end, managers must look beyond preparation costs and consider the higher capital costs created when reports aren't informative.

Above all, they must forgo misbegotten efforts to coax capital markets to overprice securities, especially by withholding truth from them. Instead, it's time to build bridges to these markets, just as managers have accomplished with customers, employees and suppliers.

The Content

In this paradigm, the preferable information concerns fair values of assets and liabilities. Historical numbers are of no interest because they lack reliability for assessing future cash flows. That is, information's reliability doesn't come as much from its verifiability (evidenced by checks and invoices) as from its dependability for rational decision making. Although a cost is verifiable, it is unreliable because it is a sample of one that at best reflects past conditions. Useful information reveals what is now true, not what used to be.

It's not just me: Sophisticated users have said this, over and over again. For example, on March 17, Georgene Palacky of the CFA Institute issued a press release, saying, "Fair value is the most transparent method of measuring financial instru-

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ments, such as derivatives, and is widely favored by investors." This expressed demand should help managers understand that failing to provide value-based information forces markets to manufacture their own estimates. In turn, the markets defensively guess low for assets and high for liabilities. Rather than stable and higher securities prices, disregarding demand for truthful and useful information produces more volatile and lower prices that don't converge on intrinsic values.

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The Strategy

Managers bring two things to capital markets: (1) prospective cash flows and (2) information. Their work isn't done if they don't produce quality in both. It does no good to present rosy pictures of inferior cash flow potential because the truth will eventually be known. And it does no good to have great potential if the financial reports obscure it.

Thus, managers need to unveil the truth about their situation, which is far different from designing reports to prop up false images. Even if well-intentioned, such efforts always fail, usually sooner rather than later.

It's especially fruitless to mold standards to generate this propaganda because readers don't believe the results. Capital markets choose whether to rely on GAAP financial statements, so it makes no sense to report anything that lacks usefulness. For the present situation, then, not reporting best estimates of fair value frustrates capital markets, creates more risk, diminishes demand for a company's securities and drives prices even lower.

The Role for Accounting

Because this crisis wasn't created by poor accounting, it won't be relieved by worse accounting. Rather, the blame lies with inattention to CDOs' risks and returns. It was bad management that led to losses, not bad standards.

In fact, value-based reporting did exactly what it was supposed to by unveiling risk and its consequences. It is pointless to condemn FASB for forcing these messages to be sent. Rather, we should all shut up, pay attention, and take steps

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In what some of us perceive to be an exercise of hubris, FASB has attempted to serve the needs of all three fields at the expense of manager or owner needs for control and performance measurements.

How We Got Here

The debate over the need for any standards began with the 1929 market crash and the subsequent formation of the SEC. Initially, Congress intended that the chief accountant of the SEC would establish the necessary standards. However, Carmen Blough, the first SEC chief accountant, wanted the American Institute of Accountants (a predecessor to the AICPA) to do this. In 1937 he succeeded in convincing the SEC to do just that. The AICPA did this through an ad hoc committee for 22 years but finally established a more formal committee, the Accounting Principles Board, which functioned until it was deemed inadequate and FASB was formed in 1973.

FASB's first order of business was to establish a formal "constitution" as outlined by the report of the Trueblood Committee (*Objectives of Financial Statements*, AICPA, October 1973). With the influence of several academics on that committee, the thrust of the "constitution" was to move to a balance sheet view of income versus the income view which had arisen in the 1930s. Although the ultimate goal was never clarified, it was obvious to some, most notably Robert K. Mautz, who had served as a professor of accounting at the University of Illinois and partner in the accounting firm Ernst & Ernst (a predecessor to Ernst & Young) and finally a member of the Public Oversight Board and the Accounting Hall of Fame. Mautz realized then that the goal was fair value accounting and traveled the nation preaching that a revolution was being proposed. Several companies, notably General Motors and Shell Oil, led the opposition that continues to this day.

The most recent statement on the matter was FASB's 2006 publication of a preliminary views (PV) document called *Conceptual Framework for Financial Reporting: Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information*. It is clear that FASB has abandoned the real daily users who apply traditional accounting to manage their businesses. The PV document refers to investors and creditors only. It mentions the need for comparability and consistency but does not attempt to explain how this would be possible under fair value accounting since each manager would be required to make his or her own value judgments, which, of course, would not be comparable to any other company's evaluations.

The only reference to the management of a company states that "...management has the ability to obtain whatever information it needs." That is true, but under the PV proposal management would have to maintain a third set of books to keep track of valuations. (The two traditional sets would be the operating set based on actual costs and sales, which would need to be continued to allow management or owners to judge actual performance of the company and personnel, while the other set is that used for federal income tax filings.)

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to prevent other disasters.

That involves telling the truth, cleanly and clearly. It needs to be delivered quickly and completely, withholding nothing. Further, managers should not wait for a bureaucratic standard-setting process to tell them what truth to reveal, any more than carmakers should build their products to minimum compliance with government safety, mileage and pollution standards.

I cannot see how defenders of the status quo can rebut this point from Palacky's press release: "…only when fair value is widely practiced will investors be able to accurately evaluate and price risk."

THE FUTURE

Nothing can prevent speculative bubbles. However, the sunshine of truth, freely offered by management with timeliness, will certainly diminish their frequency and impact.

Any argument that restricting the flow of useful public information will solve the problem is totally dysfunctional. The markets' demand for value-based information will be served, whether through public or private sources. It might as well be public.

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Since there are about 19 million private companies that do not file with the SEC versus the 17,000 public companies that do, private companies are in a quandary. The majority of them file audited financial statements with banks and creditors based on historical costs and for the most part current GAAP. They are already running into trouble with several FASB standards that introduce fair value into GAAP. What GAAP do they use?

Judging by the crash of the financial system and the tens of billions of dollars in losses booked by investment banks this year, the answer seems clear: Return to establishing standards that are based on costs and transactions, that inhibit rather than encourage manipulation of earnings (such as mark to market, FASB Statements no. 133 and 157 to name a few), and that result in data as reliable as it can be under an accrual accounting system.

The analysts and other investors and creditors will have to do their own estimates of a company's future success. However, the success of any company will depend on the quality of its products and services and the skill of its management, not on a guess at the "value" of its assets. Writing up assets was a bad practice in the 1920s and as bad a practice in recent years.

***Eugene H. Flegm**, CPA, CFE, (now retired) served for more than 30 years as an accounting executive for General Motors Corp. He is a frequent contributor to various accounting publications. His e-mail address is ehflegm@earthlink.net.*

Why historical cost is more reliable than fair value.

The Need for Reliability in Accounting

by Eugene H. Flegm

In 1976, FASB issued three documents for discussion: *Tentative Conclusions on Objectives of Financial Statements of Business Enterprises*; *Scope and Implications of the Conceptual Framework Project*; and *Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement*. These documents started a revolution in financial reporting that continues today.

As the director of accounting, then assistant comptroller-chief accountant, and finally as auditor general for General Motors Corp., I have been involved in the resistance to this revolution since it began.

Briefly, the proposed conceptual framework would shift the determination of income from the income statement and its emphasis on the matching of costs with related revenues to the determination of income by measuring the "well offness" from period to period by measuring changes on the two balance sheets on a fair value basis from the beginning and the ending of the period. The argument was made that these data are more relevant than the historic cost in use and not as subjective as the concept of identifying costs with related revenues. In addition, those in favor of the change claimed that the fair value data was more relevant than the historic cost data and thus more valuable to the possible lenders and investors, ignoring the needs of the actual managers and, in the case of private companies, the owners.

Relevancy Requires Reliability

It seems to me that the recent meltdown in the finance industry as well as the Enron experience would have made it clear that to be relevant the data must be reliable.

Enron took advantage of the mark-to-market rule to create income by just writing up such assets as Mariner Energy Inc. (see SEC Litigation Release no. 18403).

Charles R. Morris writes in his recently released book, *The Trillion Dollar Meltdown: Easy Money, High Rollers, and the Great Credit Crash*, that "Securitization fostered irresponsible lending, by seeming to relieve lenders of credit risk, and at the same time, helped propagate shaky credits throughout the global financial system."

There is much talk of the need for "transparency," and it now appears we have completely obscured a company's exposure to loss! We still do not know the extent of the meltdown!

Assigning Blame

We are still trying to assign blame—Morris identifies former Federal Reserve Chairman Alan Greenspan's easy money policies—and certainly the regulators allowed the finance industry to get out of control. However, FASB and its fascination with "values" and mark to market must be a part of the problem.

Holman W. Jenkins Jr. began his editorial, "Mark to Meltdown," (*Wall Street Journal*, p. A17, March 5, 2008) by stating, "No task is more thankless than to write about accounting for a family newspaper, yet it must be shared with the public that 'mark to market,' an accounting and regulatory innovation of the early 1990s, has proved another of Washington's fabulous failures."

Merrill Lynch reported a $15 billion loss on mortgages for 2007. Citicorp had about $12 billion in losses, and Bear Stearns failed. These huge losses came from mortgages that had been written up to some fictitious value based on credit ratings during the preceding years! In addition there is some doubt that those loss estimates might be too conservative and at some point in the future a portion of them may be reversed.

The Basic Purpose of Accounting

Anyone who has ever run an accounting operation knows that the basic purpose of accounting is to provide reliable, transaction-based data by which one can control the assets and liabilities and measure performance of both the overall company and its individual employees.

"Return to establishing standards that are based on costs and transactions..."

A forecast of an income statement each month as well as an analysis of the actual results compared to the previous month's forecast are a key factor in controlling a company's operations. The balance sheet will often be used by the treasury department to analyze cash flows and the need for financing. I do not know of a company that compares the values of the beginning and ending balance sheets to determine the success of its operations.

How did we reach the current state of affairs where the standard setters no longer consider the stewardship needs of the manager but focus instead on the potential investor or creditor and potential values rather than transactional results?

The problem developed because of the conflict between economics, accounting and finance—and the education of accountants. All three fields are vital to running a company but each has its place.

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