

Fair Value Accounting

How Bad Decisions Bring Blame to Beneficial Accounting Procedures

Thomas Ciulla

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Gene Sullivan, Ph.D.
Thesis Chair

James Shelton, Ph.D.
Committee Member

Jean Tweedy, Ed. D.
Committee Member

Brenda Ayres, Ph.D.
Honors Director

Date

Abstract

The Great Recession has sparked a debate amongst accounting professionals and economic analysts. There has been a concerted effort to blame fair value accounting and FAS 157 as the recession's root cause and an attempt to challenge FASB to return to the historic cost principle. This paper examines the guidelines and procedures for mark to market as established by FASB, observes the events leading up to the recession, conditions that materialized at the start of the recession, evaluates the role fair value played in the financial crisis, and considers how fair value should be used in the future.

Fair Value Accounting

How Bad Decisions Bring Blame to Beneficial Accounting Procedures

The housing bubble, which had been growing in the 1990s and into the new millennium, began to burst in February 2007. It triggered what is now being considered the greatest recession in recent memory since the Great Depression. Banks had neither the necessary reserves to meet their personal obligations and the demands from their customers nor the liquidity in their investments to quickly convert them into cash to keep the recession from growing as quickly and as rapidly as it did (Ryan, 2008). Many different analysts have recently attacked the fair value option, enacted by the Financial Accounting Standards Board (FASB) through Financial Accounting Standard (FAS) 157 in September, 2006, claiming that the updated accounting rules for the assets and liabilities of banks was the cause of their illiquidity, and they proposed that continuing the use of the historic cost method would have prevented the current economic crisis from transpiring. Additionally, they have written journals and articles claiming that the FASB must depart from the required use of fair value accounting immediately to prevent another bubble similar to the housing bubble in late 2007.

The predominant controversy amongst accounting professionals regarding the fair value option pertains to its apparent departure from the historic principle established within generally accepted accounting principles (GAAP). A major objection of detractors is their belief that the switch to fair value accounting and the addition of the fair value option helped create the environment responsible for the 2007 recession. More specifically, the recession was magnified by the inability of banks to continue to loan capital to businesses, entrepreneurs, and individuals who needed the capital to expand the

economy. The paramount issues which must be explored include what role fair value accounting played in the 2007 recession and the ensuing financial crisis. Additionally if fair value accounting was a major contributor to the recession an investigation must take place as to how it can be improved or eliminated to prevent a similar financial crisis from occurring in the future.

The FASB has recently spent much time handling the issue of fair value accounting and has made changes to fair value guidance both immediately prior to and since the financial crisis. It is the intention of this paper to prove that although fair value accounting as established in SFAS 157 enhanced the severity and the swiftness of the financial crisis, the root cause of the financial crisis was the poor decision making of bank management by loosely handing out loans to unqualified lenders and their use of complex financial instruments to support the loans being made. Additionally, while the FASB recently has more comprehensively defined the rules for fair value accounting in the marketplace, the fair value accounting procedures for banks must further be made definitive to prevent false earnings within banks, to decrease volatility in the marketplace and the potential for market bubbles, and to give a more fair representation of the actual financial position of banks individually and in their relationship to one another. This will help users of these financial statements to more clearly understand the financial position of banks and more readily alert customers, creditors, investors, and banks themselves of problematic financing before it is too late.

A Review of Fair Value Accounting

Fair Value Accounting Defined

Before looking further into this controversy, however, fair value must first be defined and explored as it is currently used in banks. The FASB defines fair value in ASC 820-10-35-2 as “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” (FASB 2012). This does not mean, however, that the fair value of an asset or liability is the current market value. Although it is possible for these two values to be in correspondence with one another, a clear and important distinction is that fair value refers to the value as of the measurement date, which could possibly be open to negotiation between a buyer and seller, whereas market value is a component of fair value, but not its basis. For example, the market could show the value of a stock to be at a certain level, but if an orderly transaction were to occur on that date, negotiations or other factors could cause the fair value to differ from the apparent market value on the measurement date. FASB determined that the measurement should be determined by assuming the transaction occurs in the principal market for the asset or liability, and when no principal market exists, valuation should be based upon a transaction in the most advantageous market for the asset or liability. Accordingly, the FASB outlines the proper rules and procedures determining the market and the actual fair value measurements and disclosures under section 820 of the FASB Accounting Standards Codification, which will subsequently be further explained.

Fair value accounting within the Codification is exceptionally far reaching, and is used for many different business transactions with varying, complex procedures. Because this paper relates primarily to banks’ use of fair value accounting, prior to, during, and since the recession, only these fair value procedures will be explored. The most common

use of fair value measurements are determining fair values for financial instruments, such as securities, bonds, or loans. Because the fair value option is exceptionally far reaching and complex, only fair valuation regarding these financial instruments will be explored and analyzed in depth within the Accounting Standards Codification. This analysis will then be used to explore fair value's role in the financial crisis.

Valuation Techniques

The Accounting Standards Codification (ASC) recognizes three different valuation techniques as acceptable approaches to measuring fair value: the market approach, income approach, and/or the cost approach. The ASC defines the market approach as “a valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities” (FASB 2012). Therefore, the market approach focuses on using comparable assets and liabilities within the market to determine the value of the asset or liability being measured. It is necessary to use professional judgment to determine qualitative and quantitative comparable values under this approach.

FASB defines the income approach as “an approach that uses valuation techniques to convert future amount to a single present amount” (FASB 2012). Basically, the income approach uses time value of money techniques to determine present value of cash flows and earnings based on future expectations. The valuation techniques that the ASC allows for are present value techniques, option-pricing models, and the multi-period excess earnings method (used mainly for specific intangible assets).

Thirdly, FASB defines the cost approach “as a valuation technique based on the amount that currently would be required to replace the service capacity of an asset (often

referred to as current replacement cost)” (FASB 2012). This definition is the most easily understood, as it is simply the cost that a market participant would need to pay for an asset to replace that asset. Along with these three valuation techniques, the FASB created different inputs to be used based upon the availability of market data which are subsequently discussed.

Level 1 Through 3 Inputs

When determining fair value, certain measurement techniques will be more accurate than others depending on how much information is readily available and determinable for a given financial instrument. Regarding the FASB’s codification techniques regarding fair value, Pounder notes, “The dominant fair value measurement approach under U.S. GAAP is based on a three-level hierarchy of methods” (Pounder 2010). More specifically, there are three different Levels which may be used to determine fair value, Levels 1 through 3. The FASB desires that relevant and observable inputs are used for determining fair value measurements, which are used in Level 1 and Level 2. Level 3 inputs, as will be discussed, are based on unobservable inputs and rely more highly on estimates and valuation models and techniques. At times, an asset or liability may fall into different hierarchy levels, and the FASB decided that the entire fair value measurement should be decided based upon the lowest level in which any portion of the asset or liability exists (FASB 2012).

Level 1 information is the most accurate representation of the current fair value of an asset or liability and is 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” (FASB 2012). For example, Level 1 information for an actively

traded stock would be the market value of the stock on the measurement date (it must be actively traded to be a Level 1 input, as it would be an accurate representation of its current value). Because the stock market is generally instantaneously updated in today's business environment, it is able to provide reliable and, equally important, objective information regarding fair value. Additionally, if any adjustment to the quoted market price is needed, the asset or liability fails to qualify as a Level 1 input and falls into the category of Level 2.

Level 2 information, located in the middle of the hierarchy, produces information less reliable than Level 1 information, but still remains more subjective than Level 3 information. FASB (2012) defines Level 2 inputs as "inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly," with specific examples seen in ASC 820-10-35-48. Whereas Level 1 inputs include assets and liabilities in active markets, Level 2 inputs measure assets and liabilities in inactive markets or slow-moving markets, but measurement is still observable. Adjustments are needed to the Level 1 input, but the adjustments are not severe enough to qualify it as a Level 3 input. To remain at Level 2, certain factors must be known including the condition or location of the asset being valued, the comparability of Level 1 assets and liabilities, and the volume of activity in the markets of the Level 2 instruments. An example of Level 2 information would include transactions such as "receive-fixed, pay-variable interest rate swap based on a LIBOR swap rate," or basing the price of a building held and used on the per square foot price of other buildings in the market in similar locations (FASB 820-10-55-21). These valuation methods would not be as accurate as current U.S. interest rates (as opposed to LIBOR), or the price the building

would actually sell for at the measurement date, but they are still able to provide reliable data regarding the asset or liability's fair values.

Finally, Level 3 inputs are basically a last resort, back-up plan for fair value measurement because there is generally a large amount of subjective or unreliable information used in determining fair value (Pounder 2010). They are defined as "unobservable inputs for the asset or liability" (FASB 2012). An example of a Level 3 input is a "[t]here-year option on exchange-traded shares. A Level 3 input would include historical volatility for the shares derived from the shares' historical prices" (FASB 820-10-55-22). This measurement thus provides unreliable information, as it is relying on historical changes in exchange rates which have no bearing on current or future exchange rates. Rather than using useful market information, Level 3 inputs rely heavily on valuation techniques and are much more susceptible to subjectivity. Therefore, Level 3 inputs should only be used when there is absolutely no alternative, as they still provide a more reliable valuation than predictions or no information at all. However, these Level 3 fair values pose significant complications to auditors who need assurance for the input, assumptions used, and limitations of the valuation techniques (Power, 2010). Level 3 inputs depend heavily on pricing models by trying to incorporate risk into their valuation techniques, and because of the uncertainty and subjectivity involved in valuing Level 3 inputs, the ASC offers extensive guidance on procedures for these inputs in paragraphs 820-10-35-54 through 55.

A severe limitation of fair value measurement under current GAAP is the measurement of risk for fair values of assets and liabilities. While riskier financial instruments may be measurable based on the three-level hierarchy, the valuation attained

through the inputs may not provide a truly reliable representation of the fair value of the instruments (Kaplan, 2011). This is especially true of complex financial instruments, such as derivatives, which have recently stirred up controversy among accounting professionals regarding fair value even further and have actually served as a “crucial transformative catalyst” in accounting history as recent changes in GAAP are a direct result of valuing complex financial instruments (Power, 2010). These are the same types of instruments which will later be discussed as playing a role in the bursting bubble of the financial crisis.

One such Accounting Standards Update (ASU), titled “Improving Disclosures about Fair Value Measurements,” was designed to provide further disclosures in order to more fully explain the techniques used to obtain fair value measurements, disclosing which level (1, 2, or 3) inputs were used in determining fair value, and what the numbers actually mean. This update, ASU No. 2010-06 went into effect on January 21, 2010 for all reporting periods after December 15, 2009. ASU No. 2010-06 provides that auditors must disclose transfers between Levels 1 and 2 based on the information available at the measurement date and explain their reasoning behind the transfer. This lessens the uncertainty of both the risk and reliability of fair value measurements, and provides investors with a better understanding of the financial condition of the company. ASU No. 2010-06 also forces accountants to disclose the assumptions they use under Level 3 valuations and forces them to reconcile the beginning-of-period figures for Level 3 measurements to the end-of-period figures so that users may see how assumptions and valuations have changed since the last reporting period. ASU No. 2010-06 also tried to force reports to include a sensitivity of assumptions for Level 3 measurements, where

accountants would include a best-case and worst-case scenario for assumptions, but this disclosure amendment still remains on the table for the FASB (Pounder, 2010).

Introduction of SFAS 157

SFAS 157, "Fair Value Measurements," is the accounting standard which introduced the procedures and the various inputs previously discussed. FASB's overarching goal for this statement was to provide accurate values independent of companies' management's opinion for items on their balance sheet. FAS 157 was issued in September, 2006 (Trussel & Rose, 2009) and became effective for financial statements after November 15, 2007 even though earlier application to financial statements was encouraged (Zacharski, Rosenblat, Wagner, & Teufel, 2007). The purpose of this standard was to define fair value, establish a measuring technique to measure fair value as an addition to GAAP, and to create new necessary disclosures for these techniques, which have already been explored.

FAS 157 was a bold and transformative issuance for FASB on several accounts. At the time of its institution, many accounting professionals were concerned about the effects of switching from the traditional accounting principle of historical cost by allowing assets and liabilities to be measured at their current fair market values. The historical cost principle stated that assets and liabilities should be reported at the price someone either paid for or received in the transaction, and remained unaccounted for until they were either sold or involved in another transaction. Today, critics believe this derivation to be a leading cause of the financial crisis. They argue that if the assets and liabilities held by banks during the housing bubble would have been valued at their historic cost, there would have been no liquidity crunch and thus, no collapse of the

financial system. Their criticism is not without merit. As Trussel and Rose (2009) point out that shortly after the issuance of FAS 157 was the time when many financial institutions began to unravel, making FAS 157 an obvious and easy accounting standard to blame.

Furthermore, critics have also voiced much opposition to the treatment of Level 3 holdings. They argue that auditors are unable to make objective determinations of the value of these holdings. Consequently, since these holding must be calculated and recorded, critics argue these valuations leads to detrimental pressure on financial intuitions and the financial system as a whole. Rather than being classified as trading securities or available-for-sale securities, critics advocate that these Level 3 holdings should always be classified as held-to-maturity and thus be exempt from mark to market unless the fair value option is chosen by the company (Moore & Baker, 2010). These different types of securities will be discussed in the subsequent section.

While these criticisms hold merit, it will now be necessary to explore both previous statements by FASB regarding fair value measurements and then explore the actual market conditions during the time of the financial crisis before an adequate conclusion can be reached on the effects of FAS 157. This will provide background to the evolution of fair value theory, and ultimately justify the purpose and usefulness of fair value accounting within the context of FASB's standards. The additional Financial Accounting Standards which will be explored are SFAS 115 "Accounting for Certain Investments in Debt and Equity Securities" and SFAS 159 "The Fair Value Option for Financial Assets and Financial Liabilities."

Types of Securities

SFAS 115 established three categories of investments: trading securities, available-for-sale securities, and held-to-maturity securities. GAAP now has a working definition for each of these securities. Trading securities are securities which the buyer intends to sell within a short period of time; several days for instance. Available-for-sale securities are those securities that have determinable values, but are not classified as either trading or held-to-maturity securities. Held-to-maturity securities are those that the reporting entity plans to and has the ability to hold until they reach their maturity (ASC 320-10-25-1). These different categories are important because they affect how different securities are treated with regard to fair value measurements. Entities report both trading securities and available-for-sale securities on their balance sheets at fair value. For trading securities, their unrealized gains and losses (since no transaction has actually taken place) are reported within net income. Available-for-sale securities, on the other hand, have their unrealized gains and losses reported as a component of other comprehensive income. Held-to-maturity securities are reported at their cost after any amortization and are adjusted for any more than temporary impairments (Krumwiede, Scadding, & Stevens, 2008).

However, SFAS 159, enacted in February, 2007, dramatically modified SFAS 115. SFAS 159 allowed a provision for reporting entities by allowing them to make an election to classify a security normally classified as available-for-sale or held-to-maturity under SFAS 115 at their fair value, with unrealized gains and losses reported within net income rather than within other comprehensive income. The overarching goal of SFAS 159, as cited by Krumwiede, Scadding, & Stevens (2008) is “to improve financial

reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions.” In other words, FASB believes the fair value option gives financial statement users a more accurate representation of the current financial standing of a company, based on how management intends to use its investments.

This election became effective for business’s fiscal year beginning after November 15, 2007. If an entity decides to adopt this standard, it is able to on a “contract-by-contract” basis determine which existing and all subsequent assets and liabilities will be reported on a fair value basis, with this election being irrevocable. In addition to this election, entities must disclose their reasoning when they have certain securities valued at fair value and others at historical cost if they are in a similar asset or liability class (Cataldo & McInnes, 2007).

Finally, there is an exception or closed loop hole within SFAS 159 to prevent entities from only using the fair value option when securities are increasing in value, and then switching them back when the securities are losing value, thus intentionally manipulating net income. For example, if an entity owns a security which had been elected for the fair value option and was increasing in value, but because of current market conditions the value of the security suddenly drops and is now underwater and the entity tries to replace it by purchasing a similar security without declaring the fair value option, SFAS 159 will not permit this, as it is not consistent with the Statement’s original intention. The disclosures required under SFAS 159 discourage these types of violations (Krumwiede, Scadding, & Stevens, 2008).

The Securitization Process

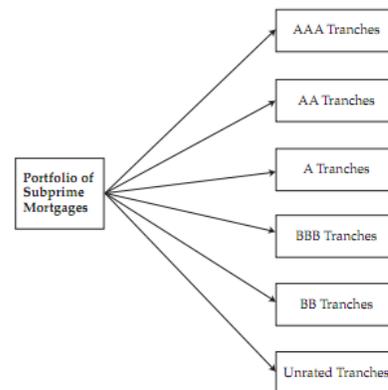
What Is a Mortgage-backed Security (MBS)?

It is now possible to further explore the securities banks held on their financial statements during the financial crisis. Alles (2009) defines mortgage backed securities (MBS) as “debt instruments backed by mortgage pools, created by financial institutions through a securitization process.” This process is crucial for banks as it allows them to continue to issue mortgages to individuals and new loans to businesses as they transform their existing loans into cash which finances the new loan, and the cycle begins over again. The quality of the underlying mortgages in these securitized bonds determines the class of the newly constructed bond, and thus affects the interest rate, maturity date, risk level, and other factors associated with traditional debt instruments (Werkmeister, 2010). Therefore, these instruments are critical to banks for them to be able to maintain enough liquidity to continue their operations. An additional perk for banks using MBS is the transfer of risk from the bank to the entity purchasing the MBS. This is advantageous to the banking industry for two major reasons, one being that banks are no longer maintaining the risk of default, but passing that risk along and two being that through the transfer, the mortgages or loans are no longer carried on the bank’s balance sheet, freeing them from regulations, such as reserve requirements, and improving their financial ratios (Batchvarov, Hani, & Davies, 2002).

Any given MBS may contain 1,000 mortgages bundled together into various tranches (levels) and rated based on the quality of the mortgages. In the years precluding the financial crisis, these instruments were being securitized from subprime mortgages. Ryan (2008) explains that in the late 1970s through the early 1980s, banks referred to

“subprime” to describe commercial loans that failed to yield the prime rate because banks were confident that these borrowers would not default and gave them a slightly better than prime interest rate. However, the current use of the term “subprime” has almost an exact opposite meaning, as since 1995 banks have used the term to describe “less than highly creditworthy assets (e.g., subprime mortgages) that yield higher interest rates than do prime assets with similar non-credit risks” (Ryan 2008). These assets are generally considered less than creditworthy when borrowers have low credit ratings or are apparently buying too much house as a percentage of their disposable income. The following figure helps to picture how mortgages are separated into tranches within a given MBS.

Figure 1. Creation of Tranches from a Portfolio of Subprime Mortgages



(Hull & White, 2010)

The portfolio, or the new debt instrument, is then rated based upon the tranches within. Hull & White (2010), in their study of MBS, examined that AAA tranches generally comprised 75-85 percent of the mortgage principle. However, banks decided to make these already complex financial instruments even further in complexity when they invented a new financial instrument called a collateralized debt obligation (CDO).

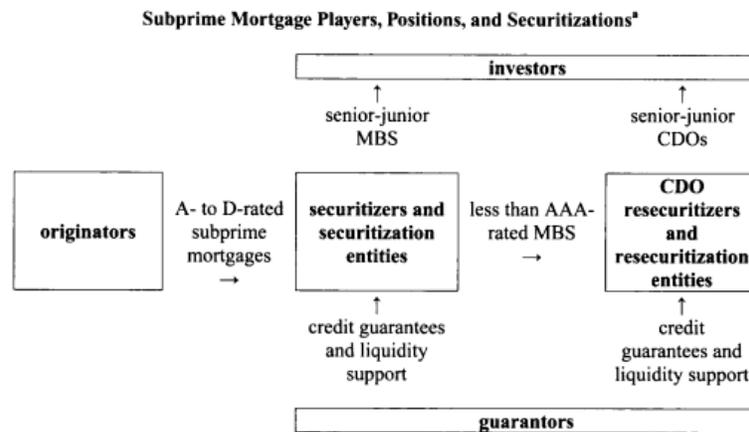
Collateralized Debt Obligations and Credit Default Swaps

Because of their complexity, especially in the years prior to the Great Recession, CDOs and credit default swaps (CDS) will only briefly be explored for the purpose of this paper. Because not all subprime mortgages were able to be packaged as what was considered AAA MBSs, many AA and lower-graded subprime MBSs were restructured and resecuritized as AAA collateralized debt obligations. Much like a MBS, CDOs are composed of senior-to-junior tranches, and through the securitization process, most of these CDOs were restructured so that their senior tranches were classified at a AAA rating even though their true underlying assets were risky MBSs (Ryan, 2008). Banks were able to justify an AAA rating because of the diversification levels of the mortgages within a given portfolio, ranging from geographic location to the type and income of the borrower. The AAA rating gave investors confidence that they were purchasing low risk investment, when in reality the CDOs were based on a pool of BBB mortgage backed securities (Thomas, 2010).

Additionally, Young, McCord, & Crawford (2010) define Credit Default Swaps (CDS) as “an insurance-type contract which promises to cover the buyer of the contract’s losses in the event of a default on the “insured” debt instrument.” In other words, a CDS is an insurance policy on different debt instruments, MBSs and CDOs included. Theoretically, CDSs are a useful tool for investors, as they have protection from the various debt investments they make. However, insurance companies thought they were insuring AAA CDOs, when in reality banks had hired different ratings agencies (such as S&P and Moody’s) to give the securities a AAA rating (Young, McCord, & Crawford, 2010), and thus creating a conflict of interest for the ratings agencies.

These ratings agencies should have been accurately portraying the inherent risk to the securities, but were being paid by the banks creating the instruments, and as a result the ratings agencies wanted to keep the banks pleased leading to insurance companies cheaply insuring the instruments with CDSs. The following figure helps to visual the entire securitization and insurance process, from the originators (banks) to the investor, with guarantors (the insurance companies) supporting the process:

Figure 2



^a Originators may also be securitizers. Originators and securitizers may also be investors or guarantors.

(Ryan, 2008).

The Great Recession

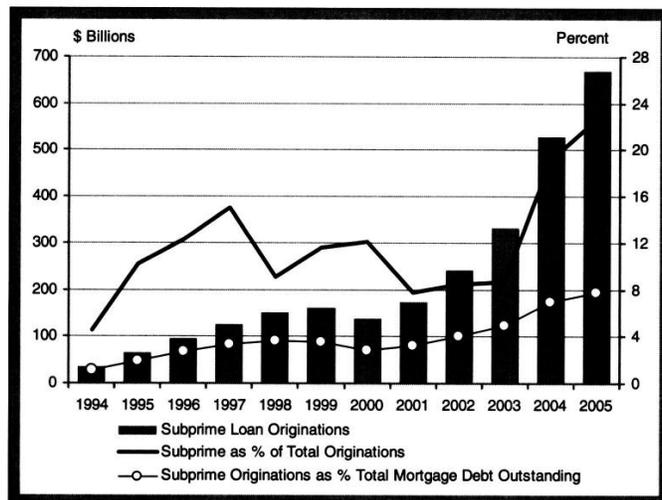
The Bubble Bursts

There is now a sufficient amount of background to explore the causes of the Great Recession and to examine the role of Fair Value accounting to see whether or not it was a major contributor. Wheaton and Nechayev (2008) researched the housing bubble by studying the inflation in housing prices and other determinants of housing prices between 1998 and 2005 to try and explain whether or not there actually was a housing bubble. Their study explains that housing prices within the United States rose only 18% from

1975 through 1988, marking a healthy and steady level of inflation, while incomes of Americans per capita rose approximately 40%. However, from 1998 through 2008, housing prices (as a whole; without factors such as geographic location taken into account) rose nearly 50% while incomes only grew between 5% and 11%. Additionally, Wheaton and Nechayev (2008) calculated that between 1965 and 1995, the homeownership rate ranged between 62% and 64%, but from 1995 through 2008 homeownership escalated to 69%, and that over the last decade (that is, 1995-2005) the total number of renters in the United States has shrunk for the first time since World War II.

The question is then raised that if incomes were shrinking over the same time period that homeownership and housing prices were rising, how were Americans able to purchase these houses and obtain loans from banks? The simple answer is the previously discussed subprime mortgages which were bundled into MBSs. The following exhibit helps to visualize the availability of subprime lending in the years leading to the housing crisis.

Figure 3: Subprime Mortgage Originations



(Wheaton & Nechayev, 2008)

This level of subprime lending left the housing market in an extremely fragile condition. Cassidy (2008) as quoted by Moore and Baker (2010) offers an explanation for increased subprime loans by stating:

In a move that could help increase home ownership rates among minorities and low-income consumers, the Fannie Mae Corporation is easing the credit requirements on loans that it will purchase from banks and other lenders. The action, which will begin as a pilot program involving 24 banks in 15 markets will encourage those banks to extend home mortgages to individuals whose credit is generally not good enough to qualify for conventional loans. In addition, banks, thrift institutions and mortgage companies have been pressing Fannie Mae to help them make more loans to so-called subprime borrowers. (p. 2)

The role of the government through Fannie Mae and other agencies goes beyond the scope of this paper, but offers some background to the rapid utilization of subprime mortgages by banks.

Furthermore, Kohn and Bryant (2010) describe the market in this way: “The prevailing attitudes of ‘bigger is better,’ or ‘as much as one can afford,’ or ‘buy now avoid future higher prices’ became the driving force for home buyers.” This mentality was based on the assumption that housing prices would continue to rise at the rate they had been over the past decade. Unfortunately but realistically, the bubble burst in a correction beginning in 2007, leading to a vastly increasing number of defaults reaching 10% by the second quarter of 2009, and thus a dramatic decrease in housing prices (Mian & Sufi, 2010). As will be seen in the adjacent section, this housing crisis dried up the

liquidity of banks and propelled the economy into the Financial Crisis, leading to extremely high levels of unemployment.

Figure 4: Weakness of Household Balance Sheets

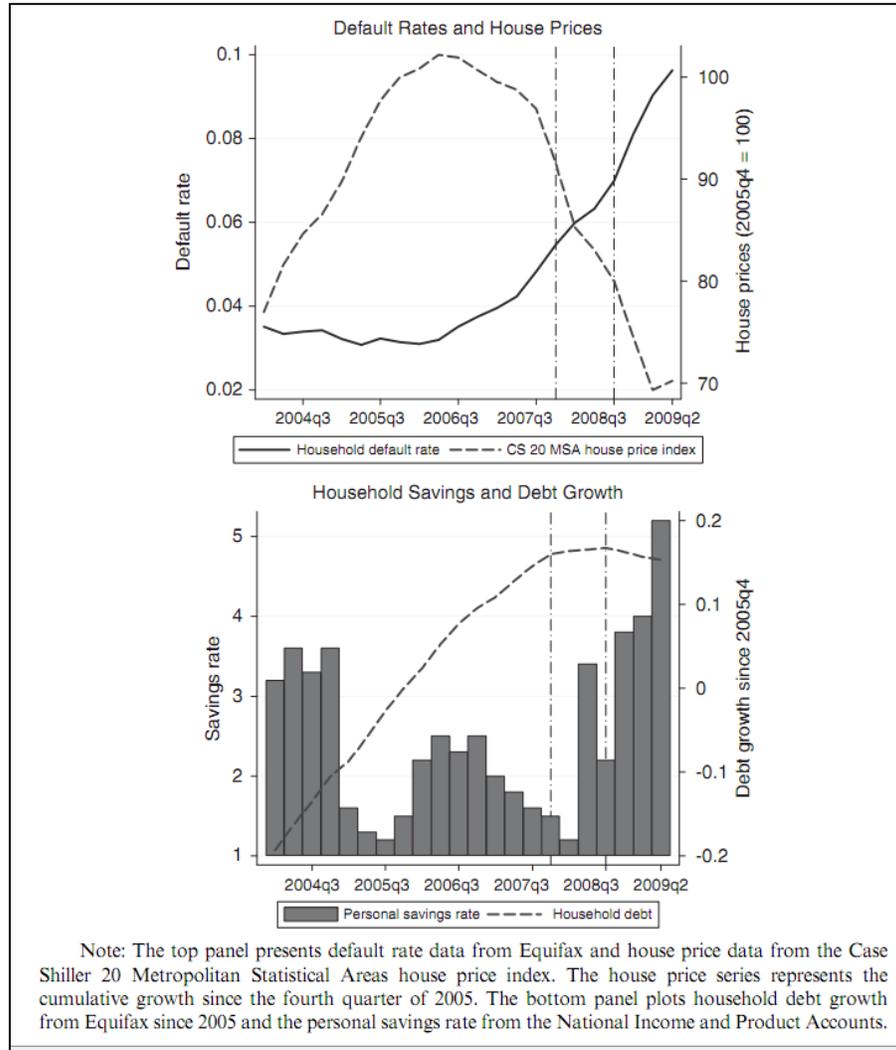
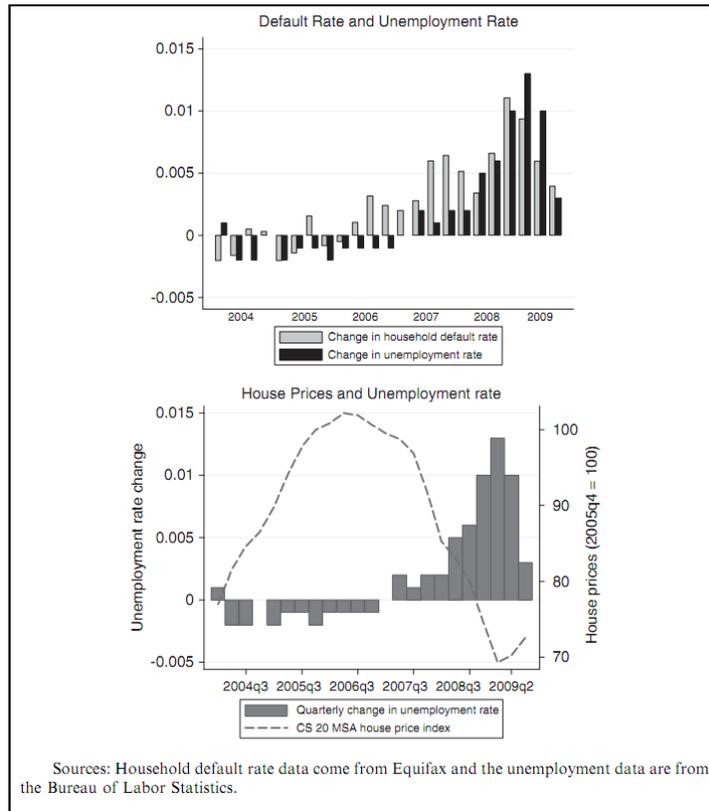


Figure 5: Household Defaults and Unemployment



(Mian & Sufi, 2010).

Lack of Liquidity Tied to Fair Value

GAAP requires holders of MBSs to report those MBSs at fair value. More specifically, ASC 948-310-35-3 states, “Fair value for uncommitted mortgage-backed securities that are collateralized by a mortgage banking entity's own loans ordinarily shall be based on the fair value of the securities. If the trust holding the loans may be readily terminated and the loans sold directly, fair value for the securities shall be based on the fair value of the loans or the securities, depending on the mortgage banking entity's sales intent. Fair value for other uncommitted mortgage-backed securities shall be based on published mortgage-backed securities yields” (FASB 2012). Generally, when banks were securitizing mortgage-backed securities, they had the intention of selling them to generate extra liquidity to support future mortgages, thus qualifying them for fair value reporting.

The bursting housing bubble created a serious predicament for the banking industry. As many subprime borrowers began to default all at once, the value of MBSs began to decline dramatically, leaving most completely worthless. What investors saw as a risk-free asset because of its AAA rating had imploded, and from January through March, 2008, major insurers of these instruments reported huge losses on mortgage-backed securities, collateralized debt obligations, and the credit default swaps insurance policies (Ryan 2008). Because of FAS 157, banks and holders of these securities were required to record them at fair value.

The fair value of a MBS became an extremely difficult process. Before the housing crisis, most MBSs were considered Level 2 inputs as they were not actively traded, but there was a rapidly growing market for these securities. Therefore, there was still a substantial amount of information in the market for financial statement preparers to find quoted bid and ask prices. However, after the housing crisis the market for mortgage-backed securities evaporated, leaving the securities with little to no price transparency (Ryan 2008). Because of the unavailability of an active market, the value of a given MBS converted from a Level 2 measurement to the much more subjective Level 3 measurement. ASC 820-10-35-26 states that a change in valuation technique must be accounted for as a change in accounting estimate, and as a result, is subject to further disclosure on financial statements (FASB 2012).

McMahon (2011) describes the effect of the written down mortgage-backed securities on the leverage ratios of banks. When housing prices were growing, it allowed banks to further leverage themselves because of the gains they were making on the risky loan assets. However, when the market took a downturn, the previous balance sheet

equity evaporated because of fair value reporting. McMahon (2011) further evaluates that if a bank is leveraged at 10 times, if the overall assets of that bank drop 9%, which was no stretch of the imagination for the Financial Crisis, then it would cause leverage to apparently leap to 91. It is because this was happening at every bank, that not only could they no longer create new loans because of their excessive leverage ratios, but they also were forced to deleverage their balance sheets to the regulated levels, as impossible as it seemed with their enormous leverage ratios. This had a ripple effect into the economy as a whole, as businesses and individuals could not obtain financing to maintain a stable economic system.

Fair Value or Poor Decision Making?

After evaluating the preponderance of evidence of the economic condition of the United States, especially within the banking industry at the start of the financial crisis, it is conclusive that SFAS 157 and fair value accounting was not the sole or even major contributor of the financial crisis. Seay and Ford (2010) explained the ethical dilemma in fair value accounting: "Politicians, lobbyists, and media representatives may not understand the operation of the capital markets and accounting's key role in resource allocation decisions within those markets." In other words, much of the criticism of the accounting practices throughout the recent meltdown has come from sources who do not fully comprehend the role of the accountant in the capital market.

Accounting during financial crises should be no different than when markets are running efficiently, and was no different during the Great Recession than at any other point in the profession's history. The SEC declared that fair value increased the quality and the reliability of financial statements for investors (Seay & Ford, 2010), and although

it was extremely painful, fair value ultimately revealed the current and future risk which banks were carrying on their books and hiding in securitizations. The level of subprime loans banks were lending, the risk levels associated with the insurance of these loans, and the inaccurate ratings of the securitized bonds were all major contributors and direct causes of the crisis. Rather than criticize fair value accounting for causing the recession, mark to market should be applauded for revealing the true economic condition of the country leading to a market correction as painful as it felt for the greater economy.

The Future of Fair Value Accounting

Recent FV News

Recently, fair value has made substantial headway in news outlets as it has been a popular element at the forefront of current accounting issues. Even after the financial crisis, banks' use of fair value accounting has been frowned upon which has only further ignited the debate amongst accounting professionals. An article from the *Wall Street Journal* (WSJ) reported that J.P. Morgan Chase & Co., for example, made a "debt valuation adjustment" which increased their 2011 third-quarter earnings by \$1.9 billion. This gain arose from a decline in the market value of J.P. Morgan's debt, mainly "certain structured and derivative liabilities" (much like, if not the same structured liabilities discussed earlier in the paper), and thus reported huge earnings with no operations tied to the earnings. In an interview for the article, accounting and tax expert Willens said, "I think this is the kind of thing that gives accountants a bad name, frankly" (Rapoport & Lucchetti, 2011).

In this same quarter, Bank of America likewise reported \$6.2 billion in gains corresponding from a drop in the value of their debt. These fluctuations in earnings have

confused certain investors, especially unknowledgeable ones, regarding comparisons between the actual financial conditions of the major banks. (The major banks include Bank of America, Citigroup, J.P. Morgan Chase, Morgan Stanley Wells Fargo & Co., and Goldman Sachs). However, most of these fluctuations are not a result of fair value accounting in and of itself but rather largely because these big banks are constantly attempting to use the rules of fair value accounting to gain short-term advantages over their competitors (Reilly, 2011).

Possibly the most blatant example of attempting to tamper with short-term gains was reported by the *WSJ* in the article “Will Goldman Mark Down It’s Principle?” Reilly (2011) proclaimed: “It’s fine to have principles on Wall Street, just so long as they don’t get in the way of short-term gains.” He then explains that Goldman and Morgan Stanley were considering and actually attempted to reclassify certain investments to historical cost to keep pace with the gigantic gains J.P. Morgan reported. Rather than being concerned with financial reporting to fairly represent their company’s financial position to investors and creditors, it appears that banks are more concerned with using accounting procedures to create a façade on their income sheets and balance sheets to falsely persuade the market they are in a better position than they actually are. Banks should be more concerned with evaluating risk of their underlying investments and debt issues and should attempt to clearly and fairly communicate these levels through their value on financial statements and disclosures about their actual nature.

Finally, the Federal Reserve will be creating new regulations to limit the interconnectedness of these major banking institutions. The net credit exposure which will be allowed between any two of the six largest institutions cannot exceed 10% of the

company's regulatory capital, as compared to the 25% allowed for most other firms under the Dodd-Frank bill (McGrane & Fitzpatrick, 2011). The Fed believes limiting the credit exposure amongst these institutions will prevent the severity experienced during the Great Recession from recurring in the future and will cause these banks to return to a more traditional banking model of making traditional loans to individuals and businesses as opposed to the recent risky investments and securitizations observed in banks.

Although this may decrease the profitability of the financial institutions, the Fed believes this regulation will hopefully eliminate paper gains and benefit society by preventing a similar financial meltdown.

Fair Value Is Here To Stay

Regardless of the opposition to fair value accounting, it appears that FASB will not curtail its procedures for mark-to-market. Therefore, accountants must learn to become content with the current procedures and enhance their expertise in valuation techniques. Power (2011) argues, "So the intellectualization of financial reporting in the shadow of financial economics is not simply an issue of technical measurement – it is a blueprint for redesigning the knowledge base of an entire profession." Therefore, it is apparent that fair valuation has become a blueprint for future accounting practices and will only continue to expand, not only within GAAP, but also in convergence with the International Accounting Standards Board (IASB) in international standards.

Likewise, auditors will be challenged in the future with determining the reliability of financial statements when fair value measurements are involved, especially when Level 3 inputs are involved. Foster and Shastri (2010) acknowledge that auditors must be extremely aware of deceptive practices in these valuations as corporate managers are able

to manipulate their valuation techniques to deceive their creditors and investors, as was seen with the major collapses of Bear Stearns and Lehman brothers during the financial crisis. Therefore, the future will be a challenging time for auditors and users of financial statements, especially in the area of fraud, as illiquid markets offer enough uncertainty for companies to skew their financial information (Foster & Shastri, 2010). It will be interesting to see the new techniques auditors begin to employ as fair valuation expands in financial practice.

Pannese and DelFavero (2010) believe the recent implications of FASB will eventually lead to the historical cost principle no longer being taught in academia over the next several decades. They argue that the Public Company Accounting Oversight Board (PCAOB) should make a concerted effort to replace education of historic cost with innovative valuation techniques. They also fear that current accounting students will not be fully prepared to meet the current challenges in the transition from historic cost to FV, as their education is taking place at the precipice of this transition. As FV continues to develop, it will be crucial for the PCAOB and auditors to continue to adapt to the new issues by FASB in addition to its convergence project with the IASB.

Conclusion

Accounting professionals must dismiss their fears of fair value accounting. It is healthy for the profession to continue to criticize these procedures to ensure the greatest reliability for users of financial statements, but to revert back to historic cost would be a major regression for GAAP. It should now be apparent that while fair value accounting may have increased the severity of the financial crisis or prematurely began it, this technique surfaced the hidden, unwise, and deceptive decisions banks and other financial

institutions were making. It is certainly possible that without the issuance of SFAS 157 in 2006, the historic cost method would have continued to allow the bubble to expand, and eventually burst into a much deeper recession than the one currently being witnessed.

As an excellent summation for mark to market's true role in the financial crisis, Hughes (2008), in an interview in a *Financial Times* article reported, "Accounting doesn't create reality, it reflects it. Here it has clarified where there are some issues and has illuminated them. In the criticism there is an element of 'we don't like the answer. If you use market valuations, that by nature creates volatility because markets are volatile. But accounting is only reflecting that volatility." Fair value did not create the reality seen in the Great Recession, it merely reflected the corrosive business practices which were slowly destroying the economy.

Many professionals and market observant will continue in their attempt to repeal SFAS 157 and all related mark to market practices, but their efforts will be much more fruitful spent on improving the current system. Fair value accounting will ultimately hold decision makers to a higher standard in the daily operations of their company and will prevent financial institutions and their executives from making risky bets to turn a quick profit. Rather, knowing that fair value accounting is the future of reporting will cause executives to make sound business decisions or otherwise have their financial statements disclose the true nature of their decisions.

This is a historic period for the accounting profession, and the future of the accounting profession will remember FAS 157 for its progressive and transformational effect on financial reporting. Accounting has and will always be focused on improving the reliability of financial statements, and fair value accounting will only continue to help

users understand the current financial condition of the businesses with whom they interact.

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