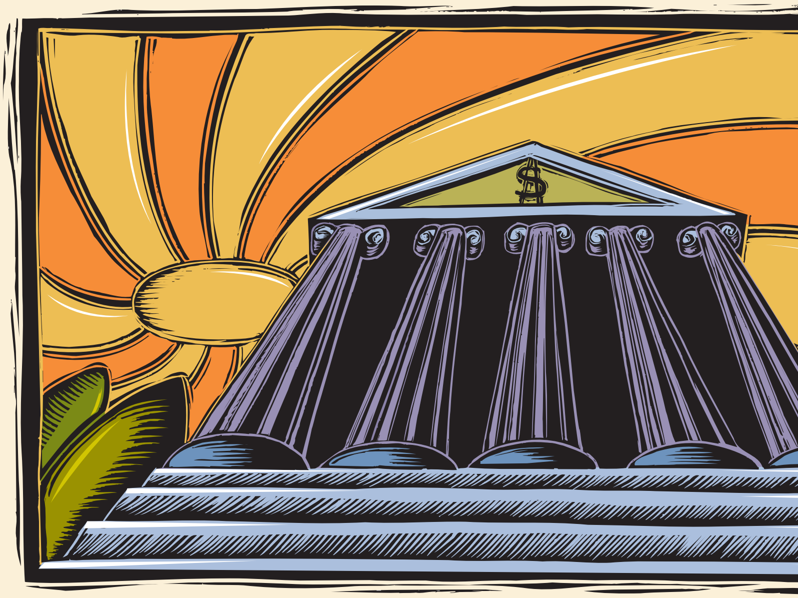
SFAS No. 157

Fair value is part of the reform process with the SEC, at the Fed, and in Congress.



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By Thomas B. Sanders

Among the elements of the first Troubled Asset Relief Program (TARP) bill voted into law on October 3, 2008, was the temporary suspension of the progressive phasing-in process of Statement of Financial Accounting Standards (SFAS) No. 157, "Fair Value Measurements," that had begun roughly a year earlier. Congressional drafters of the bank bailout bill were apparently swayed by the many critics who collectively asserted that fair value accounting had contributed mightily to the banking crisis now upon us.

In an essay written last year, "Fair Value Accounting: A Critique," Peter Wallison of the American Enterprise Institute said that while bad underwriting practices, unwise borrowers, sloppy work by bond raters, inadequate bank supervision, and poor bank-management oversight had decimated values in the mortgage pools, the aggregated $500 billion of subprime mortgages shouldn't have caused a global *crisis* in financial markets worth $140 trillion. Rather, Wallison noted, fair value accounting transformed a major economic downturn into a full-blown crisis.

Fair value accounting is pro-cyclical. That is, like debt leverage, it magnifies returns. During the good times, banks and hedge funds were glad to mark to market to enhance their market capitalization. Thus, during 2006, Bayer, for example, had profits under SFAS No. 157 that were estimated to be several times greater than they would have been under the old Generally Accepted Accounting Principles (GAAP) rules. Meanwhile, Lloyds TSB's profits were 54% higher.

But fair value also greatly magnified the declines when they came, and balance sheets, which themselves were already leveraged, sometimes collapsed.

Interpreting SFAS No. 157

According to SFAS No. 157, fair value 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." An orderly transaction is one that "assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets." Therefore, an orderly transaction

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is one that isn't forced (for example, not a forced liquidation or distressed sale). Yet in the fall of 2008, Merrill Lynch, in a single discreet move to clean up its balance sheet, sold a chunk of distressed mortgages at a 78% discount. According to auditors vetting the books of other companies, this suddenly became the market discount, and everyone had to mark down their own impaired mortgages by at least the same percentage. This episode hardly represents a "usual and customary" transaction.

Meanwhile, according to a September 20, 2008, article in *The Wall Street Journal*, "Maybe the Banks Are Just Counting Wrong," AIG's internal corporate accountants were preparing to force the company in the fourth quarter to mark down values of credit derivatives it wrote from $5.2 billion to $1.6 billion. While we don't know for sure, it's possible that this anticipated write-down could have figured predominantly in the government's decision to seize AIG.

Outside auditors and internal controllers might have concerned themselves too much with the "measurement date" and pointed to this near event as a "price" at which someone was willing to buy and another willing to sell. These professionals may have been running scared after the Enron failure, which caused the collapse of Arthur Andersen, with officials going to jail and other accountants losing their reputations. AIG accountants, therefore, might have chosen the more conservative approach.

Since SFAS No. 157 is controversial, perhaps it's useful to review the various levels of asset classification that it describes. These levels or "inputs" are organized in a hierarchy of priority, with the highest priority given to observable inputs or prices and the lowest given to directly unobservable inputs.

Three Levels of Asset Classes

Assets held to maturity are valued at historic cost, not fair value. Under SFAS No. 157, much of which had been established under SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," all other assets and liabilities are to be marked to market according to three priority levels—levels that are particularly relevant to banks. (For a good discussion of relative levels of liquidity, see "Regulatory and Accounting Standards on the Valuation of Portfolio Securities by Investment Companies," in the January 2007 issue of *Wall Street Lawyer*.)

Everyone agrees with level 1, which requires *trading assets* to be marked to prices quoted in an active secondary market, with adjustments to value going directly into earnings per share.

The center of the firestorm, however, rests with level 2, where *available for sale* assets and liabilities are valued by benchmarks that, while observable, aren't taken from quoted prices in active markets. You must use indirect pricing, taken from nonidentical-but-similar assets traded in markets or derived from some economic indicator (perhaps a yield curve). Critics argue that such values are subject to substantial creativity.

Level 2 adjustments go directly to an equity reserve, missing the earnings statement. Yet the equities markets see through to an enhancement or impairment in value, and stock prices adjust accordingly.

Level 3 assets and liabilities have no observable analogous inputs. Thus, forecasting models (called "marked to model") have to be used to establish value. Further, in the past, some of the models that auditors used had even been generated by the banks themselves. Naturally, banks wanted to magnify their value to the greatest extent during the good times. During bad times, however, the losses were amplified. Yet once adopted for the good times, the methods of valuing were irrevocable. When models were inadequate, level 3 required the use of expensive appraisal consultants to come up with values that could at times be described as subjective.

Needless to say, valuations varied.

Together with widespread doubts as to the veracity of bond ratings on mortgage-backed security pools, the varying methods of valuation naturally spawned great confusion in the markets since no one really knew the values on someone else's balance sheet. As a result, short-term liquidity was frozen out, and trading in mortgage-backed securities ceased, leading to the full-fledged systematic crisis that Congress is still working through.

But not all mortgage-backed assets are inherently bad. According to an April 2008 Institute of International Finance memorandum: "Write-downs of *sound* assets required under the current implementation of fair value accounting adversely affect market sentiment, in turn leading to further write-downs, margin calls, and capital impacts in a downward spiral that may lead to large-scale fire-sales of assets and destabilizing, pro-cyclical feedback effects. These damaging feedback effects worsen liquidity problems and contribute to the conversion of liquidity problems into solvency problems."

The general view was that the value of mortgage-backed assets should be determined by their current stream of cash flows. Since cash flows tend to be relatively steady, sudden declines in market value were unlikely to be justified by changes in cash flows. Rather, psychological shocks might have caused the sudden collapse in market values. If such reasoning is true, these assets were hardly "toxic waste," as the media described them. In fact, only about 6.4% were delinquent at one point in the fall of 2008, according to the previously mentioned *WSJ* article.

The Evolution of FASB Standards

Marking a security to market isn't new, of course. This practice dates back to the late 19th Century when futures markets were (and are today) marked to market daily and the margin adjusted. Over-the-counter swaps are only periodically marked to market since there is no exchange to keep track of daily values. The clearing of swap transactions is becoming more organized, which will facilitate more frequent mark-to-market requirements.

The first rule applying fair value accounting was SFAS No. 12, "Accounting for Certain Marketable Securities." Securities held by industrial companies and banks were carried at the lower of cost or market. But this simple rule proved inadequate during the savings and loan crisis of the 1980s, and SFAS No. 115 was written in May 1993 to supersede the old ruling. SFAS No. 115 established the levels that remained later in SFAS No. 157.

Under SFAS No. 115, securities being held to maturity were carried at amortized cost (not market value). Assets available for sale were valued at market prices, but unrealized gains and losses skipped the earnings statement entirely and went to a net worth reserve. As mentioned earlier, once the asset was placed in that class, it couldn't be reclassified.

In 2007, with mounting troubles in the banking system coming to light in the media, the Financial Accounting Standards Board (FASB) realized that SFAS No. 115 was inadequate. So SFAS No. 157 replaced it in fall 2007. While SFAS No. 157 reiterated much of what SFAS No. 115 had to say, the new version was much more detailed in its instructions to auditors and controllers on how to handle assets in a more complicated world. Now companies had to lay out their valuation practices and assign a valuation level to all assets, plus develop schedules summarizing holdings and activity. The results were required to be reported at least semiannually. Some firms began applying SFAS No. 157 as early as the first quarter of 2008.

This process was further clarified on February 15, 2008, with the adoption of SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities—Including an Amendment of FASB Statement No. 115." Under this new ruling, banks could select as a one-time option certain assets and liabilities to be held at fair value while others were to be carried at historical cost. The objective was to mitigate the earnings volatility that SFAS No. 157 introduced because of the pro-cyclicality discussed earlier.

Recent Events

On October 3, 2008, the Emergency Economic Stabilization Act of 2008 was signed into law. Section 133 of the Act stated that the Securities & Exchange Commission (SEC), in consultation with the Federal Reserve and the U.S. Treasury, should conduct a study of mark-to-market accounting standards. In late December, the SEC reported that "additional measures should be taken to improve the application and practice related to existing fair value requirements," essentially validating that something was seriously wrong.

In February 2009, the FASB indicated it wouldn't be able to complete its study of SFAS No. 157 until the end of June. This caused the banking industry to petition through Congress to speed up the process. On April 9, the FASB Final Staff Position (FSP FASB 157-4) ruled that if financial firms could prove that markets were dysfunctional, they could use internal valuation models rather than market prices. The basic view was that in cases of low market volume and activity, quoted prices may not be a fair determinant of value since market transactions that do occur may not reflect value in an orderly market.

The staff position delineated more-specific conditions that, taken together, could indicate a market that isn't orderly. These factors include:

1. Few recent transactions.

2. Price quotations based on outdated information.

3. Indices used as previous benchmarks are now demonstrated to be uncorrected by recent expressions of fair value.

4. Increased liquidity risk caused by higher delinquency rates or by losses resulting in prices discounted lower than if they had been priced in a more-liquid, normally functioning market.

5. A higher bid-ask spread causes investors to discount values to a greater extent than would occur during a normally functioning market.

6. A sharp reduction in new issues of assets/liabilities as compared to during normal market conditions.

7. Less-detailed information released about assets/liabilities than would be available during a normally functioning market.

If it can be shown that any or all of these factors result in a decrease in market volume for the assets/liabilities, then current quoted prices may not reflect fair value. This determination could justify a significant adjustment to the quoted or current market price.

Several large firms actually took immediate action on the basis of these clarifications. Wells Fargo was able to increase its capital by $4.4 billion in the first quarter of 2009. Likewise, Citigroup enhanced its first-quarter earnings by $413 million, and the Federal Home Loan Bank of Boston adjusted its earnings upward by $439 million.

Going Forward

During the development of the FSP mentioned above, the FASB received letters from the American Institute of Certified Public Accountants (AICPA) and the Center for Audit Quality (which is affiliated with the AICPA) expressing major reservations about modifications to SFAS No. 157, saying in essence that discounted prices in inactive markets might be occurring when such markets *aren't* distressed. In such cases, illiquidity itself isn't sufficient to justify abandoning market-price valuations.

Moreover, it's evident that most members of the Board are advocates of fair value accounting. Their approach is incremental, as evidenced by the progression of FASB Statements. Before the temporary suspension, their gradualist approach in the case of SFAS No. 157 was expected to take an estimated seven years before reaching the goal of full phase-in and acceptance of fair value accounting. Now it will take even longer.

In the immediate future, the controversy (mainly at the banks) will continue as the FASB staff refines its thinking about valuation during extreme periods of market disruption. When such thinking jells, perhaps there will be a new ruling to supersede SFAS No. 157.

During this period of economic recovery, management accountants, controllers, and other financial professionals need to exert extreme caution in valuing balance sheet items priced in low-volume and/or distressed markets. They need to continually follow new FASB pronouncements and clarifications.

Only when the economy recovers will such concerns fade as auditors again work in the luxury of pricing off of well-functioning markets. At banks, the controversy is overpricing of mortgage pools; in a normal economy, these pools are quite liquid. Thus, by the time the FASB finally figures out how to price illiquid assets, most of them will likely be liquid again, and its efforts might become marginally usable—until the next bust.

Impatient with the slow evolution of accounting standards, two members of Congress are currently either considering, or have proposed, amendments to establish more federal regulatory oversight of the FASB. These announcements have been met with cries of alarm in accounting circles. In the opinion of the Institute of Management Accountants (IMA®), the CFA Institute, and others, anything that takes oversight away from the SEC and puts it into the hands of a board of regulators—principally banking regulators—weakens it by injecting the potential for politics to enter into the process while, at the same time, implying that accounting standards are for the sole benefit of banks rather than for other financial institutions as well. Meanwhile, the FASB will continue to do its job of improving good accounting practices. **SF**

Note: In July 2009, the FASB launched the *FASB Accounting Standards Codification*™ as the single source of authoritative nongovernmental U.S. GAAP. See www.fasb.org for details.

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