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## Fair Value Accounting: Friend or Foe?

Ian E. Scott

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## FAIR VALUE ACCOUNTING: FRIEND OR FOE?

### ABSTRACT

*In 2008, financial institutions faced unprecedented financial, economic and social challenges. What began as a financial institution and mortgage issue has had devastating effects on all sectors of the economy, both in the United States and abroad. Scholars, investors, analysts, and the general public are all asking the same question: How did this happen to one of the most sophisticated financial systems in the world?*

*Some put the blame on the Securities and Exchange Commission (SEC) or the Financial Accounting Standards Board (FASB), and say that the requirement to account for securities on a mark-to-market or fair value basis played a key role in the financial crisis and banking failures. These proponents argue that in an economic downturn, fair value accounting causes excessive volatility that does not reflect the true underlying value of assets, forcing companies to impair their regulatory capital position by recognizing losses too quickly and all at once. Those who believe that fair value accounting is the best accounting measure argue that it better reflects the risks associated with the assets. These proponents believe that any other measure would mask real losses that should be taken into account by investors when making their decisions.*

*This Note examines the fair value accounting standards in the United States and discusses whether accounting regulation played a substantial role in the financial crisis and bank failures. In order to make this assessment, the Note reviews the fair value accounting literature for the measurement and disclosure of financial instruments as well as the history associated with the reasons these standards were put in place. This includes a discussion and analysis of the recently finalized accounting regulation on fair value accounting that was put in place to address the financial crisis. In addition, the Note explores the arguments for and against fair value accounting and assesses these arguments using examples from the history of the United States and Japan, as well as some banks and investment banks that failed in 2008.*

*While there is some legitimate debate regarding which accounting measure should be used in certain situations, this Note concludes that the arguments supporting fair value accounting for financial instruments are*

*much stronger. In addition, this Note concludes that fair value accounting did not cause or contribute to the financial crisis. This Note also concludes that while the FASB's attempt to improve disclosures is a positive step, the "relaxation" of the current accounting regulation will only serve to degrade investor confidence in financial information and independent regulatory standard setters. Finally, this Note advances the theory that accounting forms the basis for important regulatory and control functions in which capital regulators and auditors rely, and, given the complexity of our market place, that this is an appropriate role for accountants.*

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*"The SEC has destroyed \$500 billion of bank capital by its senseless marking to market of these assets for which there is no marking to market, and that has destroyed \$5 trillion of bank lending."  
Former FDIC Chairman, William Isaac.<sup>1</sup>*

*"We reiterated our position that only fair value provides the transparent and honest reporting it will take for the markets to work through the volatility and move forward."  
The CFA Institute.<sup>2</sup>*

## INTRODUCTION

In 2008, financial institutions faced unprecedented financial, economic, and social challenges. While the average person may remember the savings and loan financial crisis in the 1980s, most would not have conceived of the collapse of such landmark institutions as Bear Stearns and Lehman Brothers. Most also could not have imagined that a once mighty Wall Street would frantically search for a means of survival that included asking the government for a bail out. What began as a financial institution and mortgage issue has had devastating effects on all sectors of the economy both in the United States and abroad. In particular, the real estate market is left with many sellers and few buyers, with "mortgage foreclosure rates ... [at] the highest level since the Great Depression."<sup>3</sup> With credit markets virtually frozen, banks are still desperately trying to raise capital and strengthen their balance sheets.<sup>4</sup>

These efforts have led to the conversion of the last of the investment banks into bank holding companies in order to raise capital through deposits as well as to utilize funds from the government as a source of capital.<sup>5</sup> Even with these efforts, it has now become clear that the trust and

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1. Brooke Sopelsa, *Former FDIC Chair Blames SEC for Credit Crunch*, CNBC, Oct. 9, 2008, <http://www.cnbc/id/27100454>.

2. CFA Institute Center, *Advocacy in Action: A Synopsis of Ongoing CFA Institute Centre Efforts Underlying the Financial Market Crisis*, <http://www.cfainstitute.org/centre/topics/comment/2008/081030.html> (last visited Mar. 15, 2010).

3. Lawrence H. White, *How Did We Get into This Financial Mess 2* (CATO Inst., Briefing Paper No. 110, 2008), available at [http://www.cato.org/pub\\_display.php?pub\\_id=9788](http://www.cato.org/pub_display.php?pub_id=9788).

4. See Edmund L. Andrews, *Ailing Banks Need \$75 Billion, U.S. Says*, N.Y. TIMES, May 8, 2009, at A1.

5. Posting of Michael J. de la Merced, Vikas Bajaj & Andrew Ross Sorkin to DealBook, *As Goldman and Morgan Shift, a Wall St. Era Ends*, <http://dealbook.blogs.nytimes.com/2008/09/21/goldman-morgan-to-become-bank-holding-companies/>

confidence in the banking system, which allowed banks to maintain high leverage and short-term funding, has disappeared, and unfortunately, the end of the crisis is not yet here.<sup>6</sup> Twenty-two banks failed in 2008, casting an impending gloom over the future of banks.<sup>7</sup> The term “nationalization” is a word that is heard almost daily, and although the government stands ready to become a 36%<sup>8</sup> stakeholder in Citibank, one of the largest banks in the United States, their stock price decreased 71.7%<sup>9</sup> in 2008 and traded as low as \$.97<sup>10</sup> in 2009.

Scholars, investors, analysts, and the general public are all asking the same question: How did this happen to one of the most sophisticated financial systems in the world? There are various theories that have been put forward, and people are asking questions like: Was monetary policy to blame?<sup>11</sup> Was there lax oversight of investment banks?<sup>12</sup> Was the expansion of mortgage lending and improper lending practices over successive years to blame?<sup>13</sup> Did rating agencies play a role?<sup>14</sup> Was Wall Street too greedy?<sup>15</sup>

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(Sept. 21, 2008, 21:35 EST).

6. Associated Press, *IMF Chief: Economic Crisis Not Over Yet*, ABCNEWS, Sept. 12, 2009, available at <http://abcnews.go.com/Business/wirestory?id=8556055>.

7. Federal Deposit Insurance Corporation, *Bank Failures in Brief*, <http://www.fdic.gov/BANK/HISTORICAL/BANK/2008/index.html> (last visited Mar. 14, 2010). The Federal Deposit Insurance Corporation (FDIC) website posts information about bank failures from 1991 to present. According to the information released by the FDIC, as of December 12, 2008, there were twenty-two bank failures during 2008. As of December 18, 2009, there were 135 bank failures during 2009. Federal Deposit Insurance Corporation, *Bank Failures in Brief*, <http://www.fdic.gov/BANK/HISTORICAL/BANK/2009/index.html> (last visited Mar. 14, 2010). “Bank” refers to traditional banks, like Washington Mutual, as opposed to investment banks like Bear Stearns and Lehman Brothers.

8. Chris Isidore, *Feds Step Deeper into Citi Bailout*, CNN MONEY, Feb. 27, 2009, <http://money.cnn.com/2009/02/27/news/companies/citigroup/index.html>.

9. BusinessWeek, *Citigroup, Inc.: Historical Stock Quotes*, <http://investing.businessweek.com/research/stocks/snapshots/historical.asp?ticker=C:US> (last visited Mar. 14, 2010).

10. Geoffrey Rogow, *Crisis on Wall Street: Citigroup Touches ‘Penny Stock’ Realm*, WALL ST. J., Mar. 6, 2009, at C3; *Citigroup Stock Sinks to An All-Time Low of 97 Cents*, HUFFINGTON POST, Mar. 5, 2009, [http://www.huffingtonpost.com/2009/03/05/citigroup-stock-sinks-to\\_n\\_172167.html](http://www.huffingtonpost.com/2009/03/05/citigroup-stock-sinks-to_n_172167.html).

11. See Stephen G. Cecchetti, *Monetary Policy and the Financial Crisis of 2007-2008*, at 14-23 (Ctr. for Econ. & Pol’y Research, Working Paper, 2008) (detailing the federal monetary response to the global financial crisis in 2007-2008).

12. See *Lawmaker Slams SEC for Lax Oversight*, REUTERS, Oct. 1, 2008, <http://www.reuters.com/article/idUSTRE4906S520081001>.

13. See Richard E. Gottlieb & Andrew J. McGuinness, *When Bad Things Happen to Good Cities*, ABA BUS. LAW TODAY, July/Aug. 2008, <http://www.abanet.org/buslaw/>

Some put a substantial amount of blame on the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB or the Board) and say that the requirement to account for securities on a fair value basis played a key role in the financial crisis and banking failures.<sup>16</sup> These proponents argue that in an economic downturn, fair value (or mark-to-market) accounting causes excessive volatility.<sup>17</sup> In addition, they argue that fair value accounting forces companies to recognize losses too quickly and concurrently, incorrectly impairing a bank's capital position. This triggers banks to engage in fire sales which, in turn, drives down prices and valuations even more.<sup>18</sup> Those who believe that fair value accounting is the best accounting measure argue that mark-to-market accounting reflects the true underlying value of the asset and better reflects the risks associated with the assets.<sup>19</sup> Proponents believe that any other measure would simply not reflect reality and would mask real losses that should be taken into account by investors when making their decisions.<sup>20</sup>

This Note will examine the fair value accounting standards in the United States and will discuss whether these accounting requirements played a substantial role in the financial crisis and bank failures. In order to make this assessment, this Note will review the fair value accounting literature for the measurement of financial instruments and related disclosures as well as the arguments for and against fair value accounting. In addition, the Note will explore these arguments using examples from the history of the United States, some financial institutions that failed in 2008, and Japan's past banking crisis.

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blt/2008-07-08/mcguinness.shtml (linking improper lending with overall effects of the financial crisis and listing cities' complaints against lenders).

14. See Gerard Capria, Jr., Ash Demigüç-Kunt & Edward J. Kane, *The 2007 Meltdown in Structured Securitization: Searching for Lessons, Not Scapegoats* (World Bank Pol'y Research Working Paper No. 4756, 2008) available at <http://ssrn.com/abstract=1293169>.

15. See Janet Whitman, *Greed Comes Back to Wall Street*, FIN. POST, July 31, 2009, <http://www.financialpost.com/news-sectors/story.html?id=1850433>.

16. See Sopelsa, *supra* note 1.

17. See Guillaume Plantin, Haresh Sapra & Hyun Song Shin, *Fair Value Accounting and Financial Stability*, BANQUE DE FRANCE FIN. STABILITY REV., Oct. 2008, at 85, available at <http://www.princeton.edu/~hsshin/www/BdFFSRmtm.pdf>.

18. *All's Fair: The Crisis and Fair-Value Accounting*, THE ECONOMIST, Sept. 18, 2008, available at <http://www.cfo.com/article.cfm/12279364>.

19. See PricewaterhouseCoopers, Point of View, *Fair Value Accounting: Is it an Appropriate Measure of Value for Today's Financial Instruments?*, Apr. 2008, [http://www.pwc.com/en\\_us/us/point-of-view/assets/pwc\\_pointofview\\_fairvalue.pdf](http://www.pwc.com/en_us/us/point-of-view/assets/pwc_pointofview_fairvalue.pdf).

20. *Id.*

The Note proceeds in five parts. Part I will summarize some of the possible reasons for the financial crisis and bank failures and will look at the mark-to-market issue in a neutral fashion. Part II will summarize the fair value measurement accounting literature as well as the history of how and why accounting regulators put the standards in place. This section will also follow the U.S. accounting trend that culminated into the final accounting standards that were issued in 2006 and 2007 and the related disclosure requirements. For disclosures, the Note will review and assess the disclosures in the Credit Suisse and Lehman Brothers Annual Reports. This part will also discuss the recently finalized accounting guidance on fair value accounting that was put in place to address the financial crisis and will discuss its merits. Finally, Part II will also provide a brief summary of the capital regulatory requirements and their relationship to accounting. Part III will summarize the prevailing arguments for and against fair value accounting. Part IV will critically assess the arguments using a data study from the SEC as well as accounting and economic trends in the United States and Japan. This part will also conclude which side has a stronger argument and will use failed institutions like Washington Mutual, Indy Mac, Lehman Brothers and Bear Stearns as examples to support the conclusion.

Although this Note does offer a summary of potential contributing factors to the financial crisis, it does not attempt to explain the reasons for the crisis in any depth and does not make a conclusion regarding the reasons for the crisis.

### I. POSSIBLE REASONS FOR THE FINANCIAL CRISIS

Some commentators have blamed the economic crisis on the greed of Wall Street. In fact, in 2008 both presidential candidates regularly used the word “greed” during their campaigns and promised to do something about this “greed” if they were elected.<sup>21</sup> The idea that the crisis was caused by greed may cause some to exclaim, “I knew it!” It does not, however, do much to explain the problem. Almost everyone agrees that the crisis is linked to the explosion of the securitization market and the subsequent collapse of the subprime mortgage market.<sup>22</sup> It is also clear that the housing boom that lasted more than a decade was not only over, but also

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21. See, e.g., *Transcript of Second McCain, Obama Debate*, CNN POLITICS, Oct. 7, 2008, <http://www.cnn.com/2008/POLITICS/10/07/presidential.dbate.transcript/index.htm>

22. See Ronald D. Utt, *The Subprime Mortgage Market Collapse: A Primer on the Causes and Possible Solutions*, THE HERITAGE FOUND., Apr. 22, 2008, <http://www.heritage.org/research/economy/bg2127.cfm>.



that foreclosures and defaults were on the rise.<sup>23</sup> These defaults impacted the various types of securities held by major banks as these securities were essentially made up of mortgages and loans.<sup>24</sup> The debate becomes more heated when questions are raised as to how it came to this point.

One possible reason for the crisis relates to the predatory lending practices that occurred over the last several years.<sup>25</sup> These include, but are not limited to: extension of credit without verification of income, financing for more than 100% of the purchase price of a home, products that had low or zero interest for many years but excessive interest after a period of time, excessive fees for products, and more.<sup>26</sup> Congressman Barney Frank argued for significant reform related to lending practices in order to mitigate the impact of the crisis, and stated that predatory lending practices played a significant role in the outbreak of the financial crisis.<sup>27</sup> Congressman Frank argued that "it has been widely acknowledged that predatory lending practices lie at the root of the crises and the HFSC [House Financial Services Committee] saw a need to address the cause of the problem by regulating the mortgage lending business."<sup>28</sup> These practices permitted situations where it was easy to get a mortgage loan, and many of the people who did buy homes would not have qualified for the mortgage if objective measures had been used.<sup>29</sup> Many of these people were not able to maintain their payments and ended up in foreclosure.<sup>30</sup> During a presentation at Harvard Law School, Congressman Frank noted that he met people who were evicted from their residences as renters, and, as a result, decided to get a mortgage to buy a home.<sup>31</sup> Even with a rental

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23. See Christopher J. Mayer, Karen M. Pence & Shane M. Sherlund, *The Rise in Mortgage Defaults 2* (Fed. Reserve, Working Paper No. 2008-59), available at <http://www.federalreserve.gov/pubs/FEDS/2008/200859/200859pap.pdf>.

24. Utt, *supra* note 22.

25. See DEBORAH GOLDSTEIN, UNDERSTANDING PREDATORY LENDING: MOVING TOWARDS A COMMON DEFINITION AND WORKABLE SOLUTIONS, JOINT CTR. FOR HOUSING STUD. OF HARVARD UNIV. (1999), [http://jchs.harvard.edu/publications/finance/goldstein\\_w99-11.htm](http://jchs.harvard.edu/publications/finance/goldstein_w99-11.htm).

26. *Id.*; see Utt, *supra* note 22.

27. Congressman Barney Frank, Accompanying Materials to Presentation at the Harvard Law School Program on Corporate Governance (Nov. 24, 2008).

28. *Id.*

29. See Bob Tedeschi, *Legal Help in Face of Foreclosure*, N.Y. TIMES, June 1, 2008, <http://www.nytimes.com/2008/06/01/realestate/01mort.html>.

30. See *id.*

31. Congressman Barney Frank, Presentation at the Harvard Law School Program on Corporate Governance (Nov. 24, 2008).

eviction for non-payment, these people were able to get a mortgage, and, as Mr. Frank noted, they ultimately suffered the fate of foreclosure.<sup>32</sup>

In terms of the overall financial crisis, it is argued that these bad loans, originating from poor lending practices, were the toxic fuel added to the securitization instruments.<sup>33</sup> This was especially problematic for those who bought the instruments because the successive repackaging of the assets made most buyers unaware of the true content of the securities.<sup>34</sup>

Another possible reason for the crisis is the monetary policy implemented by Alan Greenspan under which the Federal Reserve (Fed) started “aggressively expanding the U.S. money supply.”<sup>35</sup> The expansion was accompanied by a repeated lowering of the Fed’s target for the federal funds interest rate. The rate was moved from 6.25% to 1.75% in 2001. It was further reduced to 1% by 2003.<sup>36</sup> It is argued that this cheap money fueled a real estate market and pushed up housing prices to the point where the U.S. had a housing bubble.<sup>37</sup> The policy also had an impact on the short-term interest rates which were lower than long-term rates.<sup>38</sup> As a result, many people who in the past would have selected a 30 year mortgage instead chose an adjustable rate mortgage (ARM).<sup>39</sup> Researchers at the International Monetary Fund (IMF) have corroborated the view that the Fed’s credit policy fueled the housing bubble, stating that “[t]he increase in the house prices and residential investment in the United States over the past six years would have been much more contained had short-term interest rates remained unchanged.”<sup>40</sup>

A third factor relates to the possible errors and omissions committed by regulators who either did not provide effective oversight or encouraged the proliferation of risky products.<sup>41</sup> One argument is that the mortgage products, mortgage backed securities (MBSs), or collateralized debt

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32. *Id.*

33. See Gottlieb & McGuinness, *supra* note 13.

34. Darrell Duffie, *Innovations in Credit Risk Transfer: Implications for Financial Stability* 16 (Bank for Int’l Settlements, Working Paper No. 255, 2008), available at <http://www.bis.org/publ/work255.pdf>.

35. White, *supra* note 3, at 3.

36. *Id.*

37. *Id.*

38. *Id.* at 4.

39. *Id.*

40. Roberto Cardarelli, Deniz Igan & Alessandro Rebucci, *The Changing Housing Cycle and the Implications for Monetary Policy*, in WORLD ECONOMIC OUTLOOK, APRIL 2008: HOUSING AND THE BUSINESS CYCLE 103 (2008)..

41. See R. Christopher Whalen, *The Subprime Crisis—Cause, Effect and Consequences* 4-5 (Networks Fin. Inst., Policy Brief No. 2008-PB-04), available at <http://ssrn.com/abstract=1113888>.

obligations (CDOs) were “opaque complex structure[s]” which even the developer did not fully understand.<sup>42</sup> Some argue that the opaque nature of the products was deliberate and “came into existence and grew with the direct approval and active encouragement of Greenspan, and other senior bank regulators in the U.S. and EU.”<sup>43</sup> In addition, regulators failed to ensure that rating agencies adhered to appropriate standards, leading to ratings which did not reflect the underlying product.<sup>44</sup> This argument could also be extended to suggest that the entire process, where the entities that were doing the securitizations paid the rating agencies for their ratings, was doomed to fail because it encouraged the rating agencies to provide a “rating” even if it was not based on credible analysis.<sup>45</sup>

Finally, some blame fair value accounting for the financial crisis and bank failures and have called for an elimination or suspension of fair value accounting.<sup>46</sup> The argument is that where markets are not very liquid, fair value accounting forces banks to write-down assets even though the amount may not actually be the recoverable amount if the holder were to keep the security for a longer period of time.<sup>47</sup> These write-downs cause excessive volatility that erodes capital, and, because the write-downs are occurring at the same time, this impact is exaggerated.<sup>48</sup> A former FDIC chairman, William Isaac, placed the blame for the financial crisis squarely with fair value accounting and stated:

The devastation that followed stemmed largely from the tendency of accounting standards-setters and regulators to force banks, by means of their litigation-shy auditors, to mark their illiquid assets down to “unrealistic fire-sale prices”.... The fair-value rules “have destroyed hundreds of billions of dollars of capital in our financial system, causing lending capacity to be diminished by ten times that amount.”<sup>49</sup>

In order to better understand the arguments for and against fair value accounting, this Note first must explore exactly what accounting literature says about this form of accounting.

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42. *Id.* at 4.

43. *Id.* at 5.

44. Capria et al., *supra* note 14.

45. *Id.* at 7.

46. David M. Katz, *Former FDIC Chief: Fair Value Caused the Crisis*, CFO.COM, Oct. 29, 2008, [http://www.cfo.com/article.cfm/12502908?f=members\\_110508](http://www.cfo.com/article.cfm/12502908?f=members_110508).

47. *Id.*

48. *Id.*; see also Plantin et al., *supra* note 17, at 88.

49. *Id.*; see also Sopelsa, *supra* note 1 (quoting Isaac, placing blame on the SEC as well as fair value accounting).

## II. WHAT DOES THE ACCOUNTING LITERATURE SAY ABOUT FAIR VALUE?

Under federal securities law, the SEC has the responsibility to develop accounting standards for the preparation of financial statements and financial information.<sup>50</sup> The body used by the SEC to accomplish this is the FASB, which is responsible for establishing accounting standards in the U.S. and developing accounting pronouncements to implement those standards.<sup>51</sup> Two accounting pronouncements issued by the FASB have received world-wide attention: FASB Statement No. 159—The Fair Value Option for Financial Assets and Financial Liabilities (FAS 159),<sup>52</sup> and FASB Statement No. 157—Fair Value Measurements (FAS 157).<sup>53</sup> These accounting standards became effective in 2007 and 2008, respectively.<sup>54</sup> While these pronouncements are typically mentioned in the media when discussing the “mark-to-market issue,” they did not substantially change the accounting method for mortgage backed securities and other similar debt instruments that had been used for the last fifteen years. To explain this, it is important to understand the history of fair value accounting in the U.S.

*A. Disclosures About Fair Value of Financial Instruments (FAS 107)*

One of the first significant moves toward fair value accounting in the United States came with the 1992 issuance of FASB Statement No. 107—Disclosures about Fair Value of Financial Instruments (FAS 107).<sup>55</sup> It requires entities to disclose the fair value for some instruments, primarily financial instruments, including both assets and liabilities.<sup>56</sup> This disclosure is not required if it is not practicable to estimate fair value.<sup>57</sup> If

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50. See generally 17 C.F.R. §§ 230, 240 (2008); International Accounting Standards Concept Release, Securities Act Release No. 7801, Exchange Act Release No. 42,430, 65 Fed. Reg. 8896 (proposed Feb. 23, 2000).

51. See Commission Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Securities Act Release No. 8221, Exchange Act Release No. 47,743, 80 SEC Docket 139 (Apr. 25, 2003).

52. THE FAIR VALUE OPTION FOR FINANCIAL ASSETS AND FINANCIAL LIABILITIES, Statement of Fin. Accounting Standards No. 159 (Fin. Accounting Standards Bd. 2007).

53. FAIR VALUE MEASUREMENTS, Statement of Fin. Accounting Standards No. 157 (Fin. Accounting Standards Bd. 2008).

54. See *supra* notes 52-53.

55. DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS, Statement of Fin. Accounting Standards No. 107 (Fin. Accounting Standards Bd. 1991).

56. *Id.* at para. 2.

57. *Id.* at para. 10.

estimating fair value is not practicable, FAS 107 requires disclosure of descriptive information pertinent to estimating the value of a financial instrument.<sup>58</sup>

Although this is only a disclosure standard, that is, the changes in fair value do not get recorded in the financial statements, some of the same controversy that we see today existed when FAS 107 was being contemplated. For example, many respondents<sup>59</sup> who commented on the pronouncement before it was issued in its final form expressed concern over the relevance of the information.<sup>60</sup> Because some may hold the instruments for a long period of time, some markets may not reflect the “true” market value of the instruments.<sup>61</sup> While the FASB noted these concerns, it concluded that information about fair value of financial instruments must “provide information that is useful to present and potential investors, creditors, and other users in making rational investment, credit, and similar decisions.”<sup>62</sup> The Board also noted at that time that “several articles and reports in recent years have indicated the potential usefulness of information about market value of financial instruments, particularly as an indicator of the solvency of financial institutions.”<sup>63</sup>

#### *B. Accounting for Certain Investments in Debt and Equity Securities (FAS 115)*

The next key pronouncement that shaped fair value accounting in the United States was the Statement of Financial Accounting Standard No. 115—Accounting for Certain Investments in Debt and Equity Securities (FAS 115).<sup>64</sup> This pronouncement addresses the accounting investments in debt and equity securities like mortgage or other debt-related security products, including MBSs and CDOs.<sup>65</sup> Prior to FAS 115, the accounting procedures for these products were inconsistent, and there were many instances where mortgage related securities were recorded on the balance sheet based on fair value, amortized cost, or a lower cost or market basis.<sup>66</sup> In essence, FAS 115 expands fair value accounting for most securities and

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58. *Id.*

59. *Id.*

60. *Id.*

61. *See id.* at app. C.

62. *Id.* at para. 39.

63. *Id.* at para. 42.

64. ACCOUNTING FOR CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES, Statement of Fin. Accounting Standards No. 115 (Fin. Accounting Standards Bd. 1993).

65. *Id.*

66. *Id.* at para. 2.

only allows the use of the amortized cost method for debt securities when the entity that holds the securities has the positive intent and ability to hold the securities to maturity.<sup>67</sup> The idea of the holder's intent became paramount, and this intent determined whether the item was held at cost or fair value.<sup>68</sup> It also determined whether the accounting adjustment was recorded as part of earnings or simply as an adjustment to the equity amount.<sup>69</sup>

It is important to note a distinction between fair value accounting and mark-to-market accounting.<sup>70</sup> While they are often used interchangeably, fair value accounting is a term that means the instrument is recorded on the balance sheet at fair value, but the changes related to the product are not reflected in the income statement.<sup>71</sup> Rather changes are "charged" directly to equity.<sup>72</sup> Mark-to-market accounting also records instruments on the balance sheet based on their fair value, but the changes in the value of the instrument from one reporting period to another are reflected in the income statement.<sup>73</sup> To summarize the FAS 115 treatment, securities are categorized based on the holder's intent with corresponding treatment as follows:

Intent	Measurement on Balance Sheet	Treatment of Fair Value Adjustment
Intent to Trade in the Short Term	Fair Value	Through Income
Intent to Hold to Maturity	Cost	No Adjustment
No Specified Intent but Security is "Available for Sale"	Fair Value	Adjustment to Capital <sup>74</sup>

In order to ensure that entities did not make a claim that they were going to hold a product to maturity and then sell it later, FASB imposed a "tainting" concept that imposed a penalty for instances where securities

67. *Id.* at para. 1.

68. *Id.* at para. 7-9.

69. *Id.* at para. 13.

70. See, e.g., Media Briefing, Inst. of Chartered Accountants, Fair Value or Mark-to-Market Accounting (Oct. 30, 2008), available at [http://www.icaew.com/index.cfm/route/161481/icaew\\_ga/Technical\\_and\\_Business\\_Topics/IFRS/Technical\\_releases/ICAEW\\_fair\\_value/pdf](http://www.icaew.com/index.cfm/route/161481/icaew_ga/Technical_and_Business_Topics/IFRS/Technical_releases/ICAEW_fair_value/pdf).

71. *Id.* at 2.

72. *Id.*

73. Brian S. Wesbury & Robert Stein, *Why Mark-to-Market Accounting Rules Must Die*, FORBES, Feb. 24, 2009, [http://www.forbes.com/2009/02/23/mark-to-market-opinions-columnists\\_recovery\\_stimulus.html](http://www.forbes.com/2009/02/23/mark-to-market-opinions-columnists_recovery_stimulus.html).

74. Adjustments here go to a category called Other Comprehensive Income (OCI). This has the effect of bypassing the income statement as the adjustment is made directly to capital. This adjustment does not impact regulatory capital.

initially classified as "Held to Maturity" were sold.<sup>75</sup> In essence, if an entity "tainted" its portfolio, it would not be able to utilize the Held to Maturity category for any category of assets ever again.<sup>76</sup> For several financial institutions, this led to the virtual elimination of the amortized cost method, since most wanted the option to sell a security given favorable market conditions.<sup>77</sup>

It is worth noting that FAS 115 was undertaken mainly in response to concerns expressed by regulators and others about inconsistent recognition and measurement of investments in debt securities, particularly those held by financial institutions.<sup>78</sup> Specifically, regulators "questioned the appropriateness of using the amortized cost method for certain investments in debt securities in light of certain trading and sales practices."<sup>79</sup> The Board did, however, receive some criticism regarding the proposals.<sup>80</sup> The criticisms were similar to the complaints about FAS 107<sup>81</sup> with an added complaint that the valuation of only some assets, without related liabilities, "could result in inappropriate volatility of reported earnings."<sup>82</sup> Again, notwithstanding these complaints, the Board felt that there were substantial benefits associated with the use of fair value accounting.<sup>83</sup> As with FAS 107, many members of the FASB felt that the fair value of debt and equity securities is useful, as it helps investors, creditors, and other users in evaluating the performance of a company.<sup>84</sup> In addition, the FASB reiterated the common scholarly thought that fair value was particularly beneficial as an "indicator of the solvency of financial institutions."<sup>85</sup>

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75. See ACCOUNTING FOR CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES, *supra* note 64, at paras. 8-11.

76. *Id.*

77. *Id.*

78. *Id.* at para. 2.

79. *Id.*

80. *Id.* at para. 57.

81. Advocates against fair value treatment questioned the relevance of fair value and believed that cost provides relevant information. This standard focuses on the decision to acquire the security, and advocates argued that the best way to reflect this in the financial statements is to adopt a valuation method that realizes the value of the asset and recoverability over time. In addition, proponents against fair value challenged the subjectivity regarding valuation when an item was not readily marketable and argued that the subjectivity calls into question the relevance of the information. DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS, *supra* note 55, at paras. 43-44.

82. ACCOUNTING FOR CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES, *supra* note 64, at para. 57.

83. *Id.* para. 92.

84. *Id.* para. 40.

85. *Id.* para. 41.

*C. Fair Value Measurements (FAS 157) and Fair Value Option for Financial Assets and Financial Liabilities (FAS 159)*

The next significant step the FASB took to expand fair value accounting was the issuance of two related pronouncements: Statement of Financial Accounting Standard No. 157 (FAS 157) and Statement of Financial Accounting No. 159 (FAS 159). FAS 159 essentially gives entities the “option” of selecting fair value accounting for their financial instruments (both assets and liabilities).<sup>86</sup> While this option existed for most financial instruments, some instruments such as MBSs and CDOs were still governed by FAS 115.<sup>87</sup> As a result, the only change for these instruments related to their classification.<sup>88</sup> The standard could also be applied to loans, but entities have an option to carry these assets at cost or fair value.<sup>89</sup> The objective of the pronouncement 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.”<sup>90</sup> While FAS 159 provided institutions with the option to apply fair value accounting, rather than mandating it, the FASB stated that FAS 159 was expected to expand the use of fair value measurement.<sup>91</sup> In fact, this goal was one of the Board’s long-term objectives.<sup>92</sup>

In terms of the implementation of FAS 159, there is a fair amount of flexibility regarding how entities select which products they want to carry at fair value.<sup>93</sup> For example, entities may have different types of loans on their books measured both on amortized cost and fair value. While a company cannot flip-flop between the same loan, it is permitted to carry the same product type differently on its balance sheet, as the “election” permitted under FAS 159 is on an instrument-by-instrument basis.<sup>94</sup> Once a company elects to measure an instrument using fair value, the realized

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86. See THE FAIR VALUE OPTION FOR FINANCIAL ASSETS AND FINANCIAL LIABILITIES, *supra* note 52, at para. 7c.

87. ACCOUNTING FOR CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES, *supra* note 64, at para. 137.

88. See *id.* at paras. 1-2; see also *infra* notes 96-118 and accompanying notes for a discussion of FAS 157 and classification based on level 1, 2, and 3 inputs.

89. THE FAIR VALUE OPTION FOR FINANCIAL ASSETS AND FINANCIAL LIABILITIES, *supra* note 52, at para. 7c.

90. *Id.* at paras. 1-2.

91. *Id.*

92. *Id.* at para. 17.

93. *Id.*

94. *Id.* at para. 3.



and unrealized gains and losses related to that instrument will flow through the income statement.<sup>95</sup>

FAS 157 defines exactly what fair value means, establishes a framework for measuring fair value, and expands disclosures about fair value measurements.<sup>96</sup> The first thing to note is that FAS 157 does not mandate fair value accounting for any instrument.<sup>97</sup> Second, the standard provides a definition for fair value which continues to be a highly debated topic.<sup>98</sup> FAS 157 defines fair value as follows: "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."<sup>99</sup> The FASB notes that the primary goal of FAS 157 is to increase consistency and comparability in the fair value measurements of financial instruments and related disclosures.<sup>100</sup> The statement also sets out a number of procedural descriptions for how price should be calculated, as well as some of the basic valuation techniques.<sup>101</sup> In addition, the standard outlines a distinction between the assumptions that a market participant would use in pricing an asset (including assumptions about risk) and breaks valuation inputs into observable and unobservable components.<sup>102</sup> Specifically, the standard defines these as follows:

- a. *Observable inputs* are inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity.
- b. *Unobservable inputs* are inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.<sup>103</sup>

FAS 157 uses this categorization of inputs to establish a fair value hierarchy which prioritizes the inputs that relate to the valuation techniques used to measure fair value.<sup>104</sup> The input categories are classified as

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95. See, e.g., *id.* at paras. A34-35; Media Briefing, *supra* note 70.

96. FAIR VALUE MEASUREMENTS, *supra* note 53, at para. 1.

97. *Id.*; THE FAIR VALUE OPTION FOR FINANCIAL ASSETS AND FINANCIAL LIABILITIES, *supra* note 52 (establishing the framework of fair value accounting without mandating its use).

98. FAIR VALUE MEASUREMENTS, *supra* note 53, at para. 1.

99. *Id.*

100. *Id.* at paras. 1-4.

101. *Id.* at para. 7.

102. *Id.* at para. 21a-b.

103. *Id.*

104. *Id.* at para. 22.

level 1, 2, and 3.<sup>105</sup> An asset or liability is classified as level 1 if the inputs are quoted “in active markets for identical assets or liabilities” and the prices are readily available at the measurement date.<sup>106</sup> An active market is one in which there is enough “frequency and volume to provide pricing information on an ongoing basis.”<sup>107</sup> A good example of a level 1 instrument would be a share in an actively traded company (for example, IBM) where you could look to a reliable exchange to obtain the going price. An instrument classified as level 2 is one where the inputs are not quoted prices, but are observable either directly or indirectly.<sup>108</sup> Some examples of level 2 inputs include, but are not limited to: quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, and inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates).<sup>109</sup> An example of a level 2 instrument is a high yield corporate bond or a municipal bond.

The category that has received most of the attention is level 3.<sup>110</sup> For these instruments, the inputs are unobservable, and the market does not often provide a significant amount of information regarding valuation.<sup>111</sup> Also, the inputs are developed based on the best information that is available in the circumstance, and this may include the companies’ own models and/or data.<sup>112</sup> FAS 157 states:

In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity’s own data used to develop unobservable inputs shall be adjusted

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105. *Id.*

106. *Id.* at paras. 24-27.

107. *Id.* at paras. 24.

108. *Id.* at paras. 28-29.

109. *Id.*

110. See, e.g., Yalman Onaran & Christine Harper, *Goldman Held Bigger Level 3 Share than Citi, Merrill*, BLOOMBERG, Nov. 12, 2007, <http://www.bloomberg.com/apps/news?pid=20601103&sid=a9yNwqgsVPGA> (describing the impatience of level 3 assets in relation to problems of Goldman Sachs).

111. FAIR VALUE MEASUREMENTS, *supra* note 53, at para. 30.

112. *Id.*

if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.<sup>113</sup>

On October 10, 2008, the FASB published a FASB Staff Position (FSP) that clarified the application of FAS 157.<sup>114</sup> The clarification related primarily to situations where there was an observable price gleaned from a fairly illiquid market. It stated that the use of a model to estimate the price is not only appropriate, but may be preferred to a quote from these markets.<sup>115</sup> The FASB's clarification addressed the market's fear that assets had to be written down to the value of the last bad trade.<sup>116</sup> It was prompted primarily by Merrill Lynch's deeply discounted sale of assets, which made entities ask whether the "price" represented the quoted market price that should be used to value similar instruments.<sup>117</sup> The FSP states: "For example, in cases where the volume and level of trading activity in the asset have declined significantly, the available prices vary significantly over time or among market participants, or the prices are not current, the observable inputs might not be relevant and could require significant adjustment."<sup>118</sup>

### *1. New Fair Value Guidance Issued in Response to the Financial Crisis*

The FASB has come under a significant amount of pressure to suspend, eliminate, or modify the fair value accounting rules.<sup>119</sup> To address some of the concerns, the FASB issued and recently finalized two staff positions intended to provide additional guidance regarding fair value measurements and impairments of securities. The first is FSP 157-e, entitled Determining Whether a Market Is Not Active and a Transaction Is Not Distressed.<sup>120</sup> The second is a FSP on FASs 115-a and FAS 124-a,

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113. *Id.*

114. DETERMINING THE FAIR VALUE OF A FINANCIAL ASSET WHEN THE MARKET FOR THAT ASSET IS NOT ACTIVE, FASB Staff Position on Statement No. 157-3 (Fin. Accounting Standards Bd. 2008).

115. *Id.* at para. 8.

116. *Id.* at para. 9b.

117. *Id.* at para. 9a.

118. *Id.*

119. *See, e.g.,* Sopelsa, *supra* note 1; White, *supra* note 3.

120. DETERMINING WHETHER A MARKET IS NOT ACTIVE AND A TRANSACTION IS NOT DISTRESSED, Proposed FASB Staff Position on Statement No. 157-e (Fin. Accounting Standards Bd. 2009).

and Emerging Issue Task Force (EITF) 99-20-b, entitled Recognition and Presentation of Other-Than-Temporary-Impairments (OTTI).<sup>121</sup>

The first FSP provides additional guidance for estimating fair value in accordance with FAS 157 when the volume and level of activity for the asset or liability have significantly decreased.<sup>122</sup> This FSP also includes guidance on identifying circumstances that indicate whether a transaction is considered orderly.<sup>123</sup> While some of this guidance was arguably already part of FAS 157, auditors were not always applying it in a consistent manner and sometimes forcing companies to use the last quoted price for an instrument to measure fair value.<sup>124</sup> As such, the FSP emphasizes that even if there has been a significant decrease in the volume and level of activity for the instrument, the objective of a fair value measurement remains the same regardless of the valuation method used.<sup>125</sup> That is, fair value is the price that would be received to sell an asset or paid to transfer a liability in an *orderly* transaction—"not a forced liquidation or distressed sale"—between market participants at the measurement date under current market conditions.<sup>126</sup> In addition, the proposed presumption that all transactions are distressed (not orderly) unless proven otherwise has been eliminated.<sup>127</sup> The FSP instead requires an entity to base its conclusion about whether a transaction was not orderly on the weight of the evidence.<sup>128</sup>

To explain the application, FSP 157-e provides a two-step approach for determining whether the volume and level of activity for instruments have significantly decreased as compared to a "normal" market.<sup>129</sup> In step one, the company determines whether there are factors present indicating that the volume of transactions in the market has significantly decreased.<sup>130</sup> For example, one factor that may be considered is whether the price

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121. RECOGNITION AND PRESENTATION OF OTHER-THAN-TEMPORARY-IMPAIRMENTS (OTTI), Proposed FASB Staff Position on Statement No. 115-a, 124-a, EITF 99-20-b (Fin. Accounting Standards Bd. 2009).

122. DETERMINING WHETHER A MARKET IS NOT ACTIVE AND A TRANSACTION IS NOT DISTRESSED, *supra* note 120, at para. 6.

123. *Id.*

124. *Id.* at para. 11.

125. *Id.* at para. A2.

126. *Id.*

127. DETERMINING THE FAIR VALUE OF A FINANCIAL ASSET WHEN THE MARKET FOR THAT ASSET IS NOT ACTIVE, *supra* note 114.

128. *Id.*

129. DETERMINING WHETHER A MARKET IS NOT ACTIVE AND A TRANSACTION IS NOT DISTRESSED, *supra* note 120.

130. *Id.* at para. 11.

quotations are current.<sup>131</sup> If it is concluded that there has been a significant decrease in the volume and level of activity for the instrument, then one proceeds to step two.<sup>132</sup> Step two involves looking at all available evidence to determine whether a transaction is orderly.<sup>133</sup> If it is determined in step one that there was a decrease in volume, this does not mean that the transaction is not orderly.<sup>134</sup> In order to determine whether the quoted price is associated with other than an orderly transaction, additional factors must be considered.<sup>135</sup> If it is concluded that the sales were not orderly, there is a fair amount of discretion as to how fair value is calculated due to the subjective inputs and models used to calculate the market price.<sup>136</sup> If this is the case, the entity is not required to use the quoted price.<sup>137</sup> Even if the transaction is considered orderly, or if it is undeterminable, there appears to be flexibility and discretion permitted in the calculation of the fair value.<sup>138</sup>

While the exact impact of this FSP on banks is unclear, it is expected that it will change the method of valuation for instruments in some cases.<sup>139</sup> It also provides an entity with the ability to exercise discretion when determining whether a market is active and what the subsequent valuation should be.<sup>140</sup> As the evaluation will determine whether the input is observable, the entities will have the ability to move assets between level 2 and 3.<sup>141</sup> This flexibility could create some manipulation, but disclosure of movements in and out of levels 2 and 3 may prevent abuse.<sup>142</sup> There could be a problem determining the appropriate discount rate to be used as an input when a market is deemed inactive but not distressed.<sup>143</sup> In these cases, a market does not exist, and it is unclear what an appropriate rate would be.<sup>144</sup> Again, disclosure, particularly of valuations under both the old and new methods, would help counter these potential problems.

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131. *Id.*

132. *Id.* at para. 13.

133. *Id.*

134. *Id.* at para. 12.

135. *Id.* at para. 14; FAIR VALUE MEASUREMENTS, *supra* note 53, at para. 29.

136. DETERMINING WHETHER A MARKET IS NOT ACTIVE AND A TRANSACTION IS NOT DISTRESSED, *supra* note 120, at para. 15.

137. *Id.* at paras. 14-15.

138. *See id.*

139. *Id.* at para. 6.

140. *Id.* at para. 12.

141. *Id.* Level 2 instruments have observable inputs while level 3 instruments do not.

142. *Id.* at app. A2(b). Disclosures related to level 2 instruments are minor and flows out of level 2 are not currently required.

143. *Id.*

144. *Id.*

This disclosure appears to be part of the guidance,<sup>145</sup> but it will be interesting to see exactly how the disclosures are adopted. While there are some issues with the guidance, some commentators indicate that the guidance will not have any impact on banks.<sup>146</sup> The key is that whatever valuation method is used, it is accompanied by a sufficient amount of transparency to allow users to understand the nature and reliability of the numbers.<sup>147</sup>

The second FSP deals with OTTIs and only relates to debt securities.<sup>148</sup> The new guidance says that an OTTI event occurs if it is probable that a company will be unable to collect all amounts due or obtain par value on a sale of an instrument, regardless of whether any actual credit loss has been sustained.<sup>149</sup> Prior to the new guidance, a company had to assess its intent and ability to hold a security to recovery of the security's cost basis to determine whether the impairment was other-than-temporary.<sup>150</sup> If the impairment was other-than-temporary, both credit losses and market losses would be recognized in earnings.<sup>151</sup> The new guidance eliminates the requirement that the reporting entity assert its intent and ability to hold a debt security to recovery.<sup>152</sup> Another significant change is that entities may separate losses related to credit deterioration and losses related to other market factors in the financial statements when the impairment is considered other-than-temporary.<sup>153</sup> Specifically, market related losses would be recorded in other comprehensive income while any credit losses would be recorded in earnings.<sup>154</sup> The "split" will be based on models and estimates and, as such, will require the use of significant subjectivity.

It is unclear what impact this FSP will have on financial statements. Like the other FSPs, many critics still believe that the FASB did not go far

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145. *Id.* at para. 3.

146. Citibank indicated that the new guidance would not impact their financial statements in any way.

147. DETERMINING WHETHER A MARKET IS NOT ACTIVE AND A TRANSACTION IS NOT DISTRESSED, *supra* note 120, at paras. 3-4.

148. RECOGNITION AND PRESENTATION OF OTHER-THAN-TEMPORARY IMPAIRMENTS, Staff Position on Statement of Fin. Accounting Standards No. 115-2 & 124-2 (Fin. Accounting Standards Bd. 2009).

149. *Id.* at para. 8.

150. *Id.* at para. 3.

151. *Id.* at para. 3.

152. *Id.* at para. 7.

153. *Id.* at para. 9.

154. *Id.*

enough.<sup>155</sup> One positive aspect of the change is the separation of the credit and other market components of fair value. While it can be debated whether there is justification for treating these two market figures differently in the financial statements, the breakdown definitely provides users with additional transparency.<sup>156</sup> The impact this change should have on regulatory capital is discussed in Part IV.

The FSP regarding OTTIs also requires a number of additional disclosures: quarterly fair value information, valuation techniques, and changes in valuation technique (and the related inputs) resulting from the application of the FSP and a quantification of the effects, if practicable.<sup>157</sup>

#### *D. Current Fair Value Disclosures*

FAS 157 and FAS 159 mandate a number of disclosures, and several of the elements relate to the instruments held in the level 3 category.<sup>158</sup> This Note does not summarize all of the disclosures, but acknowledges a few that relate more directly to an analyst's or investor's ability to understand the nature of the financial information presented as it relates to complex products. One key aspect of the disclosures is that they provide a fairly good categorization or classification of assets and liabilities between the three levels.<sup>159</sup> In particular, fairly expansive disclosures are provided for level 3 assets,<sup>160</sup> and this is perhaps the most significant change in accounting from prior years. One problem, though, is that there is very limited disclosure related to level 2 instruments, and the inputs related to this level are not always as observable as would be expected.<sup>161</sup> To illustrate these disclosures, this Note will discuss some of the disclosures

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155. See Amy M. Baumgardner, Anna Pinedo & Melissa D. Beck, *United States: Mark-to-Market Update: After Congressional Hearing, FASB Proposes New Fair Value Accounting Guidance*, MONDAQ, Mar. 24, 2009, <http://www.mondaq.com/article.asp?articleid=76614>.

156. See, e.g., Letter from Ann Grochala, Vice President Lending and Accounting Policy, Independent Community Bankers of America, to Russell Golden, Technical Director, Federal Accounting Standards Board (Apr. 1, 2009), available at <http://www.icba.org/files/ICBASites/PDFs/cl040109.pdf>.

157. RECOGNITION AND PRESENTATION OF OTHER-THAN-TEMPORARY IMPAIRMENTS, *supra* note 148, at para. 38-43.

158. FAIR VALUE MEASUREMENTS, *supra* note 53; THE FAIR VALUE OPTION FOR FINANCIAL ASSETS AND FINANCIAL LIABILITIES, *supra* note 52.

159. See *infra* note 164.

160. DETERMINING WHETHER A MARKET IS NOT ACTIVE AND A TRANSACTION IS NOT DISTRESSED, *supra* note 120, at paras. 48-49.

161. Lehman Brothers Holdings Inc., Annual Report (Form 10-K), at 122-23 (Dec. 31, 2007).

included in the 2007 Lehman Brothers Annual Report, its final annual report. The Note will also review some of the disclosures in the 2007 and 2008 Credit Suisse Annual Reports.

In addition to a qualitative description of the inputs related to the three levels, Lehman Brothers was also required to disclose the dollar value of the instruments in each level along with a related product break out.<sup>162</sup> For example, Lehman held \$89,106 in MBSs<sup>163</sup> in the amounts of \$240, \$63,672, and \$25,194 in levels 1, 2, and 3, respectively.<sup>164</sup> The MBS products in all categories represented 31% of the total assets carried at fair value of \$291,212.<sup>165</sup> In addition, 71% of the MBS products were classified as level 2 assets where inputs were observable.<sup>166</sup> The MBSs represented 61% of the \$41,979 of assets that were classified as level 3 assets.<sup>167</sup> Total level 3 assets represented 14% of Lehman Brothers' total assets carried at fair value.<sup>168</sup> Lehman Brothers was also required to disclose the realized and unrealized gains and losses on level 3 assets and disclosed the following with respect to gains and losses on level 3 assets:

Net revenues (both realized and unrealized) for Level III financial instruments are a component of Principal transactions in the Consolidated Statement of Income. Net realized gains associated with Level III financial instruments were approximately \$1.3 billion for the fiscal year ended November 30, 2007. The net unrealized loss on Level III non-derivative financial instruments was approximately \$2.5 billion for the fiscal year ended November 30, 2007, primarily consisting of unrealized losses from mortgage and asset-backed positions.<sup>169</sup>

Lehman Brothers was required to disclose a schedule that summarized the changes in balance sheet assets carrying values associated with level 3 financial instruments.<sup>170</sup> While this table does not take into account hedging activities, it depicts the opening balance along with transfers in and out of level 3, as well as gains and losses on these instruments by type of instrument.<sup>171</sup> This table is set out both on a year-over-year and a quarter-over-quarter basis.<sup>172</sup> Lehman Brothers was also required to disclose the

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162. *Id.*

163. *Id.* at 103.

164. *Id.* at 107.

165. *Id.*

166. *Id.*

167. *Id.*

168. *Id.*

169. *Id.*

170. *Id.* at 123-24.

171. *Id.* at 124.

172. *Id.*



valuation techniques it used; they provided a fairly general and generic description of a market, income, and cost approach that was not broken out by type of instrument.<sup>173</sup> This description provided little, if any, information on how particular instruments were valued.<sup>174</sup>

Credit Suisse<sup>175</sup> disclosed similar information in their 2007 and 2008 Annual Reports, but arguably in a clearer and more comprehensive fashion.<sup>176</sup> For example, its breakdown of the level 3 product types and gains and losses was far more granular than that provided by Lehman Brothers and was more closely aligned to all of their balance sheet categories.<sup>177</sup> Moreover, the company often displayed information in a tabular fashion, with explanation accompanying the tables.<sup>178</sup> In addition, its qualitative disclosure of valuation techniques was set out by product and was far more descriptive than that of Lehman Brothers. For example, in its 2008 Annual Report, Credit Suisse devoted two full pages to describing the valuation techniques used on each product, as contrasted to Lehman's generic one paragraph.<sup>179</sup> Credit Suisse also provided a fair amount of explanation for an incorrect mark that had resulted in a significant write-down, substantially adding additional transparency to the control procedures that they instituted regarding the establishment and monitoring of complex models.

In terms of assets carried at fair value at Credit Suisse, 55% of total assets were measured at fair value as of the end of 2008.<sup>180</sup> Also, 15% of assets that were carried at fair value were recorded as level 3 in 2008 as compared with 11% in 2007.<sup>181</sup> In terms of dollar values, "[a]s of the end of 2008, net level 3 assets were CHF 74.6 billion [Swiss Franc], of which 27% were loans and credit products, 24% were mortgage-related and CDO securities, 24% were private equity investments and 20% were equity derivatives and equity-linked securities."<sup>182</sup> It is also interesting to note that using any recognized standard, Credit Suisse is considered highly

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173. *Id.* at 126.

174. *Id.*

175. All data is from Credit Suisse Annual Reports 2007 and 2008.

176. *See, e.g.*, CREDIT SUISSE, 2008 SUMMARY ANNUAL REPORT 53-54 (2009) [hereinafter CREDIT SUISSE, 2008].

177. *Id.*

178. *See, e.g., id.* at 14-15.

179. *Id.* at 389-90. *But see* Lehman Brothers Holdings Inc., *supra* note 161, at 122-23.

180. CREDIT SUISSE, 2008, *supra* note 176, at 265.

181. *Id.*; CREDIT SUISSE, 2007 SUMMARY ANNUAL REPORT 326 (2008) [hereinafter CREDIT SUISSE, 2007].

182. CREDIT SUISSE, 2008, *supra* note 176, at 53.

capitalized, with a 13.3% tier 1 capital ratio.<sup>183</sup> Credit Suisse also discloses the following information related to unobservable inputs in various places throughout their annual report:

In addition, the Group holds financial instruments for which no prices are available and which have little or no observable inputs. Further deterioration of financial markets could significantly impact the value of these financial instruments and the results of operations. For these instruments, the determination of fair value requires subjective assessment and varying degrees of judgment depending on liquidity, concentration, pricing assumptions, the current economic and competitive environment and the risks affecting the specific instrument. In such circumstances, valuation is determined based on management's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk).<sup>184</sup>

In addition, Credit Suisse provides information regarding the control process around complex models that are used to ensure that the fair values of the financial instruments reported in financial statements are appropriate and determined on a reasonable basis.<sup>185</sup> These control processes include: review and approval of new instruments, review of income from these models at regular intervals, risk monitoring, price verification procedures, and "reviews of models used to estimate the fair value of financial instruments by senior management and personnel with relevant expertise who are independent of the trading and investment functions."<sup>186</sup>

The more comprehensive disclosure in the Credit Suisse report provides a far more transparent description of the nature and amount of assets that were subject to a significant amount of uncertainty. In addition, its upfront commentary regarding the subjective nature of level 3 valuations and the varying degrees of discretion that could significantly impact the value of the instruments provides an analyst or investor with appropriate information to make decisions.

### *E. The Regulatory Capital Environment*

In order to explain some of the accounting arguments for and against fair value accounting, it is necessary to understand the relationship between accounting and capital requirements. Although this Note does not explore capital regulatory requirements in any depth, a brief summary follows.

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183. *Id.* at 57.

184. *Id.* at 262.

185. *Id.* at 89.

186. *Id.*

Banks are regulated in a number of ways, and one form of regulation relates to the bank's capital regulatory requirement.<sup>187</sup> In essence, the regulatory capital requirement dictates amounts that each bank is required to have available as a "cushion" to protect its depositors and/or other lenders.<sup>188</sup> The required amount each bank must maintain is governed by the Basel Capital Accord.<sup>189</sup> Under this Accord, a bank's capital is divided into two "tiers" which are categorized as tier 1 and tier 2.<sup>190</sup> Tier 1 capital is the safeguard for a bank and can be viewed as the capital which is permanently and freely available to absorb losses without the bank having to cease trading.<sup>191</sup> Tier 2 capital is capital which would generally absorb losses only in the event of a bank's wind up, and, as a result, provides a lower level of protection for depositors and other creditors.<sup>192</sup> The capital adequacy of a bank is usually an important factor that investors consider when assessing the banks' solvency, and banks with lower capital adequacy are typically considered to be less likely to be able to absorb losses.

The relationship to accounting is as follows: a bank's capital adequacy is usually measured by a ratio which equates the bank's equity as a percentage of risk-weighted assets.<sup>193</sup> This ratio indicates whether a bank is well-capitalized to critically under-capitalized and requires regulators to put in place specific standards to ensure banks are in compliance.<sup>194</sup> The Federal Deposit Insurance Corporation (FDIC) has established guidelines for tier 1: 6% for well capitalized entities and 4% for adequately capitalized entities.<sup>195</sup> A ratio below 4% means that a bank is undercapitalized.<sup>196</sup> As an example, the tier 1 capital ratio for Credit Suisse at the end of 2008 was 13.3%, which is considered extremely high. When items are recorded at fair value and there are losses, these losses reduce equity, erode the capital position of a bank, and lower these ratios. As the ratios are redu-

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187. See, e.g., BASEL COMMITTEE ON BANKING SUPERVISION, THE NEW BASEL CAPITAL ACCORD 6 (2001), available at <http://www.bis.org/publ/bcbsca03.pdf>.

188. *Id.* at 50.

189. *Id.* at 3.

190. *Id.* at 4.

191. *Id.* at 14-16.

192. *Id.*

193. Risk-weighted assets are the total of all assets held by the bank which are weighted for credit risk according to a formula determined by the Regulator (usually the country's Central Bank). For example, cash would have a zero risk weighting, as it does not have credit risk. A loan though, may have a 50% risk weighting. *Id.* at 6.

194. Federal Deposit Insurance Corporation Rules and Regulations 12 C.F.R. § 325.103 (1992).

195. *Id.*

196. *Id.* § 325.102.

ced, there is an impact on the activity in which a bank may engage. For example, a bank may not be able to issue more loans if they do not have a sufficient amount of capital withheld.

In some cases, entities make adjustments to accounting figures in order to arrive at regulatory capital amounts. For example, the adjustment related to securities carried at fair value (which are classified as “Available-for-Sale securities” under FAS 115) is not generally considered for regulatory capital purposes.<sup>197</sup> That is, when the value of these instruments fall, it does not impact regulatory capital.<sup>198</sup> Accordingly, it is unlikely that the non-credit related losses of OTTI instruments will impact capital calculations. Whether regulatory capital numbers should be the same as accounting numbers is discussed in Part IV.A.1.

### III. THE FAIR VALUE DEBATE

Accounting has long been used to assess whether a company was making or losing money. For uncomplicated transactions (for example, when a company was selling widgets) accounting was seen as a “veil” or mechanical basis of measurement in which the underlying economic fundamentals of the transactions were not impacted.<sup>199</sup> For example, accounting may be considered as the rule-based mechanism to resolve the following situation: John makes 10 widgets that cost him \$1 each to make. He sells 5 of them for \$10 each, so he has made a profit of \$45. In this world, accounting is merely a set of rules that allows one to solve a problem. Accounting rules, however, can also be viewed as a form of regulation, or a control function which imposes rules that goes beyond a formula. For example, suppose that after John sold the 5 widgets, the remaining 5 lost half or some portion of their value. Perhaps one of John’s neighbors stole his idea and flooded the market, thus lowering the price. Should this impact be reflected when John determines how much he made that year? Should the answer change if John wanted to raise money through debt or equity and had to report to his investors? What if John also borrowed money to finance the investment and the interest rates significantly changed? Should we wait until John actually sells the product to determine what his gain or loss is? Does any hard line rule make sense

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197. Federal Deposit Insurance Corporation Schedule RC-R § 3.a.(1), <http://www.fdic.gov/regulations/resources/call/crinst/999rc-r.pdf> (last visited Mar. 15, 2010).

198. *Id.*

199. Guillaume Plantin, Haresh Sapra & Huyn Song Shin, *Marking-to-Market: Panacea or Pandora’s Box*, 46 J. ACCT. RES. 435 (2008), available at <http://ssrn.com/abstract=1186362>.

given the uncertainty? These are only some of the questions that arise in this simple situation.

As financial products became more complex and bank capital regulatory standards were enhanced, accounting started to take on a new role which forced it to assess the value of underlying instruments. In this world, accountants had to understand business strategies and make judgments upon which others relied. For example, accounting not only began to control how regulatory capital was calculated, but it also became a key motivator for financial players through the bonus structure.<sup>200</sup> Also, as a key input to the audit process, accounting is a key factor when deciding whether a company is in fact viable and can continue as a going concern. There are, of course, questions regarding whether accounting plays too significant a role in society, including what role fair value accounting should play.

#### *A. Arguments Supporting Fair Value Accounting*

Commentators who support fair value accounting have a number of arguments. First, they argue that fair value accounting of assets and liabilities is more relevant than historical cost because the fair value better reflects the underlying economic value of the instrument.<sup>201</sup> In addition, they believe that the fair value and related volatility does in fact reflect the underlying fundamentals, and particularly the risk of an instrument.<sup>202</sup> They point out that this is demonstrated by the manner in which entities conduct their risk management activities,<sup>203</sup> that is, on a fair value basis.<sup>204</sup> Diane Garnick, who oversees more than \$500 billion as an investment strategist at Investco Ltd., said, "Accounting does not make corporate earnings or balance sheets more volatile. Accounting just increases the transparency of volatility of earnings."<sup>205</sup>

Proponents also point to several risk management and FAS 159 disclosures that require an entity to disclose the reasons for electing to use

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200. See Rui Vieira & Keith Hoskin, *Management Accounting Practices and Discourses Change: The Role and Use of Management Accounting Systems* (Universidade Nova de Lisboa, Working Paper No. 481, 2006) available at <http://ssrn.com/abstract=902361>.

201. Plantin et al., *supra* note 199, at 436.

202. *See id.*

203. *See id.*

204. *See id.* at 450.

205. Jesse Westbrook, *SEC, FASB Resist Calls to Suspend Fair-Value Rules*, BLOOMBERG, Sept. 30, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=agj5r6nhOtpM>.

fair value for a particular instrument. They assert that when these disclosures make clear that most banks conduct their business on a fair value basis, and state this as the reason for electing fair value. For example, in both the Lehman Brothers and Credit Suisse annual reports, risk management activities were conducted on a fair value basis, and both companies used hypothetical simulations to manage risk.<sup>206</sup> In 2008, the Credit Suisse FAS 159 disclosure, in which the entity was required to state why it opted for fair value for particular products, Credit Suisse disclosed:

The Group has elected to account for substantially all Investment Banking commercial loans and loan commitments and certain Investment Banking emerging market loans held as of January 1, 2007, and those entered into after January 1, 2007, at fair value. These activities are managed on a fair value basis and fair value accounting was deemed more appropriate for reporting purposes. Additionally, recognition on a fair value basis eliminates the mismatch that existed due to the economic hedging the Group employs to manage these loans.<sup>207</sup>

Another argument in favor of fair value accounting is that the fair value only provides investors, regulators, and management with information, and, as such, fair value is only a messenger.<sup>208</sup> Arthur Levitt wrote, "Fair value reporting, when properly complied with and enforced, will simplify the information investors need to make informed decisions .... By reporting assets at what they are worth, not what someone wishes they were worth, investors and regulators can tell how management is performing."<sup>209</sup> This argument is extended to suggest that investors and analysts consider fair value when making decisions. Furthermore, analysts are in a position to evaluate fair value even when the inputs are not readily observable. Proponents argue that rational and informed investors are already doing this; such a position assumes that analysts and financiers are not only in a position to evaluate fair value, but also that they expect it and would not transact without it.

To illustrate this argument: if someone wanted to lend money to allow another to refinance his house, the lender would look at the current value of the house to make a lending decision. In this case, a lender would use an estimate of the value of the house, rather than what was paid for the

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206. CREDIT SUISSE, 2008, *supra* note 176, at 116; Lehman Brothers Holdings, Inc., *supra* note 161, at 82.

207. CREDIT SUISSE, 2008, *supra* note 176.

208. *See, e.g.*, Arthur Levitt Jr. & Lynn Turner, *How to Restore Trust in Wall Street*, WALL ST. J., Sept. 26, 2008, at A17.

209. *See, e.g., id.*

house or what the house may be worth in five years, regardless of the liquidity of the market.

To support their argument regarding investor and analyst expectations, proponents point to the various and extensive disclosures that are contained in annual reports and provide investors with information to make decisions.<sup>210</sup> Credit Suisse, for example, has an Annual Report that is 339 pages. Part of the argument is that even if fair value was not recorded in the financial statements, investors would be able to figure out the viability of a particular entity and this realization should not be blamed for any subsequent event.<sup>211</sup> Finally, to address criticism related to capital erosion, proponents of fair value suggest that changes in regulatory capital structure should be dealt with by capital regulators.<sup>212</sup> They specifically point to the current adjustment that is made regarding regulatory capital for Available-for-Sale-securities.<sup>213</sup>

Another related argument is that fair value provides a transparency that does not exist when using historical cost accounting.<sup>214</sup> A lack of transparency prevents users from understanding the true economic picture, and in effect, allows an entity to hide losses.<sup>215</sup> The CFA Institute states, "We reiterated our position that only fair value provides the transparent and honest reporting it will take for the markets to work through the volatility and move forward."<sup>216</sup> Proponents of fair value accounting also argue that transparency impacts the credibility of financial markets and contributes to their long-term stability.<sup>217</sup>

Two examples often cited to support fair value are Japan's economic crisis, and the savings and loan crisis in the United States in the 1980s.<sup>218</sup> After the savings and loan crisis, many argued that there were significant problems with the historical cost model of accounting for

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210. See generally CREDIT SUISSE, 2008, *supra* note 176.

211. Robert Boyer, *Assessing the Impact of Fair Value Upon Financial Crisis*, 5 SOCIO-ECON. REV. 779, 792 (2007).

212. Capria et al., *supra* note 14, at 23.

213. Boyer, *supra* note 211, at 794.

214. *Id.*

215. Capria et al., *supra* note 14, at 5.

216. CFA Institute Center, *supra* note 2.

217. *Id.*

218. See Franklin Allen & Elena Carletti, *Mark-to-Market Accounting and Liquidity Pricing*, 45 J. ACCT. & ECON. 358, 376 (2007); Akihiro Kanaya & David Woo, *The Japanese Banking Crisis of the 1990s: Sources and Lessons* 35 (Int'l Monetary Fund, Working Paper No. 7, 2000), available at <http://www.imf.org/external/pubs/ft/wp/2000/wp0007.pdf>.

banks.<sup>219</sup> Savings and loans institutions accepted short term deposits and used these deposits to fund much longer term mortgages.<sup>220</sup> When interest rates rose, many banks were funded by short-term deposits that demanded higher yields, and their primary assets were long-term mortgages that were negotiated when interest rates were low.<sup>221</sup> As the interest rate environment had changed significantly, the fair value of the mortgage loans was less than their face value amount.<sup>222</sup> In some cases, the value of the total assets on the balance sheet was less than the value of the total liabilities.<sup>223</sup>

Under historical cost accounting, this presented two problems.<sup>224</sup> First, the value of the losses was not recorded in the financial statements, and it was virtually impossible to tell their true value.<sup>225</sup> Even though the entities did not plan to sell the assets, the risk associated with the mismatch was not revealed from historical cost accounting.<sup>226</sup> Second, a moral hazard problem occurred because the managers of insolvent institutions had an incentive to take on more risky investments with a hope to increase their reward profile.<sup>227</sup> In addition, the lack of transparency caused other poor decisions, such as the sale of well performing assets to boost capital and the retention of poorly performing assets where losses had not yet been realized.<sup>228</sup> An article in the *Journal of Accountancy and Economics* stated:

In the Savings and Loan Crisis in the US, historical cost accounting masked the [extent of the] problem by allowing losses to show up gradually through negative net interest income. It can be argued that a mark-to-market approach would have helped to reveal to regulators and investors that these institutions had problems. This may have helped to prompt changes earlier than actually occurred and that would have allowed the problem to be reversed at a lower fiscal cost.<sup>229</sup>

Proponents of fair value often point out that the subsequent accounting regulations, in particular FAS 107, were put in place as a direct result of

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219. See, e.g., Allen & Carletti, *supra* note 218.

220. SEC, REPORT AND RECOMMENDATIONS PURSUANT TO SECTION 133 OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: STUDY ON MARK-TO-MARKET ACCOUNTING 35-36 (2008), available at <http://www.sec.gov/news/studies/2008/markto market123008.pdf> [hereinafter SEC REPORT].

221. *Id.* at 35.

222. *Id.*

223. *Id.* at 36.

224. *Id.*

225. *Id.* FAS 107, the fair value disclosure standard above, did not exist.

226. *Id.*

227. *Id.*

228. *Id.* at 225.

229. Allen & Carletti, *supra* note 218, at 378.



the savings and loan crisis in order to address some of the problems resulting from banks' strategies when no transparency was present.<sup>230</sup>

Proponents of fair value accounting also point to Japan's economic crisis, when billions of dollars of losses were hidden from an unsuspecting public until it was too late for many to recover their money. Japan's Minister of Financial Services, Yoshimi Watanabe, said that "Japanese banks exacerbated their country's economic woes by avoiding ever facing up to losses."<sup>231</sup> The Japanese story is remarkably similar to the current U.S. story for a few reasons.<sup>232</sup> First, leading up to the crisis in Japan, the prices of assets increased during an economic boom. This led to a bubble.<sup>233</sup> Second, the Japanese banking system was considered to be one of the strongest, most sophisticated, and robust financial systems in the world.<sup>234</sup> Third, the Japanese banks experienced a lack of confidence that led to a credit crunch. And finally, several banks did, in fact, fail.<sup>235</sup> One big difference is that Japan used a historical cost accounting model.<sup>236</sup> Proponents of fair value point to these failures to support the theory that the true economic value of the assets was lower than what was recorded on the books and that market participants will eventually determine the viability of a company. These details strongly refute any suggestion that fair value was a cause of the crisis, and Japan is a good example that bank failures can occur even when a fair value model is not in place.

Another argument supporting fair value accounting is that a more frequent valuation process is important for an entity so that management can engage in behavior that maximizes market discipline and proactively avoids unnecessary risk.<sup>237</sup> Proponents argue that, as with compensation for key executives, the current market value of an instrument highly motivates behavior, and if those changes are not counted, this may encourage excessive risk taking. The suggestion here is that bad decisions made by organizations get a pass if historical accounting is used. For example, the savings and loan and the Japan crises outlined above suggest that a clear picture of the relative value of assets and liabilities would

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230. DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS, *supra* note 55, at paras. 6-7.

231. *All's Fair: The Crisis and Fair-Value Accounting*, *supra* note 18.

232. *Cf.* Kanaya & Woo, *supra* note 218, at 59.

233. *Id.* at 5-8.

234. *Id.* at 4.

235. *Id.* at 28.

236. See Policy Brief, Inst. Chartered Accountants in Eng. And Wales, *Fair Value Accounting and the Financial Crisis 2* (Jan. 2009).

237. Boyer, *supra* note 211.

have, perhaps, modified the behavior of executives prior to the start of any problems.

A further argument is that fair value accounting, particularly for assets with credit risk, has, in effect, been accepted accounting for decades in the U.S. While the current accounting debate focuses on the implementation of FAS 157 and FAS 159, the fact is that even for loans, accounting has historically followed a pseudo fair value model. A pro-vision for credit losses is not technically fair value accounting; however, it has been accepted practice to write-down loans to a recoverable amount or the fair value.<sup>238</sup> Traditionally, the interest rate risk was not taken into account during valuation, but credit risk, arguably the more significant risk, was always taken into account to assess the true underlying value of loans, even when they were not traded.

Finally, most of the world has adopted a model that is at least equivalent to the United States. For example, International Accounting Standards, which govern most of Europe, and Canadian Generally Accepted Accounting Principles (GAAP) are very similar to current U.S. GAAPs where fair value is based on intent for some instruments and not mandated for others.<sup>239</sup> Although it is not clear how the International Accounting Standards Board will ultimately react to the recent FASB changes to FAS 157, it has initially signaled that it does not favor any modification to the fair value rules and that it would not follow the U.S. approach.<sup>240</sup>

### *B. Arguments Against Fair Value Accounting*

Critics of fair value accounting have put forth a number of key arguments. First, concerns have been raised that fair value accounting can cause a pro-cyclical downward pressure in asset prices. This in turn causes the price of assets to fall well below the "true economic value."<sup>241</sup> This is of particular concern when the write-downs are all occurring concurrently,

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238. ACCOUNTING BY CREDITS FOR IMPAIRMENT OF A LOAN, Statement of Fin. Accounting Standards No. 114, at para. 2 (Fin. Accounting Standards Bd. 2008). The lower of costs or market has been the accounting standard for traded loans for broker dealers, and FAS 114 requires a fair value measurement in some circumstances.

239. International Accounting Standards Board, Fair Value Measurement, <http://www.iasb.org/current+projects/IASB+projects/Fair+Value+Measurement/Fair+Value+Measurement.htm> (last visited Mar. 14, 2010).

240. Sir David Tweedie, Chairman, International Accounting Standards Board, Statement to the Economic and Monetary Affairs Committee (Sept. 28, 2009) (transcript available at <http://www.iasb.org/News/Statement+of+IASB+Chairman+Sir+David+Tweedie+to+the+Economic+and+Monetary+Affairs+Committee.htm>).

241. SEC REPORT, *supra* note 220, at 182.

exacerbating the problem.<sup>242</sup> The argument assumes that the decreased value of the assets on the balance sheet causes panic and lack of confidence, creating a reverberation effect from one market to another.<sup>243</sup> It is argued that fair value introduces an “accounting accelerator” which extends a sense of instability and fragility to the entire economic system.<sup>244</sup> One scholar notes:

As liquidity of the asset dries up, marking-to-market becomes significantly more inefficient than the historical cost regime because strategic concerns overwhelm fundamental analysis. Strategic concerns create procyclical trades that destabilize prices in the mark-to-market regime while strategic concerns result in countercyclical trades that reduce fundamental volatility in the historical cost regime.<sup>245</sup>

Second, these critics argue that fair value requires banks to record losses that they will never actually incur, and this causes excessive volatility.<sup>246</sup> It is further argued that this volatility is a consequence of the accounting rule rather than a determination of the underlying fundamentals of any given product.<sup>247</sup> The argument also includes the assumption that the asset or liability is held for either the long-term, or at least longer than the period of time when a valuation is done in an illiquid market. For example, critics argue that “the prices of assets on the books of Washington Mutual, when it was bought by J.P. Morgan at a fire-sale price, were cited as a reason to mark-down the assets on the books of Wachovia.”<sup>248</sup>

Critics argue that historical cost, which is based on a real transaction, is a better option than a less accurate or unreliable assessment of the valuation of the firm based on unlikely instant liquidation.<sup>249</sup> This suggests that volatility will force banks to adopt strategies inconsistent with their long-term strategy.<sup>250</sup> For example, fair value may cause banks to shift risk using hedging activities. The argument is extended further to suggest that because fair value eroded their capital position, many banks increased

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242. *Id.* at 1.

243. Boyer, *supra* note 211, at 803.

244. *Id.*

245. Plantin et al., *supra* note 199, at 439-40.

246. Boyer, *supra* note 211, at 802-03.

247. *Id.*

248. Brian Wesbury, *How to Start the Healing Now*, WALL ST. J., Oct. 1, 2008, at A25.

249. Boyer, *supra* note 211.

250. *Id.* at 788.

their securitization activities in order to again enhance their capital positions and limit potential exposures.<sup>251</sup>

Also, critics argue that in an illiquid market, the very premise that market efficiency would support reliable fair value information is faulty. Robert Boyer notes that fair value evaluates the worth of an asset based on its expected returns over time, and the underlying assumption of this concept is that financial markets are efficient.<sup>252</sup> The problem, he argues, is that while this argument may be supported when there is an objective valuation methodology and a high degree of liquidity and stability in the market, it is fundamentally flawed when the firm must rely on models that involve a significant amount of discretion and uncertainty.<sup>253</sup> As the efficient market theory technically implies that all the relevant information is incorporated into prices, the assumptions and uncertainty associated with models make the reliance on them inappropriate.<sup>254</sup> This argument not only applies to securities transacted in an illiquid market, but also to classes of assets, like loans, where the prices do not correspond well to the idea of hypothetical, thinly traded markets. It is argued that the concept is flawed for these types of assets because the fair value definition—the price that would be received to sell an asset—is based on the premise that there is, in fact, a market.<sup>255</sup>

Finally, critics also claim that fair value accounting causes banks to violate regulatory capital requirements, impeding lending and causing banks to sell off assets in order to maintain adequate capital.<sup>256</sup> The critics claim that former Chairman Greenspan initially opposed fair value accounting, but the method was actively promoted by economists at the Federal Reserve who were proponents of the risk-based capital requirements which make up a fundamental part of the Basel II capital framework.<sup>257</sup> The argument starts out with the criticism that fair value accounting requires inappropriate write-downs of assets, in particular, where markets are inactive or illiquid.<sup>258</sup> Critics then assert that as accounting is a key part of the capital adequacy analysis, it promotes capital charges higher than required, creating an appearance of insolvency.<sup>259</sup> Former FDIC

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251. *Id.* at 804.

252. *Id.* at 781.

253. *Id.* at 792.

254. *Id.*

255. *Id.*

256. *Id.*

257. Whalen, *supra* note 41, at 7-8.

258. *Id.*

259. *Id.* at 8.

Chair, William Isaac, argues that fair value did not represent the underlying fundamentals of financial instruments and, as a result of write-downs, banks could not maintain adequate capital reserves, which in turn prevented them from lending to consumers.<sup>260</sup>

#### IV. ASSESSMENT AND CONCLUSIONS

While there is some legitimate debate regarding which accounting measure better suits particular situations, this Note concludes that for financial instruments, the arguments supporting fair value accounting are much stronger. This Note strongly advocates fair value accounting for financial instruments held by banks, but when a business is not managed on a fair value basis or an entity intends to hold instruments for the long term,<sup>261</sup> historical cost is an acceptable solution as long as entities supplement the recognition and measurement with substantial, adequate disclosures.

In addition, this Note concludes that fair value accounting did not cause or contribute to the financial crisis. This assertion is supported by the conclusions in the SEC Report as well as an examination of reasons for bank failures that occurred in 2008. Moreover, history has shown that bank failures have occurred in the U.S. and Japan when fair value accounting was not in place. Also, the current strong capitalization of some banks that did apply fair value accounting, like Credit Suisse, and the sound banking system in Canada, where fair value is also applied, does not support the conclusion that fair value accounting caused the financial crisis.

Finally, this Note advances the theory that accounting forms the basis for important regulatory and control functions on which capital regulators and auditors rely. Given the complexity of the marketplace, this is an appropriate role for accountants. Independence is a key characteristic for any regulator, and the SEC and FASB should ensure that they demonstrate this independence, thereby enhancing the credibility of their decisions. The recent changes, while perhaps benign, question the FASB's independence, which could have negative long term effects.

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260. Sopelsa, *supra* note 1; *Restoring Confidence* (CNBC television broadcast Oct. 9, 2008), available at <http://www.CNBC.com/id/27100454>.

261. See ACCOUNTING FOR CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES, *supra* note 64. Long term is similar to the Held to Maturity Classification in FAS 115 rather than the idea of holding for a few years.

*A. Fair Value Accounting is the Best Measure for Financial Instruments*

The arguments for and against fair value accounting have been summarized in Part III and both sides have valid arguments. However, for financial instruments, fair value accounting best reflects the underlying value of an instrument and provides the most relevant information to analysts and investors. This is particularly the case for banks, where many financial instruments are either held for trading purposes, or assets are actively managed on a fair value basis.

Some argue that the inputs for assets are not observable, are based on estimates and, as such, fair values are too subjective. As some fair value estimates are based on unobservable inputs, disclosures should be improved for both level 2 and 3 instruments. These disclosures should enhance the valuation methodologies used and highlight any significant assumptions used by an entity to increase transparency.

Although the debate over whether fair value is often discussed in terms of the subjective nature of the inputs, in 91% of the cases the inputs related to the assets on the books of banks are observable.<sup>262</sup> Even Lehman Brothers had only 14% of their assets carried at fair value classified in level 3 at the end of 2007.<sup>263</sup> While fair value accounting for level 3 instruments may not be based on reliable or observable inputs, this is not the case for most products. Also, some valuation that at least is accurate in terms of a trend is better than nothing at all. This Note does not advocate a shotgun approach, but rather, a best efforts estimate with appropriate disclosure. This approach provides investors and analysts with some information that they can use to make their decisions.

This approach is reflected in current accounting literature and clarified in FSP 157-3.<sup>264</sup> Moreover, the new guidance follows this general principle and supplements the somewhat subjective valuation with explanation and disclosure.<sup>265</sup> In addition, estimates and modeling are commonplace in today's complex financial market system and should not be used as an excuse not to do anything. Estimates and projections are used by analysts to recommend investments, by credit agencies to provide ratings, and most notably, on various types of products during structuring to effect sales. There is also a long list of estimates that play an integral role in what is measured and disclosed in the financial statements. Credit Suisse devotes

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262. SEC REPORT, *supra* note 220.

263. Lehman Bros, Holdings, Inc., *supra* note 161, at 41.

264. DETERMINING THE FAIR VALUE OF A FINANCIAL ASSET WHEN THE MARKET FOR THAT ASSET IS NOT ACTIVE, *supra* note 114.

265. *Id.*

five pages in its 2008 Annual Report to discussing critical accounting estimates that are used throughout the financial statements. Credit Suisse states that judgment is required for all of them.<sup>266</sup> This approach is common in banks where several structured products are so complex that the purchase price is based almost solely on estimated cash flows.<sup>267</sup>

The other significant, related point that supports fair value accounting for bank products is that the world has changed. That is, markets have become so complex that the use of estimates is a natural progression, and this exact complexity eliminates some of the old arguments for why historical cost is a better measure. In fact, the CDO and other mortgage based securities in question became so opaque that fair value measurement became the *only* relevant measure. This point is emphasized by the fact that in some instances, these securities are held by the same entity that packaged and put them into the market in the beginning.<sup>268</sup> Should the value of these securities be the value that was established by those who created them? Admittedly, where an entity does not manage its business on a fair value basis or plans to hold an asset to maturity, fair value accounting may not be required, as long as the disclosures are adequate. Fair value is still the more relevant measure even in these situations, but the argument for or against fair value is a closer call when looking at these types of instruments or activities. This accounting is consistent with FAS 115,<sup>269</sup> and is possibly why the FASB did not move to full fair value for all instruments, instead giving entities the option of whether to use fair value for some instruments.

Furthermore, the suggestion that fair value accounting creates too much volatility is unpersuasive. While volatility in itself is not a good thing, the potential for volatility may encourage senior management to engage in strategies that limit the amount of volatility and take less risk. Accounting should not be used to actively manage a bank's activities, but it should indicate to the public when a bank is engaging in risky activities. As outlined above, a bank that has established a practice of short-term financing that is matched with long term assets is subject to significant risk if interest rates change. Fair value accounting will, at a minimum,

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266. CREDIT SUISSE, 2008, *supra* note 176.

267. Theresa F. Henry & Mark P. Holtzman, *Critical Accounting Policy Disclosures for Financial Institutions: A Review of Current Practice, Culled from 69 Financial Institutions' 2004 Disclosures*, BANK ACCT. & FIN., Apr.-May 2006, at 14..

268. *See, e.g.*, The Subprime Motive: Billions in Revenues and Bonuses, Subprimer.org, <http://subprimer.org/node/9> (last visited Mar. 14, 2010).

269. *See generally* ACCOUNTING FOR CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES, *supra* note 64.

make a manager think about this prior to the adoption of that strategy. Goldman Sachs' Chief Executive Officer, Lloyd Blankfein, indicated that the adherence to fair value "was a key contributor to [the company's] decision to reduce risk relatively early in markets and in instruments that were deteriorating."<sup>270</sup> His statement supports the assertion that volatility may be a signal reflecting the risk associated with the instrument, and as such reflects reality.

Additional support that volatility reflects risk and/or reality comes from two phenomena commonplace in financial markets. First, compensation for bankers in the front office is based on fair value. If fair value provides the benchmark and motivator for bonuses, how could it be argued that historical cost better reflects reality? The second argument suggesting that fair value treatment, even with its associated volatility, does in fact reflect reality is based on the accepted practice of managing risk based on fair value. While risk management activities have evolved over time to deal with increasingly complex transactions and structures, the thought of managing risk on a historical cost basis has always been unthinkable.<sup>271</sup> If risk managers feel that fair value represents the most relevant and useful characteristics associated with an instrument, it does not follow that a different basis should be used for accounting purposes. Blankfein supports this assertion and notes that "[i]f more institutions had properly valued their positions and commitments at the outset, they would have been in a much better position to reduce their exposures."<sup>272</sup>

Another problematic argument contends that fair value erodes bank capital and discourages bank lending. Such an argument loses sight of the purpose of the Basel capital requirements,<sup>273</sup> and the risk-based measurement. Accounting is the first step in terms of an input into capital calculations and has a similar purpose to the capital calculation, as it is an

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270. Lloyd Blankfein, *Do Not Destroy the Essential Catalyst of Risk*, FINANCIAL TIMES, Feb. 8, 2009, <http://www.ft.com/cms/s/0/0/a0f1132-f600-11dd-a9ed-0000779fd2ac.html>.

271. Susan Schmidt Bies, Governor, Fed. Reserve Bd., Address at the International Association of Credit Portfolio Managers General Meeting (Nov. 18, 2004). This special speech discusses fair value accounting versus historical cost, and while it concludes in support of fair value accounting, the presence of the dichotomy appears to *disprove* his assertion.

272. Blankfein, *supra* note 270.

273. The Basel Accords (Basel I and Basel II) are recommendations issued by the Basel Committee on Banking Supervision regarding best practices in banking. See generally BASEL COMMITTEE ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (June 2004), available at <http://www.bis.org/publ/bcbs107.pdf?noframes=1>.



attempt to measure the underlying risk and underlying fundamentals of reported amounts so decisions can be made.<sup>274</sup> As accounting merely forms part of the regulatory function, it is unclear how it could be argued that this control, or regulatory function is the problem. If this argument were valid, it would follow that adverse regulatory capital determinations should also be blamed for a reduction in consumer confidence. The second problem with the inappropriate erosion of capital argument is that nothing prevents a bank from either valuing assets not based on fair value or classifying an asset as available-for-sale so that it gets “favorable” capital treatment.

Finally, it is ironic that a capital argument is being advanced at all, given that many of these securities originated from an attempt to circumvent capital rules.<sup>275</sup> If anything, there is an argument that accounting regulation has been too permissive by permitting the transfer of assets into special purpose vehicles so that banks could free up capital. How could it now be argued that some of these securities that are back on balance sheets in a repackaged, far riskier form should be treated in a manner that allows the banks to withhold the lowest possible capital reserves?

### *1. Should Regulatory Capital and Accounting Figures be the Same?*

The question often arises whether accounting figures, and their related fair value, should be the same values that are used for regulatory capital calculation purposes. For example, there are many who argue that the current regulatory adjustments for “Available-for-Sale securities” are fully supportable.<sup>276</sup> Others argue that exempting certain losses from capital consideration contributes to an already rampant manipulation that has permitted entities to play games with capital.<sup>277</sup> A few things should be considered when considering this issue. First, capital regulators have to understand the nature and subjectivity of the accounting valuations. In particular, regulators must fully understand the potential difference in practice that will result from an entity’s ability to move assets between levels and use judgment to determine the fair value. This Note argues accounting and regulatory figures need not be identical, however, there should be a

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274. See, e.g., Financial Accounting, QuickMBA.com, <http://www.quickmba.com/accounting/fin/> (last visited Mar. 14, 2010).

275. See JOINT ECON. COMM., THE U.S. HOUSING BUBBLE AND THE GLOBAL FINANCIAL CRISIS: VULNERABILITIES OF THE ALTERNATIVE FINANCIAL SYSTEM 16-17 (June 2008) (presented by Jim Saxton (R-NJ)).

276. SEC REPORT, *supra* note 220, at 1-2.

277. *Id.*

rational and reasonable assessment for why differences exist between the two measurements, and those differences should be supportable. It is certainly understandable why, in some instances, accounting and regulatory capital numbers may differ, and perhaps the new accounting changes where credit and other market losses are separated is a good example. This appears reasonable because valuations are not perfect. Recognition of part of the loss related to credit risk for capital purposes with appropriate explanation for the remainder of the loss is a reasonable approach that provides both accountants and capital regulators with directional information that can be used to make decisions. A “reasonable valuation” concept is something that should resonate with investors and would provide transparency as long as it was adequately explained.

The issue of different accounting and regulatory numbers arises because of the way the discussion is usually framed as an all or nothing choice. That is, an entity either includes the full fair value adjustment or excludes it. In reality, a reasonable estimate of value can be an acceptable alternative for regulatory capital purposes if that differs from what is in the income statement. That said, it is difficult to see how a difference between regulatory and accounting, where *all* of the fair value loss was ignored for regulatory purposes, would be reasonable. For example, there would not be any rationale to support the entire fair value change related to an OTTI impairment to be ignored for capital purposes.

Given the subjective nature of the valuations of some instruments, perhaps regulators should consider a regulatory framework that permits some type of incorporation of additional information that could be considered by regulators when they decide whether a bank is highly capitalized. In addition, regulators may want to consider the Spanish approach, in which capital is set aside in good times to make up for the bad times.<sup>278</sup>

A final comment on this topic illustrates a problem with the convergence of accounting and regulatory numbers and the reliance of the regulators on accounting data. There is usually a significant amount of pressure on accountants to develop accounting standards that will have a positive regulatory capital impact. This forces the kind of shotgun accounting standard developments that occurred in 2009.<sup>279</sup> A heavy accounting lobby

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278. Santiago Fernandez de Lis & Alicia Garcia Herrero, *The Spanish Approach: Dynamic Provisioning and Other Tools* (BBVA Econ. Research Dep't, Working Paper No. 0918, 2009), available at [http://serviciodeestudios.bbva.com/KETD.fbin/mult/wp\\_0903\\_tcm346-212919.pdf?ts=1532010](http://serviciodeestudios.bbva.com/KETD.fbin/mult/wp_0903_tcm346-212919.pdf?ts=1532010).

279. See *The Shape of Things to Come? Accounting, Regulatory and Other Developments that May Affect Recovery in the Securitization Markets*, STROOCK SPECIAL

developed when the Transfer of Financial Asset accounting pronouncement was developed due to capital concerns at stake. One way to relieve the pressure on accountants is to adopt the reasonable valuation approach and let capital regulators set the standards and make adjustments where it is reasonable and appropriate. The mechanism would have to consider the subjective nature of fair value, but would also have to stress substance over form and be consistent with the need to hold back capital where required. A good example of an application of this relates to special purpose vehicles. While accounting standard-setters are considering putting an end to this, it perhaps should have been the capital regulators that required an add back of assets for regulatory calculation unless the assets were sold to a real third party. If capital regulators adopted this type of role, both standard setting bodies could focus on what they do best.

Finally, perhaps the notion of conservatism should drive the decisions of both capital regulators and accountants. Given the events of the last two years, additional focus should be given to ensure capital reserves are higher rather than lower. As such, a divergence from accounting in areas like "Available-for-Sale securities" and special purpose entities (where the accounting result is different for capital in that capital is increased rather than decreased) might be exactly what the doctor ordered for capital regulators.

## *2. Have We Learned from the Past?*

The final, and perhaps most compelling reason, that fair value accounting is superior to historical cost is the world's past experience. The savings and loans crisis in the United States and Japan's experience both demonstrate the significant downfalls associated with historical cost accounting when management can hide losses.<sup>280</sup> As a result, a more transparent indication of risk is far superior to a valuation based on old data. Unfortunately, the past is too often ignored or forgotten and society commits the same mistakes even when the situations have not changed. Those who support the elimination of fair value accounting have forgotten that the implementation of various fair value accounting standards was a direct result of past economic catastrophes when banks failed and account-

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BULLETIN (Stroock & Stroock & Lavan LLP, New York, N.Y.), Oct. 15, 2009, at 1-2, available at <http://www.stroock.com/sitefiles/pub839.pdf>.

280. See Doran Nissim & Stephen Penman, *Principles for the Application of Fair Value Accounting* 1-2 (Columbia Bus. Sch., Ctr. for Excellence in Accounting and Security Analysis, White Paper No. 2, 2008), available at <http://www1.gsb.columbia.edu/mygsb/faculty/research/pubfiles/3029/FairValue.pdf>.

ing was blamed for the failure. Society should not make the same mistake again.

*B. Fair Value Accounting Did Not Cause the Financial Crisis*

The second conclusion of this Note is that fair value accounting did not cause or contribute to the financial crisis.

*1. The Past Does Not Support the Claim Fair Value Caused the Crisis*

The first obvious point is that the past does not support the claim that fair value caused the crisis. History has demonstrated, both in the United States and abroad, that consumers have lost confidence in banks, and banks have failed even when historical cost accounting was used. The savings and loan crisis in the 1980s is an excellent illustration of this point and supports the assertion that a loss of confidence which, in effect, creates a “run” on a bank can occur regardless of the accounting measure used. Perhaps the only difference is that those who decide they want to run have enough information to make an informed decision.

The present, as it relates to Canadian banks, is also inconsistent with the conclusion that fair value accounting caused bank failures. As all large Canadian banks are foreign United States filers, they were required to comply with U.S. GAAP prior to 2008 and could also elect to fair value certain assets.<sup>281</sup> In addition, even for those Canadian banks that are not foreign filers, the accounting for financial instruments is very similar to accounting in the United States.<sup>282</sup> If fair value accounting is to blame for the financial crisis, one would have expected to see bank failures in Canada. Instead, even though Canadian banks follow U.S. GAAP and fair value instruments, they are the model of success in the current economic environment and have not experienced any significant bank failures.<sup>283</sup>

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281. KPMG, 2007 FINANCIAL STATEMENTS OF CANADIAN BANKS 22-24, 32 (2007), available at <http://www.kpmg.ca/en/industries/fs/banking/documents/BankBook2007combined.pdf>.

282. Media Release, Accounting Standards Board, Accounting Standards Board Announces Decision Regarding Fair Value Accounting Standards and Impairment of Debt Securities (Apr. 30, 2009), available at <http://www.acsbcanda.org/mediareleases/item18411.pdf>.

283. Keith B. Richburg, *Worldwide Financial Crisis Largely Bypasses Canada*, WASH. POST, Oct. 16, 2008, <http://www.washingtonpost.com/wp-dyn/content/article/2008/10/15/AR2008101503321.html>.

## 2. *An SEC Study Concluded that Fair Value Did Not Cause Bank Failures*

The conclusion that fair value did not play a role in the financial crisis and bank failures is also supported by the study that was mandated by Section 133 of the Emergency Economic Stabilization Act of 2008 (the Act).<sup>284</sup> The Act mandated that the SEC, in consultation with the Board of Governors of the Federal Reserve, and the Secretary of the Treasury, conduct a study on mark-to-market accounting. The study concluded that fair value accounting did not play a meaningful role in bank failures.<sup>285</sup> The Staff observed that “fair value accounting did not appear to play a meaningful role in bank failures occurring during 2008. Rather, bank failures in the U.S. appeared to be the result of growing probable credit losses, concerns about asset quality, and, in certain cases, eroding lender and investor confidence.”<sup>286</sup>

In order to come to this conclusion, the SEC first examined the application of fair value accounting on the balance sheet for fifty financial institutions where the combined assets of the fifty companies represented at least 75% of financial institutions’ assets in the United States.<sup>287</sup> The examination was comprehensive.<sup>288</sup> First, the study found that, on average, 45% of financial institutions’ assets were carried at fair value, but that only 25% had the changes in fair value impact the income statement. The other 20% either went through OCI or were offset by corresponding fair value of liabilities.<sup>289</sup> In addition, the study illustrates that only 9% of the assets in these institutions are level 3 instruments.<sup>290</sup> This means that in 91% of the cases, fair value is being determined where there are observable inputs. Although not conclusive, this refutes the argument that fair value is not reliable due to the lack of observable inputs in at least 91% of the cases. The study did find that the impact on changes to the income statement was significant and represented up to an 11% impact on equity.<sup>291</sup> These findings shed some light on the balance sheet make up and income statement impact of fair value accounting, but do not necessarily provide a conclusive answer as to whether fair value accounting

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284. SEC REPORT, *supra* note 220, at 1.

285. *Id.*

286. *Id.* at 4.

287. *Id.* at 43.

288. *Id.*

289. *Id.* at 49.

290. *Id.* at 60.

291. *Id.* at 88.

caused or contributed to the bank failures. That is, for the most part, the statistics in this section of the report could be used to support either argument.

The SEC study then went on to look more specifically at the twenty-two banks that had failed during 2008 and studied the impact of fair value accounting on those banks.<sup>292</sup> One bank the SEC looked at was Washington Mutual (WaMu).<sup>293</sup> WaMu had \$300 billion dollars in assets, but carried less than the average 45% of those assets at fair value.<sup>294</sup> It is interesting to note that WaMu had less than 5% of its assets accounted for on a fair value basis, yet still failed.

The first obvious point is that this bank failed, and it had a very small percentage of its assets carried at fair value, which does contribute to the idea that fair value accounting caused this particular bank failure. What about the argument that fair value erodes the capital position of banks? In fact, WaMu was considered “well capitalized according to applicable capital adequacy standards,”<sup>295</sup> which refutes arguments in this case of the eroding capital impact of fair value accounting. Why did WaMu fail? The study reveals that WaMu’s credit losses for instruments not carried at fair value (loans) were the most significant cause of the decline in income and amounted to \$9.4 billion in 2008.<sup>296</sup> This compares to \$500 million dollars in losses related to trading assets carried at fair value over the same period.<sup>297</sup> The high capitalization and lack of losses generated by fair value accounting strongly undermine suggestions that fair value accounting played any role in this banking failure. Similar arguments can be made for several other failed banks that were reviewed in the study.

Based on a fact sheet from WaMu’s own regulator, the Office of Thrift Supervision (OTS), the failure was caused by the quality of the banks mortgage loan assets, which were carried at cost, combined with the dramatic increase in deposit outflows sparked by concerns about the quality of the bank’s assets.<sup>298</sup> The suggestion that the lack of confidence in itself

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292. *Id.* at 97-98. For the purposes of this analysis, the SEC defined a bank as one regulated by the FDIC and the Federal Reserve, and, as such, it did not include investment banks like Bear Stearns and Lehman Brothers. The FDIC website posts information about bank failures and according to this source, as of December 1, 2008, there were twenty-two bank failures during 2008. *See supra* note 7.

293. SEC REPORT, *supra* note 220, at 109.

294. *Id.* at 110.

295. *Id.* at 101.

296. *Id.* at 121.

297. *Id.* at 122.

298. Office of Thrift Supervision, Fact Sheet on Washington Mutual Bank, at 3, <http://files.ots.treas.gov/730021.pdf> (last visited Mar. 14, 2010).

was caused by fair value accounting is at best a tenuous argument given the strong capitalization and small number of assets carried at fair value. In addition, the same “run” on deposits occurred during the savings and loan crisis and in Japan where historical cost accounting was used. This point is further illustrated in the review of Bear Stearns and Lehman Brothers in Part IV.B.\$.

IndyMac also provides strong support that fair value accounting did not play a part in the bank failures. IndyMac’s situation was different from WaMu in that it was poorly capitalized and held a significant portion (approximately 13%) of mortgage-backed securities classified in its trading book and carried at fair value.<sup>299</sup> While IndyMac did experience losses related to these securities, two things suggest fair value accounting did not cause the failure. First, the losses associated with credit losses on loans that were not carried at fair value were not greater than the losses related to fair value adjustments.<sup>300</sup> Second, and even more compelling, IndyMac believed that a portion of the fair value losses that were recognized would be recovered over time. Because of this belief, it used its judgment to arrive at a fair value that was not based on liquidation prices.<sup>301</sup> Specifically, its financial statement disclosure as it related to level 3 instruments indicated:

These recorded fair values could be significantly in excess of the actual proceeds that would be received if we were forced to sell these assets in a short period of time into the current market which is characterized by illiquidity and opportunistic pricing by a limited number of buyers .... [H]ad we relied solely on broker market indications the fair values of the trading securities would have declined by \$120 million.<sup>302</sup>

This disclosure suggests that IndyMac used a quasi-fair value to attempt to value its assets based on recoverability rather than a liquidation price. In addition, the suggestion that this bank should have used historical cost as a basis of measurement does not make sense, given that there was clearly an erosion of the value of these instruments. Even if it is agreed that this middle ground should be taken and valuations should be based on recoverability while factoring in an intent to hold, this bank appears to have done that, and yet, it still failed. The SEC clarification on fair value accounting, which was made public at the end of September, 2008, was consistent with the approach taken by IndyMac and to which auditors

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299. SEC REPORT, *supra* note 220, at 111.

300. *Id.* at 123.

301. *Id.* at 124.

302. *Id.*

obviously agreed.<sup>303</sup> Again, IndyMac's regulator points to a deposit run and high credit losses that eroded its liquidity.<sup>304</sup>

Given the results of the SEC study, it comes as a surprise that the FASB recently decided to modify the fair value accounting rules.<sup>305</sup> These rules are discussed in detail in Section II.C.1 along with a more comprehensive assessment of their merits and pitfalls. While the FASB should be commended for enhancing disclosures related to valuation methodologies and for increasing the frequency of the fair value disclosures reporting quarterly, a few of the problems with the new guidance are worth mentioning.

First, the new proposals call into question the FASB's independence. This could result in a loss of confidence in the FASB. On March 12, 2009, the Chairman of FASB, Robert Herz, highlighted the importance of neutral, independent standard-setting when he testified in front of Congress. In his prepared comments he stated:

We agree with the SEC's conclusion that fair value did not cause banks to fail. Rather, its use can help to more promptly reveal underlying problems at financial institutions. We also agree with the SEC that suspending or eliminating the existing fair value requirements would not be advisable, would diminish the quality and transparency of reporting, and could adversely affect investors' confidence in the markets.<sup>306</sup>

In a press release regarding the testimony, Herz said, "While bending the rules to favor a particular outcome may seem attractive to some in the short run, in the long run, a biased accounting standard is harmful to investors, creditors and the U.S. economy."<sup>307</sup> What happened? While it is not clear what impact the new pronouncement will have on banks, it is clear that some question the FASB's motives. At the press conference where the FASB announced the finalization of the two FSPs, Herz faced

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303. Press Release, Securities Exchange Commission, SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting (Sept. 30, 2008) *available at* <http://www.sec.gov/news/press/2008/2008-234.htm>.

304. SEC REPORT, *supra* note 220, at 119.

305. News Release, Fin. Accounting Standards Bd., FASB Issues Final Staff Positions to Improve Guidance and Disclosures on Fair Value Measurements and Impairments (Apr. 9, 2009), *available at* <http://www.fasb.org/news/nr040909.shtml>.

306. *Mark-To-Market Accounting: Practices and Implications: Hearing Before the Subcomm. on Capital Mkts., Ins. & Gov't Sponsored Enterprises of the Comm. on Fin. Servs.*, 111th Cong. 18 (2009) (statement of Robert Herz, Chairman, Financial Accounting Standards Board).

307. News Release, Fin. Accounting Standards Bd., FASB Chairman Robert H. Herz Testifies on Mark-to-Market Accounting (Mar. 12, 2009) *available at* <http://www.fasb.org/news/nr031209.shtml>.



questions from the audience related to the FASB's independence.<sup>308</sup> Only time will tell what long term effect this has.

A final problem with the new standards was also touched on in section II.C.1. While companies will have to disclose any change in valuation technique resulting from the application of the new guidance and quantify its effects if practicable, it appears a door has been left wide open for manipulation. In particular, the standard allows a significant amount of judgment to be applied—oversight is necessary in order to ensure consistent application.

Also, it is questionable whether the flexibility allows the principle of conservatism to prevail. The industry has already been severely criticized regarding unfair lending practices, poor use of taxpayer dollars, and being motivated by greed. Thus, it is questionable whether regulators should err on the side of caution rather than condone what would support higher valuations in the financial statements for these risky investments. In addition, while disclosures have been enhanced, further enhancement is needed to clarify what is occurring with assets that are moved between level 2 and 3.

### *3. Investors and Analysts Rely On & Use Extensive Fair Value Disclosure*

IndyMac illustrates another key reason why fair value accounting could not have caused the bank failures. Investors and analysts will factor in the fair value of an instrument whether it is reported on the balance sheet or the income statement. Thus, whether it is retail customers, institutions, or analysts, they will ultimately be able to ascertain whether the company is sound. Importantly, the fair value measurement helps an investor make this determination sooner rather than later.

IndyMac illustrates this point as follows. The SEC study reports that on May 12, 2008, IndyMac filed a Form 10-Q “showing a book value per common share of \$11,” but the shares were trading at \$3.<sup>309</sup> The substantial discount of the trading amount relative to the book value “suggests that investors factored in information not reflected” in the balance sheet, which applied fair value accounting.<sup>310</sup> Although some may argue that this is a reason why the information should be disclosed rather than recorded in the financial statements, most would agree that the

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308. Financial Reporting Blog, FASB Votes to Issue Guidance on Fair Value, OTTI, Disclosures, <http://financialexecutives.blogspot.com/2009/04/fasb-votes-to-issue-final-guidance-on.html> (Apr. 2, 2009, 14:38 EST).

309. SEC REPORT, *supra* note 220, at 134.

310. *Id.*

information should be available. If it is available, experts should and will use it to make their decisions. The alternative is to hide the information, but as with the savings and loans and Japan crises, financial viability is still ultimately assessed. This idea is also supported by various studies that examine how investors interpret financial data. For example, the Bank of International Settlements pointed to a study that stated, "[I]nvestors appear to discount loans' fair value estimates made by less financially healthy banks ... which is consistent with investors being able to see through attempts by managers of less healthy banks to make their banks appear more healthy by exercising discretion when estimating loans' fair values."<sup>311</sup>

As analysts use and expect relevant information affording them the ability to make decisions, it is important to supplement fair value measurement with adequate disclosures. This is especially the case as the current standards permit different accounting treatment for similar instruments which could lead to inconsistency and confusion. In addition, given the complexity associated with markets and instruments, disclosures should play a key role in providing explanations regarding transparency, an area arguably in need of more improvement.

As described in Part II.E,<sup>312</sup> a comparison of the fair value disclosures between Credit Suisse and Lehman Brothers suggests that Credit Suisse provides a more transparent picture. First, Credit Suisse provides a more comprehensive description of the valuation methodology for each product.<sup>313</sup> In addition, its categorization and description of level 3 products is more granular and comprehensive.<sup>314</sup> Finally, improved disclosures could address some of the arguments regarding the subjective nature of the valuations. As with IndyMac, disclosures can be tailored to not only fully explain management's belief regarding pricing, but also to discuss a range of alternatives. In fact, the current classification system, where level 3 assets are separately classified, already goes a long way to illustrate to investors that the numbers are somewhat soft, as they are based on unobservable inputs.

A starting place for determining additional disclosures useful to investors is the SEC and audit review process that occurred throughout the

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311. See, e.g., Wayne R. Landsman, *Fair Value Accounting for Financial Instruments: Some Implications for Bank Regulation* 6 (Bank for Int'l Settlements, Working Paper No. 209, 2006), available at <http://www.bis.org/publ/work209.htm>.

312. See *supra* Part II.E.

313. Compare CREDIT SUISSE, 2008 *supra* note 176, with Lehman Brothers Holding, Inc., *supra* note 161.

314. CREDIT SUISSE, 2008, *supra* note 176.

crisis. Even though it may not have been portrayed as such in the media,<sup>315</sup> the SEC had a good grasp of the issues surrounding fair value accounting as it related to mortgage instruments traded in illiquid markets. In particular, after liquidity started to evaporate, and after Merrill Lynch sold securities for \$0.22 on the dollar, the SEC asked organizations to formally respond to various questions supporting both the values at which they carried the assets and the explanation of the risks related to mortgage-related products.<sup>316</sup> These questions could serve as a starting point to ascertain the type of information investors and analysts would find useful. The FASB's new guidance appears to agree with this conclusion, as it expands fair value disclosures to quarterly reporting and also requires a number of additional disclosures all aimed at increasing transparency.<sup>317</sup>

#### *4. Fair Value Accounting Did Not Contribute to the Bear Stearns and Lehman Failures*

There are several explanations supporting the assertion that the economic crisis and investment bank failures, including Bear Stearns and Lehman Brothers, were not a result of fair value accounting. To illustrate this assertion, this Note first reviews the events that took place in both companies from the time rumors of their demise started until their ultimate collapse.<sup>318</sup>

On March 10, 2008, Bear Stearns' stock started to fall; by around 11:00 A.M., the shares that had traded as high as \$171 in 2007, were trading around \$60.95.<sup>319</sup> The drastic decrease was blamed on rumors that the company might be running out of cash.<sup>320</sup> On March 12th, the head of Bear Stearns appeared on CNBC and somewhat faltered when David Faber asked him about Goldman Sachs' unwillingness to do business with them.<sup>321</sup> By the 13th of March, the head of Bear Stearns was calling J.P. Morgan CEO, Jamie Dimon, to ask for an infusion of up to \$30 billion, or

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315. See, e.g., Chris Scholl, *Report: SEC Dropped the Ball*, CBSNEWS.COM, Sept. 26, 2008, [http://www.cbsnews.com/stories/2008/09/26/cbsnews\\_investigates/main4481429.shtml](http://www.cbsnews.com/stories/2008/09/26/cbsnews_investigates/main4481429.shtml).

316. For example, Credit Suisse was required to formally answer questions asked by the SEC regarding their valuations.

317. News Release, *supra* note 307.

318. *Frontline: Inside the Meltdown* (PBS television broadcast Feb. 17, 2009).

319. *Id.*

320. *Id.*

321. *Id.*

for J.P. Morgan to buy Bear Stearns outright.<sup>322</sup> Dimon suggested that he ask the Federal Reserve or Treasury Department for help, but also sent over a team to start examining Bear Stearns' books.<sup>323</sup> Timothy Geithner also sent a team from the Federal Reserve to examine the books.<sup>324</sup> At this point the quarterly report had not yet been filed, and Bear Stearns was due to issue a press release regarding its quarterly earnings on March 20, 2008.<sup>325</sup>

A few months later, in July, Lehman Brothers was in trouble. Similar to Bear Stearns, questions started arising regarding the company's financial viability. Lehman's stock started to plummet and its debt was downgraded.<sup>326</sup> It was also clear that Lehman held billions in toxic real estate assets. This combination of factors enhanced the perception that Lehman would not be able to survive.<sup>327</sup> By September 9th, the stock price had fallen 45%.<sup>328</sup> Lehman then held an analyst/investor conference call to announce its \$3.9 billion third-quarter loss a week early, on September 10th.<sup>329</sup> In addition to its loss, Lehman unveiled a new restructuring plan.<sup>330</sup> During this process, Lehman engaged in extensive negotiations with other entities to try to affect either a merger or a sale.<sup>331</sup> Notably, the company could not secure extra financing from a Korean bank once the bank reviewed Lehman's books.<sup>332</sup> Lehman had also attempted to make deals with Warren Buffett, Barclays, Bank of America, Morgan Stanley, HSBC, and sovereign wealth funds from the Middle East, and China and did not have any success.<sup>333</sup>

In addition to problems related to finding a buyer, Lehman's counterparties were starting to ask for liquid assets as collateral to cover lending

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322. *Id.*

323. *Id.*

324. *Id.*

325. *Bear Stearns Moves up First Quarter 2008 Earnings Conference Call to March 17*, BUS. WIRE, Mar. 14, 2008, <http://www.businesswire.com/news/home/20080314005831/en/Bear-Stearns-Moves-Quarter-2008-Earnings-Conference>.

326. Investopedia, Case Study: The Collapse of Lehman Brothers, <http://www.investopedia.com/articles/economics/09/lehman-brothers-collapse.asp?&viewd> (last visited Mar. 14, 2010).

327. *Id.*

328. *Id.*

329. *Id.*

330. *Id.*

331. *Id.*

332. *Id.*

333. See Louise Story & Ben White, *The Road to Lehman's Failure Was Littered with Lost Chances*, N.Y. TIMES, Oct. 6, 2008, at B1.

positions.<sup>334</sup> Unlike with Bear Stearns, the Federal Reserve made it clear that it would not bail out Lehman; Lehman had to find a buyer.<sup>335</sup> During this process, competitors examined Lehman's books, and Bank of America and Barclays emerged as two potential buyers.<sup>336</sup> Bank of America opted for Merrill Lynch instead, and at the final hour, Barclays decided that they were not interested.<sup>337</sup> Barclays' decision was made on a Friday; the following Monday Lehman was forced to file for bankruptcy protection.<sup>338</sup>

The above summary explained what happened, but not why it happened. Those who would place the blame squarely on fair value accounting suggest that fair value caused the crisis in confidence that led to the demise of these two banks. This conclusion is flawed for several reasons. First, the fact that quarterly earnings had not yet been released for Bear Stearns when they went bankrupt suggests that there was no identifiable "fair value trigger" or reportable event that occurred. While not determinative, if financial statement results had been published and the market had an immediate negative reaction, this may have bolstered an argument that once the market received word of specific write-downs, it triggered a lack of confidence. Of note, even if financial statements were released to a negative market reaction, either reaction could have easily been explained by a simple belief of investors that the results were not great and the company was legitimately in trouble. Investors often react poorly, even when companies make a profit and slightly miss expectations—in those cases, the market drop is not blamed on the analysts that made the earnings estimates.

The second, more compelling, reason supporting the assertion that fair value accounting did not contribute to the failure of these banks, and in particular Lehman Brothers, is that the due diligence performed actually scared away any potential suitors. While the due diligence performed at Bear Stearns was not extensive, Lehman Brothers attempted to negotiate with, and opened up their books to, at least five other suitors.<sup>339</sup> Several entities performed extensive due diligence, which included a comprehend-

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334. *Id.*

335. Jim Zaroli, John Ydstie & Joshua Brockman, *Q&A: Lehman Brothers' Search for a Buyer*, NAT. PUB. RADIO, Sept. 12, 2008, <http://www.npr.org/templates/story/story.php?storyId=94575047>.

336. *Id.*

337. Story & White, *supra* note 333.

338. *Id.*

339. Ben Livesey & Yalman Onaran, *Barclays May Bid for Lehman as Fed Seeks Solution (Update 1)*, BLOOMBERG, Sept. 14, 2008, [http://www.bloomberg.com/apps/news?sid=a4\\_sTZKDOUwk&pid=20601087](http://www.bloomberg.com/apps/news?sid=a4_sTZKDOUwk&pid=20601087).

sive review of the financial instruments and the financial strength of the company. It is compelling that in every single case, the suitors walked away and were not willing to invest.<sup>340</sup> Warren Buffet, who chose not to purchase Lehman, invested in Goldman Sachs instead. Barclays, Bank of America, Morgan Stanley, HSBC, sovereign wealth funds from the Middle East and China, and a Korean bank all looked at Lehman Brothers.<sup>341</sup> The only reasonable conclusion is that the experts who performed the due diligence determined that the “true” value of the company did not make it desirable, even when offered at a low price.

### *C. Accounting Acts as an Important Control and Regulatory Function*

Finally, accounting should play a dynamic and integrated role in society. An accountant’s reputation precedes him or her. He is stereotypically rigid, rule-based, bookish, and has his calculator ready. Perhaps the stereotype comes from the days when accountants sat in offices with their adding machines and accountant hats and crunched numbers. While it is not clear that those days ever existed, what is clear is that they do not exist now. Today’s environment calls for an accountant who is dynamic, strategic, and who understands the business. If accountants default to the stereotypes, frauds like Enron will continue to occur and the public will suffer.

The SEC and FASB have developed a number of complex accounting standards to address the needs of investors. The fair value standards are a part of this. The FASB states in Paragraph 47 of FASB Concepts Statement No. 2: “To be relevant to investors, creditors, and others for investment, credit, and similar decisions, accounting information must be capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct expectations.”<sup>342</sup> Fair value accounting is consistent with this concept and is a basis of accounting for financial instruments that reflects the economic realities of today. In this environment, there are products that are so complex, the best experts do not fully understand them. It is dangerous to simply utilize accounting as a mechanical device—exactly what a historical cost model does. A dynamic model, like fair value, is not

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340. See Dominic Crossley-Holland, *Lehman Brothers, the Bank that Bust the Boom*, TELEGRAPH.CO.UK, Sept. 6, 2009, <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/6143297/Lehman-Brothers-the-bank-that-bust-the-boom.html>.

341. *Id.*

342. QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION, Statements of Fin. Accounting Concepts No. 2 (Fin. Accounting Standards Bd. 1980).

only consistent with the complexities of the financial markets, but also with what is needed to satisfy analysts, investors, and regulators.

### CONCLUSION

Not only do investors and regulators expect relevant information, but accounting has also become part of the system of regulatory and control functions on which capital regulators and auditors rely. Accounting is a key input—a starting point for capital regulatory calculations. Auditors audit accounting figures ultimately making a determination of financial strength and, in some cases, commenting on whether a company will continue to be a going concern. Accounting has to meet this challenge and fair value accounting is one example of where the FASB and SEC have provided the mechanisms to do exactly that. It is unfortunate that political pressure may cause the FASB to make decisions that are not consistent with their mandate or their previous position. The manner in which the new rules were adopted suggests that this has already happened.

It is clear that if fair value accounting was not in place in 2008, there would still have been a fair value controversy, but it would have focused on the SEC's and FASB's failure to properly regulate in this important area. Diane Mott, an analyst with J.P. Morgan Chase & Company, responded best to the suggestion that fair value accounting contributed to or caused the financial crisis: "Blaming fair-value accounting for the credit crisis is a lot like going to a doctor for a diagnosis and then blaming him for telling you that you are sick."<sup>343</sup>

*Ian E. Scott*\*

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343. Westbrook, *supra* note 205.

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