# FAIR-VALUE ACCOUNTING: MAINTAIN, REFORM, OR ERADICATE

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### I. Introduction

As of August 2008, financial institutions around the world recognized losses and write-downs exceeding \$501 billion as a result of the U.S. subprime crisis in 2007 and the ensuing credit crunch.<sup>1</sup> On September 15, 2008, the Dow Jones Industrial Average experienced the biggest one-day decline on a point basis since the market's response to the terrorist attacks of September 11, 2001.<sup>2</sup> A number of factors triggered this drop; most notably, the news that Lehman Brothers was filing for the biggest bankruptcy in U.S. history, AIG's announcement of restructuring due to a lack of liquidity, and the federal government's bailout of Fannie Mae and Freddie Mac just one week earlier.<sup>3</sup> The crisis that was isolated in the subprime mortgage sector began to affect other financial and nonfinancial institutions, and the economy as a whole.<sup>4</sup> According to the National Bureau of Economic Research, the U.S. economy began experiencing a recession in December 2007.<sup>5</sup> Some analysts go so far as to compare the difficult conditions of this economic environment to those of the Great

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<sup>&</sup>lt;sup>1</sup> Yalman Onaran, *Banks' Subprime Losses Top \$500 Billion on Writedowns*, BLOOMBERG, Aug. 12, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=a8sW0n1Cs1tY&refer=home.

<sup>&</sup>lt;sup>2</sup> Alexandra Twin, *Stocks Get Pummeled*, CNN MONEY, Sept. 21, 2008, http://money.cnn.com/2008/09/15/markets/markets newyork2/index.htm.

<sup>&</sup>lt;sup>3</sup> *Id*.

<sup>&</sup>lt;sup>4</sup> OFFICE OF THE CHIEF ACCOUNTANT, SEC, REPORT AND RECOMMENDATIONS PURSUANT TO SECTION 133 OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: STUDY ON MARK-TO-MARKET ACCOUNTING 11 (2008) [hereinafter SEC REPORT], *available at* http://www.sec.gov/news/studies/2008/marktomarket123008.pdf.

<sup>&</sup>lt;sup>5</sup> *Id.* at 12.

Depression of the 1930s.<sup>6</sup> These conditions sent government officials scrambling to develop a rescue plan to stabilize the American economy and fueled a debate over what factors played a role in creating these conditions.<sup>7</sup>

Some of the factors cited as potential causes of the economic crisis include: low interest rates, rapid appreciation in the housing markets in previous years, the use of alternative mortgage products, and insufficient regulation. One potential factor receiving a considerable amount of attention is the accounting methodology known as fair-value accounting. In fact, many financial institutions and other market participants allege that the use of the fair-value method of accounting, especially in illiquid markets, is a primary cause of the ongoing financial crisis. <sup>10</sup>

Congress's immediate answer to the economic crisis was the passage of the Emergency Economic and Stabilization Act of 2008 (EESA or the Act), 11 which President George W. Bush signed into law on October 3, 2008. 12 Congress enacted the EESA to stabilize the financial markets and

<sup>&</sup>lt;sup>6</sup> Dunstan Prial, *Biggest Crisis Since Great Depression . . . or Not*, Fox Business, Oct. 2, 2008, http://www.foxbusiness.com/story/biggest-crisis-great-depression-/.

<sup>&</sup>lt;sup>7</sup> See SEC REPORT, supra note 4, at 11–12. Congress and President Bush quickly signed into law the Emergency Economic Stabilization Act of 2008 on October 3, 2008, in response to the economic conditions. See Emergency Economic Stabilization Act of 2008, Pub. L. No. 110–343, 122 Stat. 3765 (2008).

<sup>&</sup>lt;sup>8</sup> SEC REPORT, *supra* note 4, at 11–12.

<sup>&</sup>lt;sup>9</sup> *Id.* The terms "fair-value accounting" and "mark-to-market accounting" are often used interchangeably. Gary Shorter, *Fair Value Accounting: Context and Current Concerns*, in Mark to Market and Fair Value Accounting: An Examination 1, 3 (James W. Curtis ed., 2009). However, the term "mark-to-market" is also used to refer more specifically to the valuing of assets based on current observable market prices. *See infra* note 34 and accompanying text.

<sup>&</sup>lt;sup>10</sup> Joyce Joseph-Bell et al., *Banks: The Fight over Fair Value*, BUSINESS WEEK, Oct. 15, 2008, http://www.businessweek.com/investor/content/oct2008/pi20081014\_361664.htm. In a speech in Santa Ana, California, 2008 presidential candidate John McCain stated, "[I]t is time to convene a meeting of the nation's accounting professionals to discuss the current mark-to-market accounting systems." Amanda Terkel, *McCain Promises a Series of 'Meetings' to Solve Housing Crisis*, THINK PROGRESS, Mar. 25, 2008, http://thinkprogress.org/2008/03/25/mccain-housing-speech/. He went on to note, "[T]here is widespread concern that this approach is exacerbating the credit crunch." *Id.* 

<sup>&</sup>lt;sup>11</sup> Emergency Economic Stabilization Act of 2008, Pub. L. No. 110–343, 122 Stat. 3765 (2008).

<sup>&</sup>lt;sup>12</sup>See id.

restore liquidity in assets through a troubled asset relief program.<sup>13</sup> One of the key provisions in the Act restated the Securities and Exchange Commission's (SEC) authority to suspend the application of fair-value accounting if it determines that doing so would be in the public's best interest and would serve to protect investors.<sup>14</sup> It also required the SEC to conduct a study of fair-value accounting standards and to present a report to Congress within ninety days of the passage of the EESA.<sup>15</sup> On December 30, 2008, the SEC delivered the required report to Congress.<sup>16</sup> The report detailed the SEC's analysis, findings, and conclusions regarding fair-value accounting standards, and recommended not suspending fair-value accounting.<sup>17</sup> In addition, the SEC suggested that Congress readdress the methods of accounting for financial-asset impairments and called for more guidance in determining an asset's fair value in inactive markets.<sup>18</sup>

This article examines the legal doctrine and application of fair-value accounting in the business environment that currently exists and discusses the debate over whether its application is appropriate and useful. It argues that suspending or eradicating the use of fair-value accounting is not only unnecessary, but also that doing so would worsen the already struggling economy. Instead of eliminating fair-value accounting, the Financial Accounting Standards Board (FASB) and the SEC should improve both the

<sup>&</sup>lt;sup>13</sup> STEPHEN S. KUDENHOLDT, SUMMARY AND ANALYSIS OF THE TROUBLED ASSET RELIEF PROGRAM (2008), *reprinted in* GARY BARNETT, PRACTISING LAW INSTITUTE, NEW DEVELOPMENTS IN SECURITIZATION 2008, at 305, 307 (2008) (quoting Emergency Economic Stabilization Act of 2008 § 2(1)). The troubled-asset relief program allows the U.S. Department of the Treasury to purchase illiquid, distressed assets from banks and other financial institutions in an effort to improve the position of these institutions and, as a result, encourage lending amongst banks and between banks and consumers to levels seen before the current economic crisis. *Id.* 

<sup>&</sup>lt;sup>14</sup> 12 U.S.C.A § 5237 (West 2010). The SEC has the authority, under the federal securities laws, to specify the acceptable standards used by publicly traded companies in the preparation of financial information that is ultimately provided to investors and creditors. *See* SEC REPORT, *supra* note 4, at 15. The Commission has historically relied on the private sector for assistance, allowing the accounting profession to be somewhat self-regulating. *Id.* The body that the Commission looks to for issuance of acceptable standards is the Financial Accounting Standards Board (FASB). *Id.* The SEC oversees the passage of these standards and has the authority to step in when it deems necessary. *Id.* at 16.

<sup>&</sup>lt;sup>15</sup> 12 U.S.C.A. § 5238 (West 2010).

<sup>&</sup>lt;sup>16</sup> See SEC REPORT, supra note 4, at 191.

<sup>17</sup> Id

<sup>&</sup>lt;sup>18</sup> Shorter, *supra* note 9, at 2.

application of the method and the disclosure requirements that accompany the financial statements. Implementing these improvements and retaining fair-value accounting would renew investor and creditor confidence in the markets, and thus, help rebound the economy.

This article proceeds in four parts. Part II presents a general discussion of fair-value accounting, providing a brief history of the practice, summarizing how and when the accounting method applies, and discussing the benefits of its use. Part III discusses the ongoing debate over the appropriateness of fair-value accounting, including the argument made against the accounting method and its alleged role in the current financial crisis. Part III also discusses where these criticisms are correct and where they are exaggerated or altogether incorrect. Part IV discusses alternative methods of valuing a company's assets and liabilities proposed by those who contest the current rules and also explains where these alternatives either fall short or merit consideration for implementation. Finally, Part V summarizes the discussions in the prior sections of the article and proposes a plan of action for the SEC regarding future modification and improvements to the current fair-value accounting rules.

#### II. FAIR-VALUE ACCOUNTING IN GENERAL

The current model for valuing and presenting financial instruments on a company's financial statements under Generally Accepted Accounting Principles (GAAP) is referred to as the "mixed-attribute" accounting model. The mixed-attribute accounting model blends the use of historic cost-based accounting principles with fair-value accounting principles, depending on the classification of the particular asset or liability being valued. The assets and liabilities on a company's financial statement that are recorded at fair value, or some hybrid between historic cost and fair value, include the following: trading securities; available-for-sale securities; loans, including mortgages; and those instruments that the company opts to present at fair value under the Statement of Financial Accounting Standards (SFAS) 115. In particular, the fair-value method

<sup>&</sup>lt;sup>19</sup> *Id.* at 3.

<sup>&</sup>lt;sup>20</sup> See id.

<sup>&</sup>lt;sup>21</sup> STEPHEN G. RYAN, COUNCIL OF INST. INVESTORS, FAIR VALUE ACCOUNTING: UNDERSTANDING THE ISSUES RAISED BY THE CREDIT CRUNCH 7–8 (2008) (explaining that, although not required to do so by other accounting standards, an entity may elect to value particular assets and liabilities at fair value if it feels that such a valuation is more appropriate for that particular instrument), available at http://www.cii.org/UserFiles/(continued)

is causing much of the controversy surrounding the mixed-attribute accounting model currently used.<sup>22</sup>

This is not the first time fair-value accounting has been the center of controversy. In the 1990s, the use of fair-value accounting methods allegedly gave rise to high-profile corporate scandals, such as the highly publicized Enron scandal.<sup>23</sup> In those instances, companies were reporting assets at estimated valuations derived from scrupulous, aggressive financial models.<sup>24</sup> In the wake of these scandals, Congress enacted the Sarbanes-Oxley Act of 2002, 25 which provides for more government oversight of accounting standards, imposes criminal sanctions for accounting fraud, and requires companies to have more expansive and informative disclosure of the accounting methods used on the company's financial statements.<sup>26</sup> Additionally, FASB issued SFAS 157 in 2006 to define "fair value" and to provide guidance on the methods to use in marking assets and liabilities to fair value.<sup>27</sup> Prior to SFAS 157, different definitions of fair value existed. These varying definitions evolved in a piecemeal fashion over time, resulting in confusion and inconsistency in the application of the accounting method.<sup>28</sup> In addition to providing clarity and guidance, SFAS 157 expands the requirements for disclosures about the fair-value measurements that a company must present to investors and other users in its financial statements.<sup>29</sup>

file/resource%20 center/publications/CII%20 White%20 Paper%20-%20 Fair%20 Value%20 Accounting%20 July%202008.pdf.

<sup>&</sup>lt;sup>22</sup> See discussion infra Part III.

<sup>&</sup>lt;sup>23</sup> Jennifer K. Coalson, *The Sarbanes-Oxley Act of 2002: Are Stricter Internal Controls Constricting International Companies?*, 36 GA. J. INT'L & COMP. L. 647, 649 (2008).

<sup>&</sup>lt;sup>24</sup> *Id.* at 650.

 $<sup>^{25}</sup>$  Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

<sup>&</sup>lt;sup>26</sup> See id.

<sup>&</sup>lt;sup>27</sup> FIN. ACCOUNTING STANDARDS BD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 157 ¶ 6 (2008) [hereinafter SFAS 157]. FASB has provided a summary of SFAS 157. FIN. ACCOUNTING STANDARDS BD., SUMMARY OF STATEMENT NO. 157 (2008) [hereinafter SUMMARY OF STATEMENT NO. 157], *available at* http://www.fasb.org/st/summary/stsum157.shtml. SFAS 157 did not change which assets and liabilities are subject to fair-value accounting; rather, other previously issued standards provide for its required or permissible use. SEC REPORT, *supra* note 4, at 22.

<sup>&</sup>lt;sup>28</sup> SEC REPORT, *supra* note 4, at 22.

<sup>&</sup>lt;sup>29</sup> SFAS 157, *supra* note 27, at ¶ 1.

SFAS 157 defines the fair value of an asset or liability as the "price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." Thus, fair value is based on the "exit price" of an asset or liability (the price at which it would be sold) in a hypothetical exchange transaction rather than the "entry price" (the price at which it was bought), regardless of whether the company plans to hold or sell the asset or liability. Also, the measurement of the fair value of an asset or liability should be market-based rather than entity-based, meaning the company must take into consideration certain assumptions and unobservable inputs in calculating the market price. 32

Additionally, SFAS 157 provides a hierarchy with three levels of input data that one should consider when calculating this market-based exit price.<sup>33</sup> Level one inputs are quoted prices for identical items in active, liquid, and visible markets, such as the stock exchanges.<sup>34</sup> These inputs are the most reliable and should be used whenever available.<sup>35</sup> Level two inputs consist of observable information for similar items in active or inactive markets.<sup>36</sup> Level three inputs consist of unobservable information that one should use only in situations where markets do not exist or are illiquid,<sup>37</sup> such as those assets at issue in the current credit crisis. These level three inputs allow for more consideration of subjective assumptions. These assumptions include the restriction on the sale of the asset and certain risks, such as credit risk and nonperformance risk.<sup>38</sup> Level three inputs do not allow for the input of the company's expectations of market liquidity and credit-risk premiums returning to normal at some future time, regardless of what historical experience, statistical models, or expert opinions indicate.<sup>39</sup>

 $<sup>^{30}</sup>$  *Id.* at ¶ 5.

<sup>&</sup>lt;sup>31</sup> *Id.* at ¶ 7.

 $<sup>^{32}</sup>$  *Id.* at ¶ 11.

 $<sup>^{33}</sup>$  *Id.* at ¶ 22.

<sup>&</sup>lt;sup>34</sup> *Id.* The use of Level one inputs to value assets is referred to as marking-to-market, though the term "mark-to-market" is also used loosely to refer to the fair-value methodology as a whole. *See supra* note 9.

<sup>&</sup>lt;sup>35</sup> SFAS 157, *supra* note 27, at ¶ 24.

 $<sup>^{36}</sup>$  *Id.* at ¶ 28.

 $<sup>^{37}</sup>$  *Id.* at ¶ 30.

<sup>&</sup>lt;sup>38</sup> See RYAN, supra note 21, at 10.

<sup>39</sup> Id

The rationale for requiring companies to report assets and liabilities at fair value is to provide investors with an accurate and relevant snapshot of a company's financial position at a particular time. Investors are better informed when a company reports its assets and liabilities at fair value because these values are updated constantly and represent the current, more relevant value of the firm. Also, the proper implementation of SFAS 157 will improve consistency of the valuing and reporting of assets and liabilities by reducing the number of assumptions made by users of fair-value accounting in the past. Furthermore, adherence to SFAS 157 increases comparability of the financial statements of publicly traded companies because they will use similar measurement methodologies in determining fair value.

In addition to providing clarifications on the measurement of fair value, SFAS 157 requires companies to provide additional disclosures to increase transparency. With these additional disclosures, investors will be better suited to assess the reliability of the valuation methodologies, inputs, and assumptions that the company used in the presentation of its financial statements. Investors will be able to make any adjustments to the information that they deem necessary or, in extreme cases, they can choose to ignore the values completely. 46

#### III. THE ATTACK ON THE FAIR-VALUE ACCOUNTING METHOD

Fair-value accounting, as defined in SFAS 157, has come under fire recently for allegedly causing the current economic downturn.<sup>47</sup> There is a clear line between groups who are proponents of fair-value accounting and groups who advocate suspending or amending those rules.<sup>48</sup> The most avid

<sup>&</sup>lt;sup>40</sup> *Id.* at 2.

<sup>&</sup>lt;sup>41</sup> SEC REPORT, supra note 4, at 144.

<sup>&</sup>lt;sup>42</sup> SUMMARY OF STATEMENT No. 157, *supra* note 27.

 $<sup>^{43}</sup>$  Id

<sup>&</sup>lt;sup>44</sup> SFAS 157, *supra* note 27, at ¶ 1. Until recently, companies made few disclosures regarding fair value measurements. However, there is evidence that companies are in fact responding to the call for improved disclosures. *See* SENIOR SUPERVISORS GROUP, LEADING-PRACTICE DISCLOSURES FOR SELECTED EXPOSURES 1 (2008), *available at* http://www.newyorkfed.org/newsevents/news/banking/2008/SSG\_Leading\_Practice\_Disclosures.pdf.

<sup>&</sup>lt;sup>45</sup> SUMMARY OF STATEMENT No. 157, *supra* note 27.

<sup>&</sup>lt;sup>46</sup> Id

<sup>&</sup>lt;sup>47</sup> See supra notes 22–26 and accompanying text; SFAS 157, supra note 27, at ¶ 5.

<sup>&</sup>lt;sup>48</sup> RYAN, *supra* note 21, at 2.

and outspoken supporters of the fair-value accounting method are investors, trading-oriented financial institutions, and those who seek to protect investors, such as the SEC.<sup>49</sup> For example, the Council of Institutional Investors has expressed that it "is especially alarmed by reports that financial services companies are lobbying to freeze or weaken fair-value accounting for financial instruments" because doing so would "benefit Wall Street at the expense of investors."<sup>50</sup>

The attack on the fair-value method comes mostly from corporate executives and executives of non-trading financial institutions that have a vested interest in seeing a change to this method of accounting for the assets and liabilities reported on their companies' financial statements.<sup>51</sup> Others have also joined the debate, calling for a suspension of fair-value accounting standards. For example, in a recent letter to the SEC, congressional members called for the SEC to replace fair-value standards with more appropriate valuation methods, stating that fair-value, or mark-to-market accounting has "become counterproductive and is simply making the [economic] situation worse."

These advocates of change made many arguments against the use of mark-to-market accounting in the current state of the economy.<sup>53</sup> On the surface, they appear to have a strong case. However, with a better

<sup>&</sup>lt;sup>49</sup> See Shorter, supra note 9, at 8; Christopher Cox, Chairman, SEC, Opening Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission's Disclosure System (Oct. 8, 2008), available at http://www.sec.gov/news/speech/2008/spch100808 cc.htm.

<sup>&</sup>lt;sup>50</sup> Council of Institutional Investors, *Statement on the Federal Response to the Financial Crisis*, Sept. 23, 2008, http://www.reuters.com/article/idUS197631+23-Sep-2008+PRN20080923.

<sup>51</sup> See, e.g., Tim Reason, Why CFOs Hate Fair Value, CFO, May 14, 2008, http://www.cfo.com/article.cfm/11367210 (listing specific reasons for corporate executives' dislike of fair value). Several participants at the SEC's October 29 Roundtable on Mark-to-Market Accounting who expressed opposition to the use of the method include William Isaac (former Chairman of the Federal Deposit Insurance Corporation), Aubrey Patterson (Chairman and CEO of BancorpSouth, Inc.), and Bradley Hunkler (Vice President and Controller of Western & Southern Financial Group). Letter from Cynthia M. Fornelli, Executive Dir., Center for Audit Quality, to Florence E. Harmon, Acting Sec'y, SEC (Nov. 13, 2008), available at http://thecaq.com/newsroom/pdfs/CAQCommentLetter-FairValue FAS157.pdf.

<sup>&</sup>lt;sup>52</sup> Letter from Members of Congress to the Honorable Christopher Cox, Chairman, SEC (Sept. 30, 2008), *available at* http://www.complianceweek.com/s/documents/SEConFV.pdf [hereinafter Congressional Letter].

<sup>&</sup>lt;sup>53</sup> See discussion infra Parts III.B. III.C.

understanding of mark-to-market accounting, its usefulness to investors, and the methodologies that companies may employ in determining fair value, one can see that those who support the use of fair-value accounting have the stronger case. This section of the article explains and analyzes the main arguments made by those who oppose the use of mark-to-market accounting.

### A. Fair-Value Accounting's Alleged Role in the Current Economic Crisis

The most recent attack on mark-to-market accounting consisted of a barrage of accusations that the accounting method is to blame for the current credit crisis and the downturn in the economy as a whole.<sup>54</sup> For instance, the congressional letter to the SEC mentioned above states that fair-value accounting "has the unintended consequence of exacerbating economic downturns by hamstringing the ability of banks to make loans to consumers and businesses." Some analysts claim that as much as "70% of the real crisis that we face today is caused by mark-to-market accounting in an illiquid market."

The analysts making these claims recognized that the root cause of the problem is the widespread failure of mortgage loans.<sup>57</sup> Their argument,

<sup>&</sup>lt;sup>54</sup> See, e.g., Newt Gingrich, Suspend Mark-To-Market Now!, FORBES, Sept. 29, 2008, http://www.forbes.com/2008/09/29/mark-to-market-oped-cx\_ng\_0929gingrich.html (stating that mark-to-market accounting caused up to 70% of the crisis); R. CHRISTOPHER WHALEN, NETWORKS FINANCIAL INST. AT IND. STATE UNIV., THE SUBPRIME CRISIS—CAUSE, EFFECT AND CONSEQUENCES 6 (2008), available at http://papers.ssrn.com/sol3/papers.cfm? abstract id=1113888 (blaming mark-to-market for "making the collapse of the market for structured assets containing subprime debt a true catastrophe"); Francesco Guerrera & Jennifer Hughes, AIG Urges 'Fair Value' Rethink, FIN. TIMES, Mar. 13, 2008, http://www.ft .com/cms/s/0/1a0328fe-f12d-11dc-a91a-0000779fd2ac.html; Jennifer Hughes & Gillian Tett, An Unforgivable Eye: Bankers Cry Foul over Fair Value Accounting Rules, FIN. TIMES, Mar. 13, 2008, http://www.ft.com/cms/s/0/19915bfcf137-11dc-a91a-0000779f d2ac.html. Similar views were expressed by participants at the October 29 SEC Roundtable on Mark-to-Market Accounting held by the SEC, including William Isaac (former Chairman of the FDIC), Aubrey Patterson (Chairman and CEO of Bancorp South, Inc.), and Bradley Hunkler (Vice President and Controller of Western & Southern Financial Group). Letter from Cynthia M. Fornelli, supra note 51.

<sup>&</sup>lt;sup>55</sup> Congressional Letter, *supra* note 52.

<sup>&</sup>lt;sup>56</sup> BRIAN S. WESBURY & ROBERT STEIN, FIRST TRUST ADVISORS L.P., MARK-TO-MARKET MAYHEM 2 (2008), available at http://www.ftportfolios.com/Commentary/Economic Research/2008/9/25/mark-to-market\_mayhem.

<sup>&</sup>lt;sup>57</sup> *Id*.

however, is that the use of mark-to-market accounting exacerbated these problems and sent the financial markets into a "downward death spiral." <sup>58</sup>

## 1. The "Downward Death Spiral"

In the last few years, the housing market experienced a correction, which produced some of the largest decreases in home values in recent history. So As a result, the market experienced an increased number of defaults and foreclosures because the decline in home values left borrowers owing more on their mortgages than their homes were worth. The drop in housing values not only caused a decline in the value of the defaulting mortgages, but also caused a decline in the value of all mortgage-related securities. The companies holding these assets thus began making "fire sales" of their assets in an attempt to raise sufficient capital to meet regulatory requirements. Under a mark-to-market method of accounting, these fire sales become the new market price at which the company held securities are valued. Otherwise, nondistressed sellers will then prefer to stay out of the market for these products, leaving the market price to be determined by these forced, below-market sales.

This is where the so-called "downward death spiral" kicks in. The credit agencies see the declining capital margins of the companies holding these mortgage-backed securities, and they decrease those companies' credit ratings. This makes borrowing to meet the capital requirements even more difficult, and people become suspicious of buying mortgage-

<sup>&</sup>lt;sup>58</sup> See Gingrich, supra note 54; SEC REPORT, supra note 4, at 182.

<sup>&</sup>lt;sup>59</sup> Les Christie, *Home Price Drop Is Biggest Ever*, CNN MONEY, Jan. 29, 2008, http://money.cnn.com/2008/01/29/real estate/record drop in home prices/index.htm.

<sup>&</sup>lt;sup>60</sup> Bob Ivry, *U.S. Foreclosures Double as House Prices Decline*, BLOOMBERG, July 25, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=adFFhHtUhCLY&refer=home.

<sup>&</sup>lt;sup>61</sup> Gingrich, supra note 54.

<sup>&</sup>lt;sup>62</sup> *Id.* The Federal Deposit Insurance Corporation Improvement Act of 1991 includes mandatory capitalization requirements for insured depository institutions and requires banks to calculate and report these capital levels at the end of each quarter. SEC REPORT, *supra* note 4, at 100. Banks that are undercapitalized are subject to additional restrictions. *Id.* For this reason, banks are highly incentivized and encouraged to maintain high capital ratios on reserve. *See id.* 

<sup>&</sup>lt;sup>63</sup> Gingrich, *supra* note 54.

<sup>&</sup>lt;sup>64</sup> SEC REPORT, supra note 4, at 182.

<sup>&</sup>lt;sup>65</sup> Gingrich, supra note 54.

related securities.<sup>66</sup> The balance sheets of these companies then begin to show insolvency and the value of the company's stock dives.<sup>67</sup> The result, as some analysts see it, is the current credit crisis in the U.S. economy and the drastic drop in stock values in the markets discussed in this article's introduction.<sup>68</sup>

### 2. The True Cause of the Current Economic Crisis

The SEC study released in January 2009 explains that the immediate cause of the currently bleak economic conditions, which first affected the nation's banking industry, is not fair-value accounting.<sup>69</sup> Instead, the study blames the banks' failures on their inability to become adequately capitalized.<sup>70</sup> Most of the remaining failures were caused by liquidity problems and an inability to meet their depositors' needs.<sup>71</sup> In other words, the crisis was precipitated by a "run on the bank" and the banks inability to handle such a situation.<sup>72</sup>

These liquidity problems in the banking industry soon spilled over to other financial institutions and began to cause more widespread economic trouble.<sup>73</sup> Additional factors that played a role in the collapse of these financial institutions included concerns about asset quality, lending practices, risk management practice, and a failure of other financial institutions to extend credit to the institutions that were in need.<sup>74</sup> These concerns led to a rapid decline of lender and investor confidence in the financial institutions and resulted in the financial distress that the nation's economy has recently experienced.<sup>75</sup>

In reality, mark-to-market accounting serves only as the mechanism that sheds light on the current economic conditions. Fair-value accounting "does not make corporate earnings or balance sheets more volatile," it simply "increases the transparency of [the] volatility" that already exists in

<sup>&</sup>lt;sup>66</sup> Id.

<sup>&</sup>lt;sup>67</sup> *Id*.

 $<sup>^{68}</sup>$  See supra notes 51–52 and accompanying text; SEC REPORT, supra note 4, at 182.

<sup>&</sup>lt;sup>69</sup> SEC REPORT, supra note 4, at 3.

<sup>&</sup>lt;sup>70</sup> *Id.* at 101.

<sup>&</sup>lt;sup>71</sup> *Id*.

<sup>&</sup>lt;sup>72</sup> *Id.* at 3.

<sup>&</sup>lt;sup>73</sup> *Id.* at 136–38.

<sup>&</sup>lt;sup>74</sup> *Id.* at 136.

<sup>&</sup>lt;sup>75</sup> *Id.* at 138.

the market. Some analysts argue, "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 "77 or "firing the weatherman because it's raining." Suspending or eradicating mark-to-market accounting and SFAS 157 would only reduce the transparency of financial statements, which would reduce investor confidence. Therefore, the lack of investor confidence allegedly caused by this accounting methodology would, in reality, be exacerbated, rather than eliminated.

What truly undercuts the allegation that fair-value accounting was a primary cause of the current financial crisis is the accounting methodology itself. SFAS 157 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability *in an orderly transaction* between market participants at the measurement date." "An orderly transaction is one that is unforced and unhurried." The SEC acknowledged that the market for market-related securities is not "orderly." This should be a factor weighed when considering the available evidence of the value of the security. In such circumstances, "adjustments may be necessary to arrive at a more realistic fair value." Therefore, mark-to-market accounting does not require companies to mark their assets and liabilities down to the "fire sale" prices on the market.

<sup>&</sup>lt;sup>76</sup> Jesse Westbrook, SEC, FASB Resist Calls to Suspend Fair-Value Rules (Update2), BLOOMBERG, Sept. 30, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=adXpiEdV8aa4&refer=home.

<sup>&</sup>lt;sup>77</sup> *Id*.

<sup>&</sup>lt;sup>78</sup> Bill Mann, *How Not to Solve the Credit Crisis*, THE MOTLEY FOOL, Oct. 22, 2008, *available at* http://www.fool.com/investing/general/2008/10/22/how-not-to-solve-the-credit-crisis.aspx.

<sup>&</sup>lt;sup>79</sup> SARAH DEANS & DANE MOTT, J.P. MORGAN, *Lowering Standards: IASB Decision on Fair Value* 6 (Oct. 14, 2008), *available at* http://www.complianceweek.com/s/documents/LoweringStds.pdf.

<sup>&</sup>lt;sup>80</sup> SFAS 157, *supra* note 27, at ¶ 5 (emphasis added).

<sup>&</sup>lt;sup>81</sup> See RYAN, supra note 21, at 9.

<sup>&</sup>lt;sup>82</sup> See, e.g., Chris Isidore, *The Accounting Rule You Should Care About*, CNN MONEY, Oct. 1, 2008, http://money.cnn.com/2008/10/01/news/economy/mark\_to\_market/index.htm (noting massive write downs taken by banks and the reduction of banks' lending capacity); Westbrook, *supra* note 76 (pointing out that the SEC recently "encouraged companies to rely more on their own judgments").

<sup>&</sup>lt;sup>83</sup> Press Release No. 2008-234, 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 [hereinafter Clarifications].

<sup>&</sup>lt;sup>84</sup> Id.

The SEC and FASB issued a statement containing clarifications on fair-value accounting in September 2008. In that statement, the agencies encouraged companies to rely more on their own judgments and internal assumptions, such as expected cash flows, in determining the current value of illiquid assets and liabilities. The SEC and FASB explained that companies should first attempt to obtain market quotes for assets and liabilities. They then explained, "In weighing a broker quote as an input to fair value, an entity should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote . . . should be considered when weighing the available evidence." The argument that a company is strictly required to mark their assets and liabilities down to unrealistic values is therefore unfounded.

More evidence that fair-value accounting was not the primary cause of the bank failures and ensuing credit crunch in 2008 is provided in the findings of the SEC study presented to Congress in January 2009.<sup>89</sup> This study showed that the number of assets and liabilities marked to fair value is relatively small. Therefore, fair-value accounting had a less significant effect on the banking industry than opponents suggested.<sup>90</sup> For the twelve failed banks with total assets of less than \$1 billion that were included in the study, more than 80% of the loans were not subject to mark-to-market accounting requirements and were instead being valued at amortized (historical) cost.<sup>91</sup> These financial institutions had very few assets that were "accounted for on a recurring basis at fair value with changes" recognized in earnings.<sup>92</sup> The report included similar findings for banks with assets greater than \$1 billion that were involved in the study.<sup>93</sup> Therefore, the SEC found that the impact of mark-to-market accounting on

<sup>85</sup> Id

<sup>&</sup>lt;sup>86</sup> *Id.*; Westbrook, *supra* note 76.

<sup>&</sup>lt;sup>87</sup> Clarifications, *supra* note 83.

<sup>&</sup>lt;sup>88</sup> Id

<sup>&</sup>lt;sup>89</sup> SEC REPORT, *supra* note 4.

<sup>&</sup>lt;sup>90</sup> *Id.* at 105–07.

<sup>&</sup>lt;sup>91</sup> *Id.* As was discussed under Part II of this article, not all assets and liabilities are required to be reported at current fair value; rather, they may be properly presented in the financial statements at the value derived from some other appropriate measurement (such as amortized cost) depending on the instrument's classification. *See* discussion *supra* Part II.

<sup>&</sup>lt;sup>92</sup> SEC REPORT, supra note 4, at 105.

<sup>&</sup>lt;sup>93</sup> See id. at 107–14.

the financial positions of the banks was relatively insignificant, and thus, cannot be labeled a primary cause of the current economic turmoil. 94

# B. Fair-Value Measurement Requires Management to Make Unreliable Assumptions

There are attacks on the use of the current method of fair-value accounting that point to the use of management's assumptions as a flaw in the accounting method. There is a bit of truth to this argument, but recent statements from the SEC and FASB serve to mitigate these negative characteristics of fair-value accounting.

# 1. Unreliable Assumptions in Marking Assets and Liabilities to Market May Cause Problems

Those who oppose fair-value accounting claim that using management's assumptions as inputs to determine fair value undercuts the usefulness of financial statements to investors. 95 The SEC and FASB issued a statement clarifying that management may use assumptions and estimates in measuring the value of illiquid assets. 66 Level two inputs, which are permitted under SFAS 157, allow observable inputs of closely related assets and liabilities to be taken into account, creating a somewhat "adjusted mark-to-market" value. 97 "These adjustments can be large and judgmental in some circumstances."98 Additionally, level three inputs consist of unobservable information, such as the inability to sell the asset on the open market. 99 This allows for subjective assumptions that "are less accurate and more discretionary" to be included in the measurement of a company's assets and liabilities. 100 This has been referred to as a "markto-model" valuation, and it arguably gives companies choices about which valuation model to apply and which inputs to use when applying it. For example, under this model, companies may choose to use periods of historical data as an input. 101 This method, in essence, makes the output on financial statements unreliable, and therefore, less useful to investors. 102

<sup>&</sup>lt;sup>94</sup> *Id.* at 97.

<sup>&</sup>lt;sup>95</sup> *Id.* at 145.

<sup>&</sup>lt;sup>96</sup> Clarifications, *supra* note 83.

<sup>&</sup>lt;sup>97</sup> SFAS 157, *supra* note 27, at ¶ 28.

<sup>&</sup>lt;sup>98</sup> See RYAN, supra note 21, at 3.

<sup>&</sup>lt;sup>99</sup> SFAS 157, *supra* note 27, at ¶ 30.

<sup>&</sup>lt;sup>100</sup> See RYAN, supra note 21, at 3.

<sup>&</sup>lt;sup>101</sup> *Id*.

<sup>&</sup>lt;sup>102</sup> Id. at 17.

Some analysts suggest that financial-statement preparers could create hypothetical "orderly" transactions, and those transactions could be used in measuring the fair value of assets and liabilities in illiquid markets. However, the solicitation of actual market participants is not feasible because of time and cost restraints. Hypothetical transactions do not reflect the reality of an actual sale and do not reflect the value on the balance sheet date. Rather, they represent *hypothetical* sales on the *transaction date*. These factors, in addition to management assumptions and estimates discussed above, result in the presentation of less reliable and valuable information to financial-statement users.

# 2. The SEC's Clarifications of SFAS 157 Reduce the Negative Impact of Management Assumptions on Financial Statements

It is true that SFAS 157 allows companies to take into account management assumptions when determining the fair value of assets and liabilities in illiquid markets. However, the SEC and FASB statement, which clarified SFAS 157, explained in greater detail what inputs companies should consider in measuring the fair value of an asset or liability. It also explained what inputs should not be considered, such as counter-party credit risk and management's assumptions that liquidity will return to the market at some future time. Therefore, a company's management cannot simply choose the input that is in its best interest. Instead, there are clear, but flexible, limits to what a company can consider in marking an asset or liability to market. Thus, the items presented on the financial statements are, or at least should be, reliable.

In addition to the SEC and FASB guidelines on what is includable as inputs in determining fair value, there are other solutions to help address the unreliable output of financial-statement information under the mark-to-market method. For example, some analysts even suggest that companies should, in extreme cases, sell off a small portion of the actual asset or

<sup>&</sup>lt;sup>103</sup> *Id.* at 13.

<sup>&</sup>lt;sup>104</sup> *Id*.

<sup>&</sup>lt;sup>105</sup> *Id*.

<sup>&</sup>lt;sup>106</sup> Id.

<sup>&</sup>lt;sup>107</sup> See id. at 17.

<sup>&</sup>lt;sup>108</sup> See SFAS 157, supra note 27, at ¶ 30.

<sup>&</sup>lt;sup>109</sup> See Clarifications, supra note 83.

<sup>&</sup>lt;sup>110</sup> *Id*.

liability to get a true reading of an actual sale.<sup>111</sup> This would give indisputable evidence as to the market price of the asset or liability.

## C. Cost Concerns of Compliance with Mark-to-Market Standards

There are also concerns regarding the cost that companies must incur to adhere to the fair-value accounting standards. Those who criticize fair-value accounting point to the cost of compliance as one of the many reasons to eradicate this method. For example, mark-to-market requires monitoring systems that some allege only large institutions can afford.

FASB has not ignored these concerns. Specifically, it acknowledged and confronted this issue in the summary of SFAS 157, stating that some companies will need to make changes and create systems to comply with the requirements of SFAS 157. Additionally, the summary stated that companies might incur incremental costs in applying the requirements of SFAS 157. However, the benefits from increased consistency and comparability in fair-value measurements and the expanded disclosures about those measurements should be ongoing, and thus, worth the additional costs.<sup>114</sup>

Also, FASB was careful to include caveats in SFAS 157 to minimize any unnecessary costs. For example, FASB stated that companies "must not ignore information about market participant assumptions that is reasonably available *without undue cost and effort*." Provisions such as this reduce the unreasonable costs that some allege undercut the appropriateness and feasibility of mark-to-market accounting in real-world application.

#### IV. ALTERNATIVE METHODS

Perhaps the biggest problem relating to the suspension of fair-value accounting is the following unanswered question: If mark-to-market accounting standards are suspended, what replaces them? This part of the

Videotape: Roundtable on Fair Value Accounting and Auditing Standards, (SEC 2008), available at http://www.connectlive.com/events/secroundtable070908/. This idea was suggested informally by the roundtable participants. It is highly unlikely that this practice would ever be formally suggested, let alone required, by the SEC or FASB because of the understandable problem with requiring companies to involuntarily sell assets in a down market.

<sup>&</sup>lt;sup>112</sup> MICHEL CROUHY ET AL., RISK MANAGEMENT 445 (2001).

<sup>113</sup> Id

<sup>&</sup>lt;sup>114</sup> SUMMARY OF STATEMENT No. 157, *supra* note 27.

<sup>&</sup>lt;sup>115</sup> *Id.* (emphasis added).

article presents the alternative methods that have recently received attention in popular debate. These alternatives and modifications to fairvalue accounting include, *inter alia*, returning to a "cost-based measurement method," adopting a "pure mark-to-market" accounting model, using a "fundamental value" model, and using a modified model of fair-value accounting, such as a "rolling average" of fair values over a number of periods. All of these alternatives have particular strengths that enable those who propose adopting these methods or modifications to make convincing arguments in their favor. For this reason, some of these suggested alternatives should be adopted in some form or fashion. Others however, carry with them challenges and weaknesses that render their adoption impractical or ill-suited altogether.

## A. The Return to a Cost-Based Measurement Method of Accounting

The most commonly suggested alternative to fair-value accounting is amortized-cost accounting, which is a cost-based method of valuing assets and liabilities. Amortized-cost accounting was used for years before mark-to-market requirements took effect. Some analysts issued a call to return to these established standards. These analysts believe that it is destructive to have artificial mark-to-market accounting rules ruin companies that would otherwise survive under the rules that were previously in place. 119

Under an amortized-cost accounting model, assets and liabilities are valued using historic information about future cash flows and risk-adjusted discount rates. Amortized-cost accounting applies an economic-value approach to reporting financial-statement items and is based on discounted-cash-flow analysis of anticipated income streams from the securities. Unlike mark-to-market, in amortized-cost accounting,

RYAN, *supra* note 21, at 5. The amortized-cost accounting method is a cost-based method in that it reports the value of the asset or liability on the balance sheet at its original cost with an allowance for depreciation or amortization over time.

<sup>&</sup>lt;sup>117</sup> Gingrich, *supra* note 54.

<sup>&</sup>lt;sup>118</sup> *Id.*; Eugene H. Flegm, *The Need for Reliability in Accounting: Why Historic Cost Is More Reliable than Fair Value*, J. ACCOUNTANCY, May 2008, at 37–39, *available at* http://www.journalofaccountancy.com/Issues/2008/May/TheNeedForReliabilityInAccounting.

<sup>&</sup>lt;sup>119</sup> Gingrich, supra note 54.

<sup>&</sup>lt;sup>120</sup> See Flegm, supra note 118.

<sup>&</sup>lt;sup>121</sup> Gingrich, *supra* note 54.

unrealized gains and losses are not realized until they are disposed of or they mature.  $^{122}$ 

# 1. Arguments in Favor of Adopting a Cost-Based Method of Accounting

There are several arguments in support of amortized-cost accounting. Proponents of the amortized-cost accounting method claim that the inputs taken into consideration in valuing assets under this model are more reliable and verifiable. Additionally, they argue that the gains and losses on assets and liabilities that flow through the income statement under fairvalue accounting are irrelevant when firms intend to hold those assets or liabilities to maturity. This is because the company will eventually receive or pay the full amount promised on these securities.

There are also arguments in favor of amortized-cost accounting that relate to the arguments against fair-value accounting discussed above. <sup>126</sup> As with most other alternative valuation methods suggested, the amortized-cost method would not result in the "calling-in" of mortgages whose collateral has decreased in value below the carrying amount of the outstanding loan. <sup>127</sup> Under this reasoning, there would not be the initial markdown in the value of the balance sheet items to "fire sale" values. <sup>128</sup> Arguably, this would stop what some have called a "downward death spiral" of credit problems that have plagued our credit markets and the economy as a whole in recent months. <sup>129</sup>

# 2. Arguments Opposing the Adoption of a Cost-Based Method of Accounting

As discussed above, proponents of a cost-based method of accounting give sound reasons for using amortized-cost accounting as the standard for reporting assets and liabilities on financial statements. However, the

<sup>&</sup>lt;sup>122</sup> See Flegm, supra note 118.

<sup>&</sup>lt;sup>123</sup> See id.

<sup>124</sup> See Shorter, supra note 9, at 11.

<sup>125</sup> Id.

<sup>&</sup>lt;sup>126</sup> See discussion supra Part III (noting that the argument that fair-value accounting was a contributing cause of the current housing crisis, in part because the decline in housing prices in recent history caused mortgage companies to foreclose on homeowners whose home value fell below the balance of the outstanding loan).

<sup>&</sup>lt;sup>127</sup> See Gingrich, supra note 54.

<sup>&</sup>lt;sup>128</sup> *Id*.

<sup>&</sup>lt;sup>129</sup> *Id*.

pitfalls of this method outweigh its positive attributes. Under a cost-based method, income is typically constant and steady for as long as a company holds its assets and liabilities. This can mislead investors. When the assets and liabilities are eventually sold or mature and are replaced with new assets and liabilities at current market terms, income may fluctuate suddenly and significantly. 132

Additionally, there are concerns with inconsistency and timeliness under amortized-cost accounting. Assets and liabilities incepted at different times may be accounted for using different historical information and discount rates, yielding inconsistent and untimely accounting. <sup>133</sup> In practice, amortized-cost accounting is usually not applied in its pure form; rather, assets and liabilities are subject to impairment write-downs. 134 It is argued that this approach results in a more realistic, middle of the road value for the assets and liabilities that typically falls between fair value and the value arrived at through amortized-cost accounting in its pure form. 135 However, this method is flawed in the same way that mark-to-market is flawed: it allows companies to consider estimates, assumptions, and subjective judgment in determining the value of its assets and liabilities, which can result in inaccurate reporting because of the difficulties related to forecasting and estimating the required rate of return used to discount future income. 136 Further inconsistency results from the fact that similar assets are valued based on differing purchase prices, meaning identical individual assets will have different values. 137 Therefore, the adoption of this cost-based method of accounting does little to resolve the issues raised relating to the mark-to-market method.

Another reason that it may be inappropriate to employ a cost-based method for all balance sheet items is the ability of companies to take advantage of an activity referred to as "gains trading" under such a cost-based method. Under mark-to-market accounting, companies report assets and liabilities at fair value on the balance sheet and the gains and losses

<sup>&</sup>lt;sup>130</sup> See RYAN, supra note 21, at 4.

<sup>&</sup>lt;sup>131</sup> *Id*.

<sup>&</sup>lt;sup>132</sup> *Id*.

<sup>&</sup>lt;sup>133</sup> *Id*.

<sup>&</sup>lt;sup>134</sup> *Id*. at 6.

<sup>135</sup> Id

<sup>&</sup>lt;sup>136</sup> *Id.*; see also SEC REPORT, supra note 4, at 176 ("Implementation challenges for valuation under a pure historical cost accounting system center around appropriate matching, forecasting, and estimation of a required rate of return.").

<sup>&</sup>lt;sup>137</sup> SEC REPORT, *supra* note 4, at 180.

flow through the income statement each period. Alternatively, amortized-cost accounting allows a company to accumulate the unrealized gains and losses because the assets are not marked to fair value. This occurs because the true value is more or less than what is shown on the company's financial statements. These companies can intentionally hold assets with offsetting risks, thereby keeping the aggregate of risk within company guidelines while at the same time receiving above riskless rates of return on individual assets. Because one side of a company's assets will have a cumulative unrealized gain and the other side will have a cumulative unrealized loss, the company can selectively dispose of particular assets to raise or lower its net income at its discretion. This tactic, which could potentially allow for abuse of the cost-based accounting rules, should encourage standard-setting bodies to steer away from an across-the-board amortized-cost accounting system.

Proponents argue that requiring particular financial statement disclosures would mitigate the effects of gains trading. However, simply requiring disclosure of these assets and liabilities would provide little value to investors because the required disclosures have historically been quite limited in scope and it is difficult to conduct an analysis with such information. 144

### B. A Pure Mark-to-Market Model as an Alternative

Surprisingly, amidst the attack on mark-to-market accounting, some analysts are actually calling for a change to a pure mark-to-market model. Under a pure mark-to-market accounting model, a company would report all assets and liabilities at fair value rather than valuing some securities on a cost-based method, which is the standard used under the current mixed-attribute model. 145

<sup>&</sup>lt;sup>138</sup> See RYAN, supra note 21, at 3–4.

<sup>&</sup>lt;sup>139</sup> *Id.* at 5.

<sup>&</sup>lt;sup>140</sup> *Id*.

<sup>&</sup>lt;sup>141</sup> *Id*. at 6.

<sup>&</sup>lt;sup>142</sup> *Id.* at 5.

<sup>&</sup>lt;sup>143</sup> *Id*. at 6.

<sup>&</sup>lt;sup>144</sup> *Id*.

<sup>&</sup>lt;sup>145</sup> *Id.* at 8.

## 1. Arguments in Favor of Adopting a Pure Mark-to-Market Model of Accounting

These analysts believe that the primary flaw with the current model as applied today is not mark-to-market, but rather the mixed-attribute accounting model discussed above. They argue that this method of accounting allows firms to choose the measurement attribute to apply to assets and liabilities through how they classify the position. Specifically, SFAS 159 states that a company may "choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value." Thus, companies have discretion as to what method they can apply to certain assets and liabilities. This discretion, some argue, allows for manipulation and inconsistency in the reporting of the net value and risks of financial institutions' portfolios, making financial statements unreliable. As a solution to these problems, those in favor of a pure mark-to-market model suggest using fair-value accounting for all financial institutions' instruments, rather than allowing or requiring different methods for different instruments.

# 2. Arguments Opposing the Adoption of a Pure Mark-to-Market Model of Accounting

Although the adoption of pure mark-to-market accounting as the standard for all financial instruments would provide investors with important information regarding the current financial position of an entity, there are problems that make its adoption impractical. The presentation of all assets and liabilities at their current exit value is inappropriate and not useful to investors when the company expects to continue its operations as an ongoing entity.<sup>151</sup> Additionally, there are implementation issues, such as the difficulty in obtaining accurate and reliable values for the various balance sheet items being valued.<sup>152</sup>

<sup>&</sup>lt;sup>146</sup> See id. at 7–8 (discussing how the mixed-attribute accounting model is limited and unsatisfying for financial instruments).

<sup>&</sup>lt;sup>147</sup> *Id.* at 8.

 $<sup>^{148}</sup>$  Fin. Accounting Standards Bd., Statement of Financial Accounting Standards No. 159 ¶ 1 (2007) [hereinafter SFAS 159].

<sup>&</sup>lt;sup>149</sup> See RYAN, supra note 21, at 8.

<sup>150</sup> Id

<sup>&</sup>lt;sup>151</sup> SEC REPORT, *supra* note 4, at 181 (citation omitted).

<sup>&</sup>lt;sup>152</sup> *Id.* at 175.

The current mixed-attribute model is in place for several reasons. Proponents point to these reasons as support for the current mixed-attribute accounting standards. First, the current fair-market value of an asset or liability is not always the most relevant value for all classes of assets. For example, the future cash flows of assets held until maturity may be more relevant to financial statement users than the current market value of that asset if it was sold. Thus, providing the current fair-market value would not give an investor the most relevant information available.

Also, SFAS 159 requires management to disclose its reasons for electing, in whole or in part, the option to report the asset at fair value. Horeover, it requires the company to disclose what the earnings would have been if the company used the fair-value method rather than the method it actually employed. These disclosures give investors a plethora of information that they can use in analyzing the financial statements and presents the statements in a way that the company believes is the most accurate and relevant. In fact, investment bankers often do not take a company's financial statements at face value; rather, bankers often look much deeper. These bankers typically make adjustments where they deem appropriate and look to the note disclosures for supplemental information they believe they should consider. For these reasons, using the mixed-attribute standard provides more information to the investor than the pure mark-to-market model.

### C. Fundamental-Value Accounting Standards as an Alternative

In a September 2008 letter to the SEC, several members of Congress suggested that mark-to-market accounting be immediately suspended and replaced with a fundamental-value accounting method "that more accurately reflects the true value of the asset." Others echoed this view,

<sup>153</sup> See Robert McCabe, Why Do Bankers Oppose the Use of Fair Value?, April 23, 2008, http://www.glgroup.com/News/Why-do-bankers-oppose-the-use-of-fair-value--23996.html (discussing the reasons for supporting the mixed-attribute accounting standards, such as "assets like investments in debt securities are stated at fair value and others perhaps at original coast modified for unamortized discount or premium").

<sup>&</sup>lt;sup>154</sup> See id.

<sup>&</sup>lt;sup>155</sup> See id.

<sup>&</sup>lt;sup>156</sup> *Id.*; SFAS 159, *supra* note 148, at ¶ 18.a.

<sup>&</sup>lt;sup>157</sup> McCabe, *supra* note 153; SFAS 159, *supra* note 148, at ¶ 19.d.

<sup>&</sup>lt;sup>158</sup> See, e.g., SEC REPORT, supra note 4, at 142, 144.

<sup>159</sup> Id. at 146.

<sup>&</sup>lt;sup>160</sup> Congressional Letter, *supra* note 52.

calling for a valuation method based on the estimated future cash flows over the useful life of an asset or liability. Therefore, if there is no decline in the future expected cash flows of the instrument, there will not be a decline in the asset's fundamental value and no accompanying write-down. The state of the companying write-down.

There are, however, implementation issues that make the adoption of a fundamental-value method less desirable. The valuation of financial instruments under this method would be based on the present value of estimated future cash flows, which would require making a number of assumptions and estimates to determine their values. Consequently, there is uncertainty in determining what cash flow estimates are reasonable and whether these estimates should be based on management's estimates or those implied in the market. Under either approach, the problems with mark-to-market accounting will not be resolved. If fundamental-value accounting allows management to determine estimated future cash flows and the applicable discount rate, then it will rely on the same kind of subjectivity and give rise to the same investor skepticism that plagues the mark-to-market method. If market implications and trends are used to determine the estimated future cash flows, the value under the fundamental-value and the fair-value approaches tend to converge.

Additionally, one could argue the benefits that would come from permitting a fundamental-value model are already available to some extent in the current fair-value model. Level three inputs permitted in the case of illiquid markets allow management to consider estimates in addition to the market data related to the value of the instrument. Although these estimates should be based on management's assumptions of market participants rather than company-specific assumptions, the fair-value model still can incorporate the concept of fundamental value in its current form of application. 169

<sup>&</sup>lt;sup>161</sup> SEC REPORT, supra note 4, at 186.

<sup>&</sup>lt;sup>162</sup> *Id*.

<sup>&</sup>lt;sup>163</sup> Id. at 187.

<sup>&</sup>lt;sup>164</sup> *Id.* at 186.

<sup>&</sup>lt;sup>165</sup> *Id*.

<sup>&</sup>lt;sup>166</sup> SEC REPORT, *supra* note 4, at 186; RYAN, *supra* note 21, at 7 (discussing the potential for institutional risk management to be mistaken for speculation).

<sup>&</sup>lt;sup>167</sup> SEC REPORT, supra note 4, at 186.

<sup>&</sup>lt;sup>168</sup> SFAS 157, supra note 27, at 12; see also Clarifications, supra note 83.

<sup>&</sup>lt;sup>169</sup> SFAS 157, *supra* note 27, at 12.

## D. Suggested Modifications and Improvements to the Current Fair-Value Accounting Model

Rather than calling for a reversion to the old traditional methodology for valuing securities (amortized cost) or a complete makeover into a new valuation standard (pure mark-to-market), many analysts suggest that the private-accounting sector or the legislature should make modifications to the current mark-to-market method, while retaining its main principles. <sup>170</sup> In fact, even some of the analysts who believe that fair-value accounting has been a primary cause of the current economic conditions, because of its alleged downward spiral or pro-cyclical effect, agree that fair-value accounting is preferable over the various alternatives. <sup>171</sup> However, they note that some modifications may be necessary to diminish these effects. <sup>172</sup>

# 1. Use of a Rolling Average to Value Instruments Under Fair-Value Accounting Standards

Some analysts proposed the use of a rolling average of mark-to-market prices in measuring assets and liabilities for financial statement presentation. They claim this is a more workable system and lessens the impact of value changes that exists under the mark-to-market method by using the value of the instrument over some period of time. Under this reasoning, when there is a temporary impairment in asset values due to marketplace and economic events, regulators must give institutions an opportunity to survive the temporary impairment rather than marking the assets to fire-sale prices. 175

<sup>&</sup>lt;sup>170</sup> See, e.g., SEC REPORT, supra note 4, at 7–10 ("Advisability and Feasibility of Modifications to Fair Value Accounting Standards.").

<sup>&</sup>lt;sup>171</sup> See, e.g., Jodi Scarlata et al., Fair Value Accounting and Procyclicality, Global Fin. Stability Rep., Oct. 2008, at 109 (noting that although weaknesses within the fair value method "may introduce unintended volatility and pro-cyclicality . . . it is still the preferred accounting framework for financial institutions").

<sup>&</sup>lt;sup>172</sup> *Id.* ("[C]apital buffers, forward-looking provisioning, and more refined disclosures can help to mitigate the procyclicality of [fair-value accounting].").

<sup>&</sup>lt;sup>173</sup> See, e.g., Gingrich, supra note 54 (calling for a three-year rolling average to measure the fair value of assets and liabilities). See also Carsten Zielke, Michael Starkie & Thomas Seeberg, Reporting Move Could Break the Writedown Spiral, FIN. TIMES, Apr. 23, 2008, at 27, available at http://us.ft.com/ftgateway/superpage.ft?news\_id=fto040220081901006886 (calling for a six-month or twelve-month rolling average to measure fair value of assets and liabilities).

<sup>&</sup>lt;sup>174</sup> See Gingrich, supra note 54.

<sup>&</sup>lt;sup>175</sup> See id. (quoting former FDIC Chairman William Isaac).

As with other alternative measurement methods, there are implementation issues that accompany the rolling-average method that make it less desirable than other options. Most importantly, the asset and liability values presented on the financial statements under such a method could only be characterized as an average price or value. Presenting average prices or values would reduce investor confidence in the accuracy and usefulness of the financial statements of the entity. Furthermore, it is unclear what an appropriate length is for the evaluation period; suggestions ranged from as short as a matter of days to as long as three years. Lastly, the SEC and FASB have tried to avoid establishing such bright-line rules by setting accounting standards in an attempt to move towards principle-based or objective-oriented accounting standards.

# 2. Improved Guidance Regarding Fair-Value Measurement in Illiquid and Disorderly Markets

Another modification suggested is an improvement to SFAS guidance regarding fair-value measurement to help cope with illiquid or otherwise disorderly markets.<sup>179</sup> This suggestion stems from the current requirement that a company provide convincing evidence that the method employed in determining fair value is appropriate so as to not be forced to use lower-level inputs.<sup>180</sup> Being forced to use lower-level inputs could result in even larger unrealized losses for those companies.<sup>181</sup> Specifically, companies need to know what constitutes "convincing evidence."

The SEC partially resolved this issue through releasing its clarifications of fair-value accounting, which gives those who prepare financial statements a better picture of how the SEC interprets SFAS 157 in the current illiquid market. However, some would like to see the SEC release examples and more detailed statements on *how* and *when* the inputs allowed under SFAS 157 should be applied rather than simply explaining *what* is appropriate to consider in measuring fair value. 183

<sup>&</sup>lt;sup>176</sup> SEC REPORT, *supra* note 4, at 187.

<sup>&</sup>lt;sup>177</sup> *Id.* (citation omitted).

<sup>&</sup>lt;sup>178</sup> Id.

<sup>&</sup>lt;sup>179</sup> RYAN, *supra* note 21, at 13.

<sup>&</sup>lt;sup>180</sup> Id.

<sup>&</sup>lt;sup>181</sup> *Id*.

<sup>&</sup>lt;sup>182</sup> Clarifications, *supra* note 83.

<sup>&</sup>lt;sup>183</sup> See SEC REPORT, supra note 4, at 8 (listing potential measures for improving fair value measurement application and practices). Participants at the SEC Roundtable on (continued)

# 3. Relaxing Sarbanes-Oxley Regulations to Alleviate the Negative Effects of Fair-Value Accounting

There has been a call for modifications to the Sarbanes-Oxley laws that impose criminal sanctions for accounting fraud. Analysts argue that if the criminal sanctions were less strict, accountants and executives would not panic and undervalue assets and liabilities when the market shows slight fluctuations or when they must employ some discretion in determining fair-market value. Arguably, if Sarbanes-Oxley were loosened or repealed, the downward spiral effect that was allegedly the primary cause of the current financial crisis would not have taken place. However, the criminal sanctions were imposed for a reason. The Enron scandal and other scandals in the late 1990s and early 2000s ignited the debate on government oversight of the accounting profession, and Sarbanes-Oxley was the result. These concerns still exist today, making regulators uneasy about repealing or amending the law.

# 4. Increased Disclosure Requirements to Accompany Fair-Value Accounting Standards

In addition to suggesting various modifications, there has been a call to maintain the mixed-attribute model of accounting, but to require increased disclosure in the financial statements. Financial-statement disclosures are required to allow for full disclosure of information to investors and other users of financial statements that "is better provided, or can only be provided, by notes to financial statements or by supplementary information or other means of financial reporting" to enhance the transparency of the statements. These disclosures require, *inter alia*, "a discussion of known trends, demands, commitments, uncertainties, and events that are reasonably likely to materially affect the issuer's financial condition,

Mark-to-Market accounting in July 2008 also made suggestions. Roundtable on Fair Value Accounting and Auditing Standards, *supra* note 111.

<sup>187</sup> See id. at 659-60.

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<sup>&</sup>lt;sup>184</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

<sup>&</sup>lt;sup>185</sup> See Coalson, supra note 23, at 659.

<sup>&</sup>lt;sup>186</sup> *Id.* at 649.

 $<sup>^{188}</sup>$  See, e.g., Joseph-Bell, supra note 10; see also SEC REPORT, supra note 4, at 184; RYAN, supra note 21, at 6–7.

FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS No. 5: Recognition and Measurement in Financial Statements of Business Enterprises, ¶ 7 (1984), available at http://www.fasb.org/pdf/aop CON5.pdf.

results of operations, or liquidity, as well as other information that provides context to the financial statements." <sup>190</sup>

SFAS 157 significantly expanded the disclosures required for items measured under the fair-value method, especially those instruments that fall under Level three of the hierarchy discussed above. Financial-statement users have supported the SEC and FASB in expanding disclosure requirements stating "the need to supplement fair-value accounting with robust disclosure of the underlying assumptions and sensitivities, particularly when fair value estimates are necessary in the absence of quoted prices."

However, some financial-statement users are calling for even more enhanced disclosures or for other changes to the presently required disclosures. For instance, users recommend that disclosures "include more information on the methods [and inputs] used" in applying fair value to the financial statement items "along with the . . . assumptions [that were made] and [the] sensitivit[ies] around those assumptions." Other disclosures suggested include listing forward-looking information relating to the expected value of investments over the life of the asset or upon maturity and consolidating fair-value disclosures into a single location rather than permitting those disclosures to be spread throughout the financial statements. This would make the financial statements more valuable to investors and would increase investor confidence in the presented values of the instruments.

Between December 2007 and September 2008, the SEC issued three "Dear CFO" letters to public companies that provided guidance and encouraged companies to voluntarily provide more transparent and complete disclosures related to fair-value accounting. These letters

<sup>&</sup>lt;sup>190</sup> SEC REPORT, supra note 4, at 19.

<sup>&</sup>lt;sup>191</sup> SFAS 157, supra note 27, at 3; SEC REPORT, *supra* note 4, at 87, 89.

<sup>&</sup>lt;sup>192</sup> SEC REPORT, supra note 4, at 145.

<sup>&</sup>lt;sup>193</sup> Id. at 150–51.

<sup>&</sup>lt;sup>194</sup> Id. at 146.

<sup>&</sup>lt;sup>195</sup> *Id.* at 151.

<sup>196</sup> Id. at 146.

<sup>&</sup>lt;sup>197</sup> *Id*.

<sup>198</sup> Sample Letter from the Div. of Corp. Fin., SEC to Certain Public Companies (Dec. 2007), available at http://www.sec.gov/divisions/corpfin/guidance/cfoffbalanceltr1207.htm; Sample Letter from Div. of Corp. Fin., SEC to Certain Public Companies (Mar. 2008), available at http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm; [hereinafter March 2008 Letter]; Sample Letter from Div. of Corp. Fin., SEC to Certain (continued)

identified current disclosure issues. Additionally, they included a call for additional disclosures regarding the Level three estimates used as inputs in the fair-value calculations, as well as a discussion of how sensitive the fair-value estimates are to the inputs used in the valuation technique or model. In the "Dear CFO" letters and in other recently released guidance materials, the SEC encouraged companies to comply with several financial-statement user suggestions mentioned above. For example, in SFAS 157 companies were encouraged to combine the fair-value information disclosed with other fair-value information to make the financial statements clearer, and thus, more valuable to investors.

In the SEC Report released in January 2009, the Commission noted that recent releases by the SEC and FASB have called for enhancements to companies' voluntary disclosures. However, this call has largely gone unanswered. There are several potential reasons for this lack of compliance. The SEC Report notes that the underlying reason that there has been little change in the disclosures is due to their voluntary, rather than mandatory, nature. The report points to the desire of companies to avoid costly litigation that may arise from inaccurate disclosure made on a voluntary basis. Companies tend to shy away from voluntary disclosure because of the harsh penalties imposed on companies since the highly publicized scandals of the last decade and a half, such as the Enron scandal. Lastly, there are concerns among both financial-statement preparers and users that providing too much disclosure, required or

Public Companies (Sept. 2008), *available at* http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0908.htm [hereinafter September 2008 Letter] (follow-up letter to March 2008 letter).

<sup>204</sup> Id.

<sup>&</sup>lt;sup>199</sup> March 2008 Letter. supra note 198.

<sup>&</sup>lt;sup>200</sup> September 2008 Letter, *supra* note 198.

<sup>&</sup>lt;sup>201</sup> SUMMARY OF SFAS 157, supra note 27; March 2008 Letter, supra note 198.

<sup>&</sup>lt;sup>202</sup> SEC REPORT, *supra* note 4, at 172.

<sup>&</sup>lt;sup>203</sup> Id.

 $<sup>^{205}</sup>$  Id

<sup>&</sup>lt;sup>206</sup> Christopher A. Wray & Robert K. Hur, *Corporate Criminal Prosecution in a Post-Enron World: The Thompson Memo in Theory and Practice*, 43 Am. CRIM. L. REV. 1095, 1134 (2006).

otherwise, may result in "disclosure overload," making the financial statements less useful and less valuable to investors. <sup>207</sup>

### V. CONCLUSION

The debate sparked by the current economic crisis threatens the existence of fair-value accounting as we know it. Those who are attacking its appropriateness make strong arguments about its role in the current crisis and its reliability in general. However, these arguments are often exaggerated, unfounded, or simply outweighed by the benefits that fair-value accounting provides. Of course, no method of accounting is perfect. The key flaw in the argument proposing eradication or suspension of the fair-value accounting standard is the lack of viable alternatives.

The SEC and FASB should continue their defense of fair-value accounting, even under the current economic conditions. Specifically, they should ignore the call to suspend the application of fair-value accounting as defined in SFAS 157. Prior to SFAS 157, no single accounting standard clearly defined or codified measurement principals, and those principles were applied differently under the various accounting standards that existed. Therefore, suspension of fair-value accounting alone would only cause a reversion to less consistency and more confusion among financial-statement preparers and users. Furthermore, a reversion from fair-value accounting in general to prior standards and methodologies would only result in more inconsistency and would diminish investor confidence, likely making the current economic situation even worse.

Fair-value accounting was not the primary cause of the current economic conditions; rather, it only revealed the weakness that already existed among various institutions. To suspend SFAS 157 or fair-value accounting as a whole would be akin to, as some have put it, "shooting the messenger." As the SEC Report on fair-value accounting suggests, "it is

<sup>&</sup>lt;sup>207</sup> See, e.g., Arthur J. Radin, Have We Created Financial Statement Disclosure Overload?, THE CPA JOURNAL, Nov. 2007, available at http://www.nysscpa.org/cpajournal/2007/1107/perspectives/p6.htm.

<sup>&</sup>lt;sup>208</sup> See discussion supra Part III.A–B.

<sup>&</sup>lt;sup>209</sup> SEC REPORT, *supra* note 4, at 22.

<sup>&</sup>lt;sup>210</sup> See discussion supra Part IV.A.

<sup>211</sup> Id

<sup>&</sup>lt;sup>212</sup> See discussion supra Part IV.A.2.

<sup>&</sup>lt;sup>213</sup> See, e.g., SEC REPORT, supra note 4, at 12; Dane Mott & Sarah Deans, Shooting the Messenger, J.P.Morgan, Sept. 29, 2008, available at http://techspill.com/fin20/wp-content/uploads/2008/10/shooting-the-messenger.pdf.

more appropriate to instead look at the underlying economic causes of the global financial crisis (which may include aspects of effective risk management, availability of liquidity, increasing volume of activities in largely unregulated financial instruments, and counter-party confidence)."<sup>214</sup>

There are, however, some improvements that could be made that do not threaten the accounting model. For example, the SEC should provide financial-statement preparers with additional guidance on the actual application of the rules and the use of the inputs in determining an asset or liability's fair value. Companies should be informed as to what constitutes convincing evidence in support of the method applied in their financial statements. In addition, the SEC and FASB should consider the use of a rolling average of market values as a potential input, but not the only input, in determining fair value. However, the suggestion that the government repeal Sarbanes-Oxley goes too far.<sup>215</sup> Doing so would encourage accounting fraud and misuse of management estimates in the application of mark-to-market accounting.

The most important improvement to fair-value accounting as it is currently applied involves enhanced disclosures. Companies should be *required* to disclose material information regarding the fair-value calculations of all significant assets and liabilities presented in the financial statements. Concerns that financial statements will become less valuable due to an overload of information are commendable, but investors have largely supported increased and enhanced disclosures despite these concerns<sup>216</sup>

The changes in financial-statement disclosures should not, however, be one-sided in favor of investors. Accounting standards should permit companies to provide information in the notes to the financial statements that they believe will increase investor and creditor confidence, such as the value of the assets and liabilities based on other valuation methods that management perceives as more reflective of the true value of the entity. These improved disclosure requirements, along with the improved guidance on the implementation of mark-to-market accounting, will

<sup>&</sup>lt;sup>214</sup> SEC REPORT, *supra* note 4, at 183.

<sup>&</sup>lt;sup>215</sup> See discussion supra Part IV.D.3.

<sup>&</sup>lt;sup>216</sup> JOHN O'ROURKE, THE FUTURE OF FINANCIAL REPORTING: A MARKET PERSPECTIVE 2 (Oracle 2008), *available at* http://www.oracle.com/appserver/business-intelligence/hyperion-financial-performance-management/docs/hyperion-wp-futurefinance.pdf.

increase investor confidence and help rebound the economy, a result which fares well for all interested parties.