[By-Lined Article]

Fair Value Accounting Leads to Volatility; Volatility Leads to Litigation

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Did fair value accounting standards, issued by the Financial Accounting Standards Board, and required to be applied for fiscal years ending subsequent to November 2007, hasten the onset of the current economic and financial crisis? What will be the impact of these standards on legal and accounting activities in the future? What will be the impact of FASB's April 2009 rule change giving financial institutions more flexibility in valuing assets? These unknowns are one of the most hotly contested debates in the accounting profession today, and one that is likely to reverberate through accounting and legal circles, with significant impact, for years to come. The subprime meltdown, the massive write-downs in complicated mortgage-related securities, the recent failures of and threats to financial institutions, the continuing write-down of goodwill by public companies and the current credit crisis have focused enormous attention on the methods used to determine asset values reported in financial statements, hence the increased levels of focus and the urgent nature of appropriate fair value accounting.

New accounting rules surrounding fair value measurements likely will serve as a catalyst for legal claims, particularly as companies in the process of asset acquisition negotiations assert material adverse changes in the valuation of target assets based upon the application of new and untested asset valuations. When the current economic crisis ends, some experts predict a surge in lawsuits directed at companies that are in the midst of making deals while simultaneously applying the new fair value rules.

The new standards for fair value accounting are reflected in Statement of Financial Accounting Standards No. 157, or FAS 157, were effective for both annual and quarterly financial statements issued under generally accepted accounting principles, or GAAP, for fiscal periods beginning after Nov. 15, 2007. FAS 157 creates a single definition of fair value, establishes a framework for measuring fair value and requires enhanced disclosures surrounding an entity's fair value measurements.

Before this standard was promulgated, there were various definitions of fair value and limited guidance for applying those definitions within the realm of GAAP. This lack of guidance, and the differences in what limited advice the guidance provided, added to the ever-increasing complexity of applying GAAP. There is wide belief that this inconsistent application of GAAP, coupled with different views of how fair value should be measured, led to misleading financial statements, which some believe contributed, at least in part, to the current economic downturn.

Some critics feel the rules prior to the April 2009 amendment by FASB are also part of the cause of the current financial downturn. Many have called for eliminating the current guidelines, revisiting the issue and proposing a fresh look. The Securities and Exchange Commission released a report to Congress Dec. 30, 2008, on the fair value accounting rules and argued that the suspension of fair value accounting to return to historical cost-based measures would likely increase investor uncertainty. The report also stated that fair value and mark to market accounting do not appear to be the cause of bank and other financial institution failures. Paul Volcker, a top economic adviser to President Obama, has signed off on a financial reform program that may be more sympathetic to the views of those in the financial sector than the current FASB's fair value regime has been thought to be.

Under the new rules, fair value is based on market measures, or in limited cases, estimates of them. FAS 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. The significant difference in the new perspective of fair value is that the definition no longer resides in the old "price exchange between a willing buyer and willing seller in an arm's length transaction" theory, but focuses more on market-based measurements. This is vastly different from historical definitions of fair value.

FAS 157 establishes a hierarchy of fair value measurements for financial disclosure that will increase consistency and comparability in fair value measurements:

- Level 1 inputs are observable assumptions that reflect quoted prices for identical assets or liabilities in active markets such as a stock that trades on a stock exchange.
- Level 2 inputs are assumptions, other than quoted prices, that are observable either directly or indirectly for similar assets and liabilities in active markets.
- Level 3 inputs are unobservable inputs. These could be an entity's internal valuation model that incorporates management assumptions that cannot be corroborated with observable market data.

The new fair value measurement guidelines also include assumptions about risk, previously ignored under the old definition, inherent in a particular fair value measurement technique, such as an economic pricing model. If market participants would normally include risk assumptions in the pricing related to asset and liability transfers, then those assumptions should be included in current fair value measurements. This is a far different approach from previous fair value definitions, where risk assumptions were not considered.

These substantial differences in the measurement of fair value have caused tension throughout the financial community. Financial institution executives contend that the requirements of the fair value measurement standards have forced the valuation of their assets at artificially low prices, resulting, in part, in the onslaught of the current credit crisis, while investor groups and accounting standard setters believe that the new rules provide a much needed transparent look to financial reporting, which can only strengthen capital markets in the long term. It is certainly evident that recent large write-downs resulting from fair value measurements most likely have attributed to rapid deteriorations in credit market conditions, primarily in the broker-dealer and banking industries, however, this provides support for the position that reporting assets at fair value, particularly financial instruments, is critically important. Despite the various challenges to the new rules, by the end of 2008, it appeared that investor groups won, as the SEC agreed with and affirmed that the FASB's fair value rules should stand as issued.

However, as recently as early April 2009, the FASB again succumbed to government pressure and revised the rules yet again to give financial institutions more judgment in deciding how to determine asset valuation when the markets for those assets are either not functioning, or functioning below expectation, as in the case of mortgage backed securities. As part of the change the FASB changed the definition of fair value to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. This change may bolster financial institutions' financial position and profitability by allowing asset valuations at levels above true market conditions, as banks claim that because these assets still pay cash flow streams, and the probability that those streams will cease is low, they should be taken into account, and not ignored, when valuing the assets. Banks argue that ignoring these factors in valuation does not allow presentation of true value when markets for those assets are distressed. Opponents of this change argue that this will cloud the waters for investors further as it will be difficult to determine whether financial institutions are accurately assessing the value of their assets. The issue is still quite volatile and the rules will likely be tested in court.

Legal Implications

When an organization adopts FAS 157, from an accounting perspective, the adoption is effectuated by recording a cumulative adjustment to equity on the first day of the period of adoption. This implies that fair value changes that have been deferred, in part, because of uncertainty surrounding the ultimate adoption of the new rules, will now impact current earnings. Management and securities analysts understand smooth results but often struggle to understand volatile results and explain them appropriately to the marketplace. The volatility and complexity likely created in the year of adoption will certainly result in increased levels of press attention and scrutiny, and perhaps an increased risk of stakeholder dissatisfaction, not to mention increased SEC scrutiny and implications from a regulatory capital perspective.

There are many companies that have reported substantial reductions in asset values because of fair value accounting for the fourth quarter of 2008. The reduction is usually reflected either as a reduction of goodwill or in the investment accounts listed on the balance sheet of the company.

If significant restatement activity results from increased levels of scrutiny, legal implications can be anticipated, as history has shown during other periods of financial results restatement activity. This could result in additional litigation through shareholder lawsuits.

These legal issues could result not only from the complexities created by the initial year adoption of fair value accounting, but by the risk of using values that may not necessarily reflect market activity, as is required. If internal controls and procedures are not in place, supported by those with a clear understanding of the rules, improper adoption could occur. Improper adoption would exist if not all assets within a class were valued in accordance with FAS 157, and they incur losses that were charged directly to equity.

Improper adoption could also occur if the documentation and disclosure of the election to fair value, as well as in depth disclosure of adoption adjustments, is inadequate, even though the adjustments are proper. It is therefore critically important that companies, as adoption of FAS 157 occurs, carefully evaluate the impact of changes in fair value on earnings separately from key business operations, and communicate and disclose fair value information appropriately. Expert guidance is highly recommended. If application and disclosure is improper, be sure to have qualified consulting experts on hand as litigation presents itself, as it surely will, particularly in this era of initial adoption.

Certainly one of the most infamous cases in history involving issues surrounding fair value, even before the implementation of FAS 157 was required, is the Enron matter. The fair-value issues surrounding this case highlight some of the legal risks improper application of fair value standards could present. Enron made extensive use of what it called "mark-to-market" accounting. Enron's mark-to-market activities actually could have been described as "mark-to-estimate" practices. Not only did fair value accounting probably contribute more to Enron's collapse than "off balance sheet entities" did, but it was also partially responsible for Enron's decision to use them. As mark-to-fair-value accounting allowed Enron to record substantial profits, it did not provide cash flow. This illustrates the risk improper application of fair-value standards could subject issuers of financial statements and the investing public to.

From a liability perspective, the Exxon Valdez case is another high-profile example of the impact fair value accounting may have on financial reporting and litigation activities. The FASB, in 2008, after the Exxon Valdez accident, proposed, as part of the fair value standards, that companies substantially increase the amount of information they must disclose about potential future losses from lawsuits, including the fair value impact of those losses on their current earnings. This reporting requirement would have produced vastly different results for Exxon in the year of occurrence. FASB withdrew this proposal and does not currently require that companies assign a fair value to all pending litigation, but it still requires that companies disclose "specific quantitative and qualitative information" about these types of loss contingencies, and may, in the future, re-introduce the fair value concept to reporting on loss contingencies resulting from litigation.

A current example of the possible impact of fair value reporting is the recent turmoil surrounding insurance giant, American International Group. Within the last year, the insurer has reported $11 billion in asset write-downs. AIG executives have stated that they are trying, like many others, to value very complex financial instruments involving difficult estimates and judgments in a new world in accordance with new rules. Many trial lawyers believe that these types of situations will have significant impact on accounting related and securities class action litigation, although the impact cannot be fully appreciated at this time, as companies are just beginning to report under the new rules for the first time.

The impact of fair value accounting has and will continue to be far-reaching. It's important to watch developments in this area closely as they continue to unfold, to evaluate the impact on client financial reporting and to be prepared to defend clients subjected to fair value litigation or pursue actions against those misapplying the requirements of fair value measurements, not if, but when financial reporting is challenged.

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