The 2008 financial crisis: FAS 157 and SAS 59 – did they reflect realty?

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ABSTRACT

The effects of the 2008 Financial Crisis continues unabated, and the resulting credit crunch escalated the crisis globally. Both domestic and foreign markets are volatile. The G7 nations continue to address how to best address the crisis and prevent a reoccurrence. The government has experienced the greatest bailout in history, which to date, has not sufficiently thwarted the downward economic spiral. The causes are complex, created by intricate financial instruments, such as asset based securities (ABS) and credit default swaps (CDS), but there were warnings. It is inevitable that Congressional hearings will continue to be held to discuss cause, blame and preventive measures. Like the hearings that led to the 2002 Sarbanes-Oxley Act, attention has been and will continue to be directed at possible accounting/audit failures. Two statements in particular fall under scrutiny: FAS 157, Fair Value and SAS 59, Going Concern. Arguments against and in defense of FAS 157 have been made in the press but little or no attention has been given to the failure of SAS 59. This article discusses these two statements in the context of the Financial Crisis and whether they served the purpose for which they were intended.

Keywords: Financial Crisis, Housing Bust, SAS 59, FAS 157

INTRODUCTION

"In a move that could help increase home ownership rates among minorities and low-income consumers, the Fannie Mae Corporation is easing the credit requirements on loans that it will purchase from banks and other lenders. The action, which will begin as a pilot program involving 24 banks in 15 markets will encourage those banks to extend home mortgages to individuals whose credit is generally not good enough to qualify for conventional loans. In addition, banks, thrift institutions and mortgage companies have been pressing Fannie Mae to help them make more loans to so-called subprime borrowers" (Cassidy, 2008). "In moving , even tentatively, into this new area of lending, Fannie Mae is taking on significantly more risk, which may not pose any difficulties during flush economic times. But the government-subsidized corporation may run into trouble in an economic downturn, prompting a government rescue similar to that of the savings and loan industry in the 1980s" (Cassidy, 2008).

The above quote could have easily come from today's headlines. This is not the case. It is a quote from an article in the September 30, 1999 New York Times. As early as ten years ago there were warnings about what could, and in fact, did happen. After much debate in Congress, a $700 billion rescue bill, euphemistically called the "Emergency Economic Stabilization Act Of 2008" was passed. The legislation gives the government authority to purchase mortgage related investments and other distressed assets to bolster the economic well-being of the nation's financial institutions. The purpose is to alleviate the credit crunch and strengthen confidence in the markets. At one point, during the first day of trading following the passage of the Act, the Dow dropped 800 points. In addition, markets in Russia, Brazil and Iceland suspended trading, and Germany and other European nations are considering legislation to insure deposits similar to that of the FDIC. Many countries moved to shore up their banks. For the first time in recent memory, a CNN commenter used the "D" word - depression. Clearly, this is not just a U.S. crisis but a global crisis. How did we reach this point and were there warning signs?

Causes

While much as been written as the Crisis little focused on "early warning signs." Several conditions converged to cause a financial "perfect storm." The storm wasn't caused by one factor but rather several. Many of these are intertwined and created a synergistic effect on the financial markets. A brief discussion of each of these causes follows:

1. Ease of Credit – How many of us received multiple offers of credit? Preapproved credit card offers became ubiquitous. Even the automotive industry, in its eagerness to increase revenues, offered no down-payment leases, which led consumers to buy more car than they could afford. Consumers were gorging themselves in available credit offers and over-consuming. This was followed by sub-prime and other creative mortgage schemes. People that were already heavily in debt were buying homes that, under normal circumstances, they would not be able to afford. As economic conditions worsened many people were forced into foreclosure (Marquit, 2009).
2. Lack of regulation – The investment banking industry is regulated by or subject to SEC oversight. Due to factors such as the repeal of the Glass-Steagell Act of 1933, which prohibited commercial banks from acting as investment banks, the dichotomy between commercial and investment banks became less distinct. It could be argued that the SEC abdicated its responsibilities to the Federal Reserve who were, at best, reluctant

to accept oversight of investment banks. In any case, the investment banks and their attempts to bolster revenues through such vehicles as Asset Backed Securities (ABS) went under the regulation radar (Chossudovsky, 2008).
3. The repeal of the Glass-Steagell Act of 1933 - Early in the 20th century commercial banks created affiliates that would underwrite stock issues. This became a prevalent practice until the 1929 Stock Market Crash. This created a severe lack of confidence in the U.S. banking structure. In an effort to regain confidence, Congress passed legislation that would help ensure that banks followed reasonable banking practices. The Act prevented commercial banks from underwriting securities and prevented investment banks from receiving traditional customer-type deposits. Under pressure, the Glass-Steagell Act was repelled in 1999 (Cox, 2008). John Cassidy (The New Yorker, 2008) explains:

> Commercial banks, such as Chase Manhattan, merged with investment banks, such as J. P. Morgan. The remaining Wall Street firms, grappling with new competition in their traditional businesses, increased their borrowing and made riskier bets. Last year, Bear Stearns, Lehman Brothers, and Merrill Lynch had more than thirty dollars of investments on their books for every dollar of capital. Having borrowed so heavily, the firms were hostage to a withdrawal of credit on the part of their lenders. After the sub-prime-mortgage market collapsed, that was precisely what they faced.

4. Financing long-term assets with short-term borrowings – Investment banks, which do not have customer deposits as do commercial banks, became heavily involved in the lending business and had to borrow large amounts of money. Their first choice for financing came from the issuance of commercial paper which resulted in temporal financial asymmetry. That is, they were financing long-term loans with short-term commercial paper. As a result they were forced to "roll-over" their short-term borrowings or secure long term financing (Rothbort, 2008).
5. Credit default swaps (CDS) – Credit default swaps are insurance-like contracts that protect bondholders from the risk of default by creditors. As Rothbort (The Street, 2008) describes, "Typically the buyer of the contract makes periodic payments to the seller of the swap. In the event of a default the seller will be obligated to purchase the defaulted securities at an agreed upon price" (Rothbort, 2008). These are used as effective hedges against the risk of default. However, with the introduction of speculators , the CDS market became increasingly large, partially due to its unregulated nature. The sub-prime credit crunch and resulting economic decline led to large numbers of defaults. In addition, due to the nature of the CDS market, realistic or accurate valuations of CDS contracts were difficult to ascertain. AIG is a good example of what can happen when the CDS market becomes out of control: AIG experienced an $11 billion write-off of their CDS holdings. On Friday, October 10th, AIG began selling off their CDS for 10 cents on the dollar. (Hughes, 2008)
6. Elimination of the up-tick rule – The up-tick rule requires a trader to wait until a given security price goes up before selling the security short. The Rule was rescinded by the SEC in July, 2007. According to Market Watch, the Dow Jones Industrial average dropped 17% since the Rule was rescinded. Short selling was temporarily suspended by

the SEC, further demonstrating their concern about speculators selling short and creating more downward pressure on prices. (Weiss, 2007)

7. Implementation of the Fair Value Rule – Depending on one's perspective, the newly implemented FAS 157, "Fair Value Measurements", is either a cause or a red flag signaling the "true financial well-being" of the financial market. However, few would argue that the requirement of FAS 157 to "mark to market" resulted in the unprecedented recorded losses that acted to bring more downward pressure on the financial markets. (Hughes, 2008)

8. The housing crisis – Perhaps the greatest cause leading to the Financial Crisis is the bursting of the" housing bubble." While the housing crisis is receiving the most attention, the Financial Crisis has multiple causes that, in concert, led to the global financial meltdown. So what was the root of the housing market collapse? Quite simply, its financial creativity and more notably, subprime loans and unconventional term financing (Cox, 2008).

Median home prices, adjusted for inflation, rose 32 percent between the years 2000-2005. For example, in San Diego prices rose 127 percent, in Los Angeles prices jumped 110 percent and in New York housing prices rose 79% (Newsweek, 2006). At first glance it appeared to be an excellent way to increase net worth and live the American dream. As the housing boom escalated many were priced out of the market, resulting in financing arrangements that future homeowners found attractive. "In 2003, a family with an income of $40,320 could buy the median-priced existing home of $180,200, estimates the National Association of Realtor. By August 2006, an income of $56,544 was required to buy a median-price home, now costing $225,700" (Samuelson, 2006). To increase housing purchases financing vehicles such as ARMs, sub-prime loans and mortgages requiring little or no down payments became popular. According to Michael Fratantoni of the Mortgage Bankers Association, ARMs account for 25% of the nearly $10 trillion in single-family mortgages. Even Fannie Mae and Freddie Mac were not immune to using subprime loans. Political pressure was brought to bear by President Bush contending that Fannie Mae and Freddie Mac were trailing the rest of the mortgage market in servicing low-income families and minorities wishing to purchase homes. The Department of Housing and Urban Development (HUD) required that a greater percentage of funding go to low-income housing. "The pair met HUD's requirements partly by buying the AAA-rated portions of mortgage securities created by Wall Street firms and backed by subprime home loans" (Hagerty and Karp, 2008).

Investment banks purchased many of these subprime mortgages and repackaged them into ABS. When the housing boom turned into a housing bust, with huge numbers of foreclosures, the underlying securities lost tremendous value. When the companies were required to "mark to market'', as required by FAS 157, they booked unprecedented losses. This fueled an already spiraling downturn in the economy and eventually led to government bailout legislation passed October 3rd.

Warnings

Why were there no warnings? According to "The Economist" (August 9, 2008), the first alarm came with the 2005 downgrading of General Motors bonds from investment grade to "junk." The following statistics are taken from the Milken Institute, U.S. Census Bureau. Each

of the statistics taken either individually or together provide ample warning that the financial structure of the mortgage industry was in distress.

1. Percentage of all mortgages bundled into securities – 1994 – 2007 increased by 18.4%.
2. Percentage of all subprime mortgages packed into securities – 1994 – 2007 increased an astonishingly 61.2%.
3. Percentage of mortgage originations that were subprime – 1994 – 2006 increased by 15.6%.
4. Increase in face value of subprime mortgages issued between 1994 – 2005 was 1700%.
5. Household debt as a percentage of disposable income – In 1985 was 74.9%, in 2006 it was 137%.
6. Foreclosure rate on prime mortgages issued between January, 1999 and July, 2007 2% and on subprime mortgages 13.7% (Weiss, 2008)

Why was the escalation of subprime mortgages ignored? Why was the percentage of disposable income allocated to household debt allowed to exceed 100%? Lastly, given the first two questions, why was the percentage of subprime mortgages packed into securities (ABS) allowed to increase by over 61%? The answer is simple: no one wanted to. Consumers wanted the American dream, the mortgage industry saw an opportunity to increase margins and there was no clear regulatory accountability.

FAS 157 and Level 3 Assets

In the remainder of the article two Statements and the role they played in the crisis will be discussed. It is inevitable that Congress will hold additional hearings, not dissimilar from those held after the collapse of Enron and other companies, which led to the passage of the Sarbanes-Oxley Act. When these hearings occur, the focus on the accounting profession and rules will almost certainly be of continuing interest. FAS 157 "Fair Value Measurements" and SAS 59 "The Auditors Consideration of an Entity's Ability to Continue as a Going Concern" will likely be the focus of future Congressional hearings.

The aim of Statement 157 is "to produce independently verifiable values, where possible without relying on management views for the numbers" (Hughes, 2008). Statement 157 (sometimes referred to as mark to market) was issued to: (1) provide for a single, consistent definition of fair value, (2) to provide a uniform, consistent guidance on how to measure fair value, (3) the establishment of a hierarchical fair value measurement framework, and (4) expand the information required to be provided to financial statement users about fair value measurements. 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" (FASB, 2007). The term orderly transaction is deemed a sale where the seller is not under distress or duress. Measuring fair value involves determining an exit price. The standard provides for a hierarchy of preferred valuation methods. The first (and most reliable) level is quoted prices in active markets for identical assets or liabilities that are being measured. The second level is observable data, including market transactions for similar assets, data from small/inactive markets and inputs that directly correlate with data affecting the

elements being measured. The third level of the hierarchy is unobservable data taken from the entity's data or economic models.

Statement 157 is not without its critics. Much of the criticism is aimed at measuring level 3 assets. Banks are being required to classify much of their assets as level 3 and write down billions of dollars. As early as November, 2007, Stephen Taub warned that companies will find it harder to avoid losses on level 3 assets (CFO.com, 2007). This was echoed by The Royal Bank of Scotland Group who estimated that U.S. banks and brokers faced losses of hundreds of billions of dollars because of level 3 rules. Bob Janjuah, Royal Bank's chief credit strategist, reported that Morgan Stanley has the equivalent of 251% of its equity in level 3 assets, while Goldman-Sachs had 185% and Lehman Bros. had 159% (CFO.com, 2007). Given that there is no ready market for level 3 assets it is possible, if not likely, that companies will write up these assets to unrealistic or inflated amounts. Financial firms have considerable latitude when valuing level 3 assets. Many use in-house pricing models to determine a price for these assets. These firms would argue and attempt to substantiate the validity of using their in-house models. Never-the-less, ultimately the values based on in-house models are not objectively determined leading to possible manipulation

Institutions have experienced unprecedented losses from level 1 and 2 assets. The true value of level 3 assets is not readily determinable. They are based on subjective models by management who are not motivated to book more losses. According to SEC filings made in 2007, seven of the largest banks/brokers held a total of $387 billion in level 3 assets. The total amount held by all companies is unknown, but likely to be many times greater. How do auditors make an objective determination regarding the models and assumptions used by management? The inevitable write down of level 3 assets will put more pressure on the financial markets. Given the nature of level 3 "mark to model" assets, more scrutiny will be given to evidence generated by auditors when valuing these assets. The second objective of FAS 157 is to provide a uniform, consistent guidance on how to measure fair value. How does one develop a uniform and consistent guide when each company and each type of level 3 asset is subjected to different models with varied assumptions? This is a major criticism of FAS 157.

Critics argue that level 3 holdings should be treated not as trading or available-for-sale securities but rather as held-to-maturity securities. This would prevent writing down to market (or model) since they would be carried at their maturity value. Of course, with the large numbers of foreclosures the securities would still have to be written down since collectability would be in doubt. According to an article in the Economist (September 20, 2008) not all criticisms of FAS 157 are without merit. One such concern discussed is that of "procyclicality." Statement 157 requires the write down of assets, which in turn, brings downward pressure on prices and valuations. The write downs are more accelerated in periods of economic downturns. In spite of the criticisms, Statement 157 works. As Richard Bennison, KPMG UK head of audit, stated, "accounting doesn't create reality, it reflects it" (Hughes, 2008).

The Issue of SAS 59

The accounting profession underwent intense scrutiny after several high profile bankruptcies. This led to the passing of the Sarbanes-Oxley Act of 2002. The Weiss Report (2008), discussed several failures of public accounting firms. The failures are broken down into two categories, accounting irregularities and bankruptcies. Three findings regarding bankruptcies are the most alarming. These are:

> "Auditing firms failed to warn of nearly half of bankruptcies. The auditing firms gave a clean bill of health to 42.1% of the public companies that subsequently filed for bankruptcy between January 1, 2001 and June 30, 2002.
> The companies that filed for bankruptcy despite a clean bill of health from their auditors had a peak market value of more than $225 billion, nearly all of which has been lost by shareholders.
> Among companies that subsequently filed for bankruptcy, 88.9% displayed at least two negative financial indicators that were evident in their accounts at the time of the audit."

Furthermore, the Report states that, "The first and more important line of defense is manned by the nation's auditing firms. The auditing firms should play the primary role in protecting the public against accounting manipulations, financial failures and the devastating investment losses that almost invariably result" (Weiss, 2008). In short, the Report found a widespread failure on the part of firms to identify and warn of bankruptcies.

SAS 59 "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern," requires the auditor to evaluate whether there is substantial doubt about entity's ability to continue as a going concern. The period under consideration is not to exceed one year beyond the date of the financial statements under audit. The Statement focuses on four broad areas: negative trends, financial difficulties, internal matters and external matters.

A review of the latest audit reports for AIG, Fannie Mae, Freddie Mac, Lehman Bros., Goldman Sachs Group and The Bear Stearns Companies revealed that none of the companies received going concern language. It is noted that the AIG report stated, in part, "AIG did not maintain…effective internal control over financial reporting as of December 31, 2007…related to the AIGFP super senior credit default swap portfolio valuation process and oversight thereof existed as of that date." As mentioned earlier, AIG sold their CDS for .10 on the dollar. The audit report for fiscal year 2006 for Freddie Mac identified five material internal control deficiencies, including the following, "The design of internal control over financial reporting was inadequate with respect to the process related to the pricing process for securities. As a result the Company's accounting conclusions, including certain conclusions related to the fair value of its securities…could have been materially affected." Subsequently Freddie Mac was taken over by the government. None of the remaining companies received any indication of material internal control weaknesses.

Bear Stearns collapsed and was taken over by JP Morgan and Chase, AIG received two multi-billion dollar bailouts, Fannie Mae, like Freddie Mac, was taken over by the government, Goldman Sachs received a government bailout and Lehman Bros. went bankrupt. Yet none of these companies' audit reports contained any going concern language. Is SAS 59 effective? According to the Weiss Report, SAS 59 was ineffective in predicting whether a company would remain viable over the subsequent 12 months, even though in their study many of the examined reports and companies had several "yellow flags" indicating substantial doubt.

Auditors are not prophets. Statement 59 provides some guidance on conditions and events, responsibilities and procedures. Absent evidence to the contrary, the assumption is that the company is a going concern. Auditors have been reluctant to discuss going concern in audit reports for fear of creating a "self-fulfilling prophecy." As is common in auditing, the auditor must rely on his/her judgment. Should SAS 59 remain as is, be rewritten to give more precise and direct guidance regarding when to doubt going concern or be completely eliminated? What is clear is that Congressional hearings will inevitably focus on the responsibility of auditors and

whether they are, as the Weiss Report stated in their 2002 report to the Senate, "The first and more important line of defense… The auditing firms should play the primary role in protecting the public against accounting manipulations, financial failures and the devastating investment losses that almost invariably result." The Sarbanes-Oxley Act did not act upon the comments relating to SAS 59. The accounting profession must be pro-active and be prepared to address public concerns about auditors' responsibilities, especially in a time of crisis.

Summary and Conclusions

The following is a list of several noteworthy observations about the 2008 Financial Crisis:

1. There were early warnings that went unheeded.
2. The level of sophistication contributed to the delayed recognition of the crisis.
3. FAS 157, while not a causation, contributed to the recognition of the crisis due to the ambiguous nature of the statement.
4. Auditors did not apply SAS 59, when clearly many of the failed firms were in financial distress.

FAS 157 has fallen under scrutiny by many agencies including the SEC, but to date, no significant changes have been made. Accountants and auditors are the front line in the prevention of deceptive or overly ambiguous treatment of financial events, yet both must accept some level of responsibility. The FASB should have foreseen the potential pitfalls of allowing companies to value assets based on in-house models. This type of action violates both the spirit and substance of generally accepted accounting principles (GAAP), and in particular the role of stewardship. The level of financial creativity is outpacing the FASB's attempt to create appropriate GAAP.

Auditors are held to the highest standards, and yet failed to recognize the potential misuse of FAS 157 as it applies to level 3 assets. In addition, SAS 59 was never applied to the extensive financial perils that faced the financial firms. Public accounting firms are, and always have been, very hesitant about adding going concern language to audit reports. If this is the case, one must ponder the question: Why do we continue to retain SAS 59. It is time that the profession either appropriately apply SAS 59, modify it to reduce in expectation gaps relating to it, or simply eliminate it.

One last observation can be made from the events surrounding the 2008 Financial Crisis. The rule making process currently in place by FASB must be streamlined to keep pace with the level of sophistication of the financial markets. Until this is done we can assume future issues will arise.

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