

**FINANCIAL REPORTING
AFTER THE SUBPRIME CRISIS:
NEW CHALLENGES FOR AUDIT COMMITTEES**

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INTRODUCTION

Though it may not have been apparent at the time, in some ways the subprime crisis can be seen as ushering in a new era of financial reporting. It is hard to think of an earlier time when public companies so quickly accumulated, processed, and made available to the public the details behind reported assets as well as the volatility of changing asset values. Nor is it easy to recall a time when financial markets reacted with such broad-based severity. Some might understandably wonder, in the aftermath of a significant recession, whether such a system is best. But if one assumes that the objective of financial reporting is to fairly report current financial information, in fundamental ways the reporting system did its job.

For better or for worse, there's probably no turning back. The accounting principle at the center of the crisis – fair value accounting – is no doubt here to stay. Indeed, as FASB and the IASB continue to head toward accounting “convergence,” fair value accounting will likely become more, not less, of a force in financial reporting. At the same time, the pressure to get bad news to investors fast – one of the driving forces in the subprime crisis – can only be expected to increase.

Many investors have been seeking such changes, and therefore will greet these developments as good news. But for those charged with responsibility for financial reporting, the reactions may be more mixed. For the crucible of today's financial markets – and in particular the prevalence of derivative instruments – poses new challenges for everyone with some level of responsibility for public company financial reporting. Among those are the system's overseers, public company audit committees.

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This article talks about those challenges. It starts with the subprime crisis itself, the challenges it posed for financial reporting, and how financial reporting systems sought to meet them. It then talks about the consequences for audit committees going forward.

THE SUBPRIME CRISIS

For many, the events that unfolded into the subprime crisis seemed to start in the summer of 2007. It was then that newspaper headlines riveted attention on two Bear Stearns hedge funds in trouble, with one result being increased investor focus on an esoteric financial instrument known as a “CDO.” As investors tried to understand CDO structure and prevalence, they quickly encountered complexity and confusion. Seemingly overnight, key markets for mortgage-related financial instruments froze.

Behind the scenes, this freezing of markets had an impact that at first only the accountants would appreciate. Under a new “principles-based” accounting standard, FAS 157, the disappearance of trading markets meant that the accounting approach to reported asset valuation had to change. In particular, it needed to change from reliance on the now-nonexistent markets to more judgmental valuation approaches. Those judgmental approaches often looked for help to sophisticated valuation models.

Unfortunately, in important instances such sophisticated valuation models were not in place. This was, in context, completely understandable: While the markets had been active and observable, such valuation models had not been needed. And it was just as companies were trying to come to grips with this dilemma that another challenge of the financial reporting system kicked in. This was the desire to get the best possible information about sudden valuation declines to investors fast.

For those faced with responsibility for financial reporting, the dilemma was acute. The financial community understandably wanted fast, updated information. But the financial reporting system – just as understandably – was not in a position to deliver it. Adding still another layer of difficulty, when presented with updated information to be presented to investors, outside auditors wanted to be satisfied. Among other things, they wanted to see that, to the extent possible, updated information to be reflected in audited financial statements could be objectively supported.

As it turned out, the system found a way to cope. Through sometimes extraordinary effort, sophisticated valuation models came to be put in place.

Enough data was found, often in analogous markets, so that sufficiently objective reliability could be established. And accompanying disclosure came to be drafted allowing investors to judge for themselves how numbers were being put together and whether they did, or did not, want to use the newly-derived information. In hindsight, while there may have been exceptions, overall it is remarkable how well the system met the obstacles.

Still, the process was painful for almost everyone involved. And it is thus that, today, many audit committees find themselves in a tough spot. On the one hand, the evolution of financial reporting has given rise to new demands and opportunities for fast, updated information. On the other hand, the ability of financial reporting systems to deliver that information may not be completely in place.

While it is still fresh in everyone's mind, it is a good idea to look back and focus on the challenges of the crisis. It is just as good an idea to think about how those challenges may affect audit committee oversight of financial reporting going forward. Breaking them down, the main topics are: (1) the accounting regime of "fair value accounting"; (2) increased investor expectations for faster financial information; (3) the broader evolution from accounting rules to principles; (4) implications of these developments for the practice coming to be known as "accounting engineering"; (5) new features of auditor and audit committee interaction; and (6) the audit committee's role in the oversight of risk management.

CHALLENGES FOR AUDIT COMMITTEES

Fair Value Accounting – Recent controversy notwithstanding, the concept of fair value accounting is actually not that new. As far back as the early 1990s, fair value accounting was already playing a prominent role in financial reporting, and the gradual trend since then had been for its use to increase. That is not to say that everyone was enthusiastically embracing this approach, which basically posits that market value, rather than cost, is the best way to value certain assets. Still, a consensus had seemed to develop that, on balance, for certain assets and in certain circumstances, fair value accounting made sense.

What was new in the subprime crisis was not an extended use of fair value accounting, but the consistency and discipline with which fair value accounting was applied. This was largely owing to the new accounting standard, FAS 157, which, while not extending fair value accounting into new areas, did seek to bring more consistency to how fair values would be

determined and the accompanying explanations about how and where fair value was being used. The basic idea behind FAS 157 was to divide valuation approaches into three “levels” depending on the data inputs through which market value would be derived. At “Level 1,” fair value was derived through the observation of active markets for the asset in question. At “Level 2,” fair value was derived essentially through analogous markets. At “Level 3,” which assumed the absence of active, observable markets, fair value was derived through other means such as valuation models. The overall principle behind the standard was fairly straightforward: Assets should be reported at the price at which they could be sold. In the language of FASB, that was referred to as the “exit price.”

For audit committees, oversight of the system where fair value can be determined through Level 1 inputs isn’t that tough. Valuation can be as simple as looking up the price in *The Wall Street Journal*. It is when active, observable markets disappear – as they did during the subprime crisis – that things can get much more difficult.

The main difficulty is to have in place a system that can derive the hypothetical “exit price” when the valuation needs to be at Level 3. Anyone who has sought to estimate the value of his home when nothing in the neighborhood is selling can understand the problem. When it comes to public company financial reporting, the downsides of getting it wrong can be much more severe. They may include, for example, the potential for SEC investigation and penalties. In particularly egregious circumstances, they may include interest by the Department of Justice.

There’s only so much an audit committee can do, but a good starting place is to seek an understanding as to which assets are being “fair valued” pursuant to FAS 157 and at which of the three levels asset valuation is taking place. Where the valuation is at Level 1, the committee can breathe a sigh of relief. But where the valuation is at Level 3, a few follow up questions may be useful. These may include questions about the valuation inputs, their objectivity, the use and reliability of financial models, and the extent to which the values thereby derived can be supported by objective market data. No one should expect an average audit committee member to be an expert in the mathematics of Level 3 valuation. But a search for system weaknesses is often something even a layman can undertake.

One potential weakness in particular may be a useful topic of inquiry. That is the potential for influence on the objectivity with which valuation judgments are made. The key point here is that, at Level 3, the role of

judgment can be significant. The audit committee will want to keep in mind that the objectivity of valuation judgments can be influenced from all sorts of directions – pressures for performance, compensation, the arguments of others (like counterparties), and simply the constraints of the valuation methodology. Even small influences on judgment, moreover, can have enormous consequences for valuation as the numbers play through the system. The math may be too much for those other than the quants. But inquiry directed to the objectivity of the judgment calls can pay great dividends.

Faster Financial Reporting – The subprime crisis illustrates all too clearly what is sure to be a fundamental tension in financial reporting going forward. That is the tension between the desire to provide sufficiently reliable financial information to investors but at the same time to increase the speed of financial reports, particularly when the news is bad.

This desire for more rapid information is driven largely by investors. They have made plain their impatience with a “periodic” system of financial reporting that was initially designed only to present information once a year or, more recently, once a quarter. Trying to be responsive, those responsible for the design of financial reporting systems have worked hard to make improvements. Hence, the deadlines for periodic reports – Forms 10-K being the most prominent – have been shrunk. Sarbanes-Oxley contains new “real time” provisions seeking to increase the speed of information. Increased emphasis has been placed on internal control over financial reporting with one of the objectives being more reliable and efficient information collection and transmittal.

Still, capturing and processing the requisite data takes time. That was particularly evident in the subprime crisis where the analysis often started with companies trying to figure out exactly where within their various business units mortgage-related assets were being held. The overnight evaporation of markets, moreover, meant the numbers were that much harder to figure out. All the while investors were clamoring to know what was going on.

This investor demand for more rapid information is unlikely to change. Indeed, such is the desire for updated information that at times investors have almost seemed willing to trade reliability for speed, arguing “a rough number is better than no number.” And one consequence is to place the audit committee between a rock and a hard place. On the one hand, it wants to be responsive to the desires of investors who are, after all, the main

customers for public company financial information. On the other hand, it wants to be satisfied that the financial reporting system is producing information that is sufficiently reliable to be reported to the public. Striking the right balance between the two competing considerations can be a perilous undertaking. And, again, the downsides can include SEC or Department of Justice investigations.

There is no easy solution to this one. Therefore, one of the most important things is for the audit committee to simply appreciate that the tension between reliability and speed exists. Another important reaction is to understand the significant benefits of improved financial reporting systems and, in particular, enhancement of the systems by which fair values can be derived. Just as it's easier to fix the roof when the sun is shining, the time for improvement is when markets are calm. When volatility strikes, it can be difficult to play catch up.

From Rules to Principles – The evolution to fair value accounting – and the resulting need for sometimes-difficult judgments in fulfillment of the principle of reporting asset “exit price” – illustrates a broader trend in financial reporting. That is the trend from a system that relies more on technical rules, which is how many would characterize U.S. GAAP, to a system that relies more on broader principles, which is how many would characterize International Financial Reporting Standards or “IFRS.” The general trend even in the U.S. is from a rules-based to a more principles-based system.

Here, too, the evolution is not without controversy. Described as a debate of “principles versus rules,” the discussion often focuses on which is actually better for U.S. financial reporting given U.S. cultural inclinations and the way financial reporting in the U.S. actually works. Adherents of rules say that rules can be clearer, offer brighter lines, be easier to apply in the field, and thereby make accounting less susceptible to manipulation. Beyond that, the application of rules can be – a critical concern for some – more difficult to second guess (the SEC is often mentioned). On the other side, adherents of principles argue that the application of principles requires more thought about the broad objective of the accounting standard, is less vulnerable to abuse through accounting engineering, and thereby allows for a truer financial picture of what is actually happening. Those arguing for a more principles-based approach also point to the occasional ridiculousness of some aspects of U.S. GAAP. The 1000+ pages of interpretive data on derivative accounting under FAS 133 is often the poster child.

In truth, the notion of a debate of “principles versus rules” is largely artificial. Financial reporting needs both. At the same time, there is a general consensus that the emphasis on bright-line rules in the U.S. has gotten out of hand. Accordingly, as FASB in the U.S. and the IASB in London continue to work toward convergence, one outcome is almost certain: There will be much more emphasis on principles.

For the accounting systems that U.S. audit committees oversee, this will represent a cultural change. For whatever reason (and lawyers may have played a role), U.S. accountants tend to express greater comfort with the application of rules. A shift to principles will require less of a focus on rule compliance and more of a focus on the objective of a particular accounting standard and whether a particular application furthers that objective. In the end, such a change away from a “compliance mindset” may be healthy. But the comfort of being on the right side of a rule may be lost.

For audit committees, as in the oversight of fair value accounting, an important consideration will be the increasing prominence of judgment in a principles-based system. The watchword for audit committee oversight in such a system may increasingly become “informed objectivity.” In a more principles-based system, the audit committee will want to be informed as to the basic judgment calls. But more than that, the audit committee will want to keep in mind that influence on those judgment calls can come from a variety of directions. An important goal, therefore, will be to protect the “objectivity” of the system.

If everyone is trying to do the right thing, a more principles-based system can serve to enhance financial reporting and the usefulness of reported results. But that assumes everyone is trying to do the right thing.

“Accounting Engineering” – An implication of the evolution to a more principles-based system, briefly mentioned above, may be a further trend away from that which some refer to as “accounting engineering.”

The concept of “accounting engineering” by its terms carries an almost sinister tone, but it is useful to keep in mind that attentiveness to accounting consequences in structuring transactions has historically been commonplace. Not that long ago, financial executives would explicitly seek to structure a business combination to attain “pooling” accounting treatment and candidly describe that they were doing just that. More recently, structures to place assets and liabilities “off balance sheet” have

been ubiquitous. Just as it seemed perfectly natural to lawfully structure transactions to minimize taxes, structuring transactions toward a particular accounting result had historically seemed fine.

But things have gotten a bit more dicey of late. The SEC has expressed growing frustration at corporate structures driven by the accounting rather than what makes sense for the business. More than that, accounting-driven structures are being second-guessed in accounting investigations (think of Lehman Brothers), in litigation, and by the financial press. In all of this, the line between legitimate profit maximization and improper manipulation of accounting can be hazy, unlawfulness is often far from clear, and the discussion can end up focusing on such imprecise concepts as the adequacy of disclosure and “economic substance.” If nothing else, the reputational damage from suspicious accounting structures can be considerable.

For audit committees, it may be good news that accounting engineering will in some respects be more difficult in a principles-based system. While counterintuitive to some, the fact is that the lack of sharp edges to bright-line rules can make it more difficult to know precisely the point at which accounting treatment changes. Rather than aim for the edges, those seeking to determine accounting consequences under a more principles-based system may be more drawn to “aim for the center,” that is, to fulfill the objective of the principle at issue. For audit committees worried about technical compliance lacking economic substance, a greater focus on the underlying principles may help.

Nonetheless, continued attentiveness to this area may be useful. The distinction between acceptable and unacceptable approaches can be difficult to pin down, and it can be difficult for an executive to know exactly when he or she is stepping over the line. Beyond that, a preoccupation with profit maximization through accounting devices can suggest a nonoptimal environment. In this area, audit committees will want to stay on their toes.

Auditor Interaction – In some ways, the subprime crisis put to the test the strength of relationships between audit committees and their auditors. The increased need for judgment calls, the pressure-cooker environment in which accounting judgments needed to be made, the difficulties in finding observable market data – all of these understandably created stress even as everyone was trying to figure out the right things to do.

Unfortunately, factors giving rise to that stress will to some extent continue. Tough judgment calls will continue to be needed. Financial reporting will continue to get faster. Objective market data will come and go. It will be more important than ever, therefore, for audit committees to cultivate excellent auditor relationships.

The hallmarks of an excellent relationship will include candor and transparency both in providing objective information and in making objective judgments. The concept of audit committee “informed objectivity” again comes to mind. A natural outgrowth may be increased audit committee interaction with internal audit so that the committee can learn more about, and improve, system frailties even before the outside auditors get started. A healthy and candid dialogue among all three participants – the audit committee, the outside auditor, and internal audit – should improve the workings of the system overall.

Responsibility for Risk Management – A particular challenge for audit committees coming out of the subprime crisis will be the need to address increased expectations for risk management. Those increased expectations are perfectly understandable. However, it is far from clear that the audit committee members are the best ones to address them.

The reason is that the risk emerging as the principal culprit in the subprime crisis did not involve falsely-reported financial results but, rather, the liquidity of reporting entities. In a nutshell, they ran out of cash. A typical audit committee may, as a result of legal requirements and practical need, possess significant experience in debits, credits, and GAAP. But enterprise liquidity, and the intricacies of the financial markets underlying it, are a different thing altogether. Add in the other risks gaining prominence in the subprime crisis – credit risk and market risk to name two – and it is far from clear that the audit committee’s accounting expertise makes it the best committee to take them on.

And this is before getting to the fact that, with all of the new demands on financial reporting systems, the audit committee will have enough to do just staying on top of financial reporting. Rather than placing on the audit committee additional responsibilities for risk management, boards of directors may want to approach it from another direction. It may make sense, for example, for boards to consider the establishment of a separate “risk management committee” as the central board-level committee responsible for risk.

THE REEMERGENCE OF FRAUD?

As we continue to emerge from the recession, audit committees may understandably think they've earned the right to take a sigh of relief. The prevailing view seems to be that the worst is behind us and that, while it may take awhile, things are gradually going to get better. That is obviously good news for the economy.

But, ironically, an economic recovery may carry with it a new challenge for financial reporting. The fact is that, during the depths of the recession, some of the toughest pressures on the accounting system had been removed. Foremost among these was the quarterly earnings expectations of outside analysts. During a time when everyone was fighting for cash flow and survival, a failure to meet earnings estimates was a complete nonevent.

That can be expected to change as companies again start making money. And an ominous sign, as we emerge from the recession, is that companies are being perceived as stepping back onto growth curves and analyst expectations are again starting to matter. Financial fraud rarely starts with dishonesty; it starts with pressure of the sort put in place by quarterly analyst expectations. With the increased prominence of fair value accounting, and the increased need for judgment calls in a principles-based system, the opportunities for the nonobjective application of accounting standards by those under pressure will in some ways increase.

All this means that audit committees will want to stay on guard against the influence of business pressures on accounting determinations and that an approach of "informed objectivity" may be more important than ever. The subprime crisis created significant challenges for audit committees and financial reporting systems. An economic recovery will create new ones.

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