



# ACCOUNTING POLICY & PRACTICE



## REPORT

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## Auditor Liability in the Wake of the Subprime Meltdown

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The subprime crisis that the financial pundits have been talking about for the last two years has seeped beyond Wall Street to the point where there is nary a soul on Main Street that is not aware of the situation thanks to the failure of Lehman Brothers, the shuttering of several major banks, and the federal government's historic \$700 billion bailout. The stock market has been on a wild roller coaster ride, with 700-point drops followed by increases of nearly 1,000 points, only to be followed by more 700-plus-point drops.

After reviewing the fundamentals of how subprime mortgages and securitization of those high risk loans work, this article turns to the fair value accounting rules that require the use of price quotes from active markets rather than modeling techniques when valuing the mortgage-backed securities that are key to the subprime meltdown. Lastly, the article addresses the responsibility that auditors have to audit and report on the valuation of those securities.

### The Subprime Crisis in a Nutshell

The real estate boom that saw the price of housing skyrocket from 1997 through 2006 led to dramatic in-

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creases in housing starts and the proliferation of loans to homebuyers to purchase those homes, many of which were to people for whom the purchase of a home may have once seemed out of reach due to low income levels and poor credit histories. The loans to borrowers with a high debt-to-income ratio and less than stellar credit histories are referred to as subprime mortgages and were originated at a premium above the prime mortgage rate paid by individuals with good credit. Because of their characteristics, subprime mortgage loans carried a higher probability of default as compared to standard mortgage loans.

The subprime mortgage industry thrived during the 1997 through 2006 period due in large part to innovations that reduced the costs for lenders of assessing and pricing risks.<sup>1</sup> In particular, technological advances made it easier for lenders to collect and disseminate information on the supposed creditworthiness of prospective borrowers.<sup>2</sup> Moreover, many lenders had incentive structures that tied originator revenue to the numbers of loans closed, which made increasing loan volume, rather than ensuring the quality of the loans, the objective of some lenders.<sup>3</sup>

The secondary mortgage market also fueled the growth of the industry by allowing lenders to move loans—and the risks associated with those loans—off of their own balance sheets by selling them to financial intermediaries who, in turn, pooled the mortgages into securitizations through which debt securities known as mortgage-backed securities (MBSs) were issued, and

<sup>1</sup> Remarks by Ben S. Bernanke, chairman of the Board of Governors of the Federal Reserve System, at the Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition, Chicago, May 17, 2007.

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

paid interest and principal out of the cash flows generated from the mortgage loans underlying the securities. The growth of this secondary market thus gave mortgage lenders greater access to the capital markets, lowered transaction costs, and spread risk more broadly, thereby increasing the supply of mortgage credit.<sup>4</sup>

The increase in subprime mortgage lending over the last 10-year period is staggering. In 1997, only 5 percent of mortgage loan originations were subprime; by 2005 the figure had risen to approximately 20 percent.<sup>5</sup> In the first quarter of 2007, there were approximately \$1.3 trillion in subprime loans outstanding.<sup>6</sup> Approximately 6 percent of those loans were adjustable rate mortgages (ARMs) that were issued with initial “teaser” interest rates that would eventually reset to higher interest rates.<sup>7</sup>

The Federal Reserve began raising short-term interest rates in June 2004, which led to increased costs for mortgage borrowers. More expensive mortgages, combined with continued construction of new homes, as well as foreclosed homes being placed on the market, led to the decline of property values. The housing bubble that the economy had enjoyed for 10 years officially ended in 2006. Prior to that time, when subprime borrowers faced the prospect of not being able to meet their mortgage obligations, rising home values provided borrowers with the option of refinancing their mortgages or selling their homes rather than falling behind or defaulting on their loans. Without the ability to refinance at a lower interest rate or to sell their home at a price above the outstanding balance on their mortgages, borrowers began to default at record rates.

Most of the mortgage loans originated during the housing boom were securitized into MBSs which were held by banks and sold to other investors such as mutual funds, hedge funds, insurance companies, and pension funds. There were nearly \$2.5 trillion in total mortgage originations in the United States in 2006, of which \$1.9 trillion was securitized into MBSs.<sup>8</sup> Approximately 25 percent of the MBSs issued in 2006 were subprime loans.<sup>9</sup>

As noted, the risks of the loans underlying the MBSs were transferred to the purchasers of those securities. Thus, when the delinquency and default rate of subprime mortgage borrowers began to rise sharply due to factors noted above, the ratings placed on the MBSs by the rating agencies were downgraded and the value of many MBSs declined as well. The ABX derivatives index, which serves as a benchmark of the market for securities backed by subprime loans, declined significantly from the time it was introduced in January 2007 (falling 15 percent in its first four weeks), as more subprime lenders reported losing money.<sup>10</sup> As a result, the investors who were pouring billions of dollars into

MBSs, looked for other places to invest their money, contracting the supply of funds that the subprime mortgage lenders had come to rely on for the origination of new mortgages.

The subprime lenders, who often agreed by contract to repurchase the mortgages it sold to the financial intermediaries if certain delinquency and default rates in the mortgages they sold were exceeded, experienced substantial losses and 20 of the top 25 originators at year-end 2006 were shut down, Countrywide Financial Corporation being the most high profile failure of the bunch.<sup>11</sup>

## The Valuation of MBSs

As noted, the substantial majority of subprime loans originated during the last decade were securitized and sold to investors as MBSs.<sup>12</sup> By mid-2008, banks had recognized \$312 billion in subprime-related losses, \$269 billion of which resulted from mark-to-market writedowns of MBSs. Writedowns of that magnitude inevitably raise the question of whether those securities had been correctly valued in the financial statements that investors rely on to make their investment decisions or whether they were marked down early enough before a decline in value turned into a panic.

Under generally accepted accounting principles, securities are to be carried on an entity’s financial statements at “fair value.” For securities which are traded on a national exchange (i.e., common stock), fair value is very straightforward—the closing price in the principal market in which the instrument trades.<sup>13</sup> While reported prices do play a role in the valuation of MBSs, determining fair value for MBSs is more complex than simply taking the closing price on any given day to value the securities.

## FAS 157

The framework of the valuation of MBSs is found in Financial Accounting Standards Board Statement of Financial Accounting Standard 157, *Fair Value Measurements*. FAS 157 was issued by the FASB in September 2006 and became effective for fiscal years beginning after Nov. 15, 2007. However, while FAS 157 made certain clarifications with respect to the definition of fair value, the FAS 157 definition of fair value is not conceptually different than the definition found in previous accounting literature.<sup>14</sup> Thus, FAS 157 provides guidance on the valuation of MBSs even for financial statements issued prior to its effective date.

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

<sup>4</sup> *Id.*

<sup>5</sup> *The Subprime Meltdown: a Primer*, Part I of a NERA Insights Series, by Dr. Faten Sabry and Dr. Thomas Schopflocher.

<sup>6</sup> *Id.*

<sup>7</sup> *Delinquencies and Foreclosures Increase in Latest MBA National Delinquency Survey*, press release of the Mortgage Bankers Association, June 5, 2008.

<sup>8</sup> *The Subprime Meltdown: a Primer*.

<sup>9</sup> *Id.* at p. 4 relying on Data from Inside Mortgage Finance Publishing, Inc.

<sup>10</sup> *Subprime Mortgage Derivatives Tumble for a Fourth Straight Week*, Bloomberg.com, Feb. 16, 2007.

<sup>11</sup> *The Housing Bubble of 1997-2006 and the Financial Panic of 2007 and On*, Larry Cordell, Federal Reserve Bank of Philadelphia, at ALI ABA Conference, Sept. 18, 2008.

<sup>12</sup> MBSs come in many different varieties and are sold under different names. However, as the accounting requirements related to the valuation of MBSs is essentially the same across the board, this article simply refers to all variations as MBSs.

<sup>13</sup> Statement of Financial Accounting Standard 115, *Accounting for Certain Investments in Debt and Equity Securities*.

<sup>14</sup> *Measurements of Fair Value in Illiquid (or Less Liquid) Markets*, Center for Audit Quality of the American Institute of Certified Public Accountants, Oct. 2007.

at the measurement date.”<sup>15</sup> In describing what an “orderly transaction” is pursuant to the rule, FAS 157 states:

An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets . . . ; it is not a forced transaction (for example, a forced liquidation or distress sale). The transaction to sell the asset . . . is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset. . . . Therefore, the objective of a fair value measurement is to determine the price that would be received to sell the asset . . . at the measurement date (an exit price).<sup>16</sup>

Since fair value is meant to represent the price that would be received in an orderly transaction between market participants, a determination of fair value necessarily begins with an assessment of the actual prices obtained by market participants in transactions in the securities. With the collapse of the subprime mortgage market and related declines in the volume of the MBS market, questions arose as to whether the prices observed in the market were consistent with the definition of fair value in FAS 157, or whether they were more indicative of distressed sales which, under FAS 157, would not be taken into account in a fair value determination.<sup>17</sup> A white paper issued by the CAQ in October 2007, concluded that market prices were indeed relevant to fair value even in times of low volume, reasoning that:

[i]f orderly transactions are occurring between market participants in a manner that are usual and customary for transactions involving such assets, then those transactions are not “forced” sales. The fact that transaction volume in a market is significantly lower than in previous periods does not necessarily mean that these are forced or distressed sales. Moreover, decreased volumes in a market do not necessarily mean the market has become inactive. Persuasive evidence is required to establish that an observable transaction is a forced or distressed transaction. . . . Because the objective of a fair value measurement is to determine the price that would be received to sell the asset at the measurement date (an exit price)—such a measurement, by definition, requires consideration of current market conditions, including the relative liquidity of the market. It would not be appropriate to disregard observable prices, even if that market is relatively thinner as compared to previous market volume.<sup>18</sup>

The definition of fair value provides that the orderly transaction used to determine the price of a security must be between market participants. FAS 157 provides that market participants are independent of the reporting entity, knowledgeable about the asset or liability such that the transaction is based on all available information, able to transact for the asset or liability, and

willing to transact in that they are motivated but not forced or otherwise compelled to do so.<sup>19</sup>

Although not included in the definition of fair value, FAS 157 provides that the fair value measurement “assumes that the transaction occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability.”<sup>20</sup> The principal market is the market with the greatest volume and level of activity.<sup>21</sup> The most advantageous market is the market in which the reporting entity would transact at a price that maximizes the amount that would be received or minimize the amount that would be paid.<sup>22</sup> “In either case, the principal (or most advantageous) market (and thus, market participants) should be considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities.”<sup>23</sup>

An overarching theme of FAS 157 is that the fair value of the asset at issue “be determined based on the assumptions that *market participants* would use in pricing the asset or liability.”<sup>24</sup> Thus, for example, a hedge fund that holds MBSs is not free to use its own subjective assumptions to value the securities it holds, it is required to use assumptions that market participants would use to price the securities.

## The Fair Value Hierarchy

FAS 157 sets forth a three-level “fair value hierarchy” of inputs to be used in measuring fair value. Level 1 inputs are quoted prices (unadjusted) in active markets for *identical* assets or liabilities.<sup>25</sup> An active market is a market in which transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis.<sup>26</sup> A quoted price in an active market generally provides the most reliable evidence of fair value.<sup>27</sup>

Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable either directly or indirectly.<sup>28</sup> Level 2 inputs include: quoted prices for similar assets in active markets; quoted prices for identical or similar assets in markets that are not active; inputs other than quoted prices that are observable for the asset (i.e., interest rate and yield curves, volatilities, prepayment speeds, loss severities, credit risks, and default rates); and inputs that are derived principally from or corroborated by observable market data by correlation or other means.<sup>29</sup>

Level 3 inputs are unobservable inputs for the asset.<sup>30</sup> Unobservable inputs shall be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset at the mea-

<sup>15</sup> FAS 157, par. 5.

<sup>16</sup> FAS 157, par. 7.

<sup>17</sup> *Measurements of Fair Value in Illiquid (or Less Liquid) Markets* at p. 3.

<sup>18</sup> *Id.* at p. 4.

<sup>19</sup> FAS 157, par. 10.

<sup>20</sup> FAS 157, par. 8.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> FAS 157, par. 11 (emphasis added).

<sup>25</sup> FAS 157, par. 24.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> FAS 157, par. 28.

<sup>29</sup> *Id.*

<sup>30</sup> FAS 157, par. 30.

surement date.<sup>31</sup> Even in this situation, however, the fair value measurement objective remains the same, that is, to obtain an exit price in the principal market from the perspective of a market participant that holds the asset.<sup>32</sup> Therefore, unobservable inputs shall reflect the reporting entity's own expectations about the assumptions that *market participants* would use in pricing the asset in a current transaction (including assumptions about risk), even if the market participant assumptions are different than the reporting entity's own expectations. The reporting entity may not ignore information about market participant assumptions that is reasonably available without undue cost and effort.<sup>33</sup>

Applying the fair value hierarchy to MBSs, if there are quoted market prices in an active market for the identical MBSs, those are the prices that need to be used to value the securities. When those Level 1 inputs are not available, entities will turn to valuation techniques that utilize Level 2 and Level 3 inputs. While many entities use discounted cash flow models to value MBSs, those entities must consider what information is available about some or all of the assumptions that marketplace participants would use in assessing the current fair value of the MBSs at the reporting date.<sup>34</sup>

Some have suggested that market pricing under current market conditions is irrational and that entities should instead use a model-based measurement that is based on the economic "fundamentals" of the asset.<sup>35</sup> However, as the CAQ white paper noted, "FAS 157 states that the use of an entity's own assumptions about future cash flows is compatible with an estimate of fair value, *as long as there are not contrary data indicating the marketplace participants would use different assumptions. If such data exist, the entity must adjust its assumptions to incorporate that market information.*"<sup>36</sup>

Putting the foregoing into practical terms, the CAQ white paper provides the following guidance about the valuation of MBSs:

When using a valuation model to measure the fair value of securities backed by subprime mortgages (when quoted prices are not available), assumption[s] such as prepayment speeds, default rates and discount rates are often key inputs. To the extent that default rate assumptions can be derived from transaction prices observable for similar securities and/or credit default swaps, such data must be used. An additional adjustment, such as a liquidity adjustment, or higher discount rate, might be necessary to ensure the model reflects current market conditions. To test whether the model reflects current market conditions, the model can be applied to similar securities for which price information is available. If the model appropriately reflects current market conditions, it should produce approximately the market price. The parameters and assumptions used in those valuations should also be used, with adjustments where appropriate, to value similar securities where a market price is not currently available. *Im-*

<sup>31</sup> *Id.*

<sup>32</sup> *Measurements of Fair Value in Illiquid (or Less Liquid) Markets* at p. 5.

<sup>33</sup> *Id.* at p. 5-6.

<sup>34</sup> *Id.* at p. 6.

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* (emphasis in original).

*portantly, valuation models that utilize historical default data, an entity's own default assumptions, rather than assumptions that marketplace participants would use, are not appropriately utilizing market participant assumptions, even if the default assumptions are stressed.*<sup>37</sup>

## Auditing the Fair Value of MBSs

The auditor's responsibilities with respect to auditing the fair value of MBSs pursuant to generally accepted auditing standards are set forth in AU Section 328, *Auditing Fair Value Measurements and Disclosures*. AU Section 328 provides that the auditor should obtain "sufficient competent audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP."<sup>38</sup> As FAS 157 is the GAAP provision relevant to the valuation of MBSs, it is the auditor's responsibility to provide reasonable assurance that the reporting entity is appropriately valuing its securities in accordance with the fair value hierarchy and other requirements set forth therein.<sup>39</sup>

The subprime crisis and the rapidly changing dynamics of the MBSs market created a high level of concern for auditors who were charged with the responsibility of ensuring that their clients were appropriately valuing their portfolio of MBSs in accordance with GAAP. In response, in December 2007, the Public Company Accounting Oversight Board issued Staff Audit Practice Alert No. 2 entitled, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*, noting that due to the declines in the housing and mortgage markets and the price declines of many securities backed by subprime mortgages "[l]ower volumes of transactions in certain types of collateralized securities might make it more difficult to obtain relevant market information to estimate the fair value of these financial instruments."<sup>40</sup>

The PCAOB's Staff Audit Practice Alert No. 2 reminded auditors that "[i]n planning and performing procedures in response to the risk associated with fair value measurements, the auditor should obtain an understanding of the company's process for determining fair value measurements and disclosures, including relevant controls."<sup>41</sup> The Staff Alert specified that the auditor should, among other things:

- Evaluate whether management's assumptions are reasonable and reflect, or are not inconsistent with, market information. For example, *the fact*

<sup>37</sup> *Measurements of Fair Value in Illiquid (or Less Liquid) Markets* at p. 6-7 (emphasis added).

<sup>38</sup> AU Sec. 328.03.

<sup>39</sup> As noted above, FAS 157 was not effective for financial statements issued prior to Nov. 15, 2007. However, the concepts codified in FAS 157 were well established prior to its effective date. For example, AU Section 328, which was promulgated before the issuance of FAS 157, stated "[a]lthough GAAP may not prescribe the method for measuring the fair value of an item, it expresses a preference for the use of observable market prices to make that determination. In the absence of observable market prices, GAAP requires fair value to be based on the best information available under the circumstances." AU Sec. 328.03.

<sup>40</sup> *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*, PCAOB, Dec. 10, 2007.

<sup>41</sup> *Id.* at p. 4.

that transaction volume in a particular market is lower than in previous periods may not necessarily support an assumption that transactions in that market constituted forced or distressed sales.

- If management relies on historical financial information in the development of an assumption, consider the extent to which such reliance is justified. However, historical information might not be representative of future considerations or events. For example, *an auditor should evaluate whether a company's use of historical default rates, in an environment in which default rates are increasing, is justified.*
- Evaluate whether the company's method for determining fair value measurements is applied consistently and if so, whether the consistency is appropriate, considering possible changes in the environment or circumstances affecting the company. For example, the relative weightings in a company's model may not be reasonable in situations where there has been a change in market conditions. In such cases, auditors should consider whether compliance with applicable accounting standards might require a change in the model.<sup>42</sup>

After summarizing the fair value hierarchy under FAS 157, the Staff Alert cautioned auditors that:

[b]ecause there are different consequences associated with each of the three levels of the hierarchy, the auditor should be alert for circumstances in which the company may have an incentive to inappropriately classify fair value measurements within the hierarchy. For example, *an asset . . . with Level 1 inputs generally must be measured using unadjusted quoted prices in an active market*, while an asset . . . with Level 2 inputs is measured using observable market inputs other than quoted prices included in Level 1. Accordingly, a Level 2 measurement might allow for more discretion or judgment on the part of management than a Level 1 measurement.<sup>43</sup>

## Auditor Liability for Mark-to-Market Loss Recognition related to MBSs

Banks, hedge funds, and other institutional investors who held MBSs have recognized hundreds of billions of dollars in losses related to mark-to-market writedowns of the securities. What, if any, responsibility is attributable to auditors for the losses? Clearly, no one could argue that auditors are responsible for losses recognized in the normal course of business as a result of following the fair value rules pursuant to FAS 157. But what about auditors who issued unqualified opinions on past financial statements of reporting entities that carried MBSs at artificially inflated prices in violation of FAS 157?

With respect to claims brought under Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), it is not sufficient to merely demonstrate that an auditor violated GAAS, there must also be sufficient allegations that the auditor acted with scienter, or culpable in-

tent.<sup>44</sup> In the context of an accounting firm's audits, the scienter requirement for a Section 10(b) claim generally:

requires more than a misapplication on accounting principles. The plaintiff must prove that the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts.<sup>45</sup>

Given that the subprime crisis and its effects on MBSs occurred so recently, there is a dearth of reported cases addressing the issue of auditor liability as it relates to the valuation of MBSs. However, it is not difficult to predict at least one scenario where allegations against an auditor would inevitably meet the scienter requirements of Section 10(b) of the Exchange Act—the situation where a reporting entity used a valuation model to price the MBSs in its portfolio despite the existence of quoted prices in active markets for identical securities. As detailed above, if there are quoted prices in an active market for the identical securities held by the reporting entity, those prices must be used without any adjustment.

As part of an audit of an entity that holds MBSs, the auditor must obtain “sufficient competent audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP.”<sup>46</sup> The PCAOB's Staff Audit Practice Alert No. 2 provides that “[q]uoted market prices in active markets are the best evidence of fair value and should be used as the basis for the measurement, if available.”<sup>47</sup> In light of the foregoing, it is clear that as part of its audit procedures, an auditor must include two basic steps in its testing of the valuation of MBSs: (1) check for the existence of quoted prices in active markets and (2) compare those prices with the prices utilized by the reporting entity in pricing the MBSs in its portfolio.

The failure of an auditor to check for the existence of quoted prices given the clarity of the relevant GAAP and GAAS pronouncements would certainly meet the scienter requirements of Section 10(b) of the Exchange Act as an accounting practice so deficient that the audit amounted to no audit at all. Similarly, an auditor's acquiescence in a client's use of prices other than quoted prices in active markets, if they exist, should also satisfy the scienter standard in light of the clear guidance that quoted prices *must* be used without any adjustment.

Thus, the use of modeling when true market prices are available is suspect. As part of the professional skepticism required of auditors, it is their duty to appreciate that traders face financial and reputational consequences if their portfolios are marked down. Under the

<sup>44</sup> See *Ezra Charitable Trust v. Tyco International, Ltd.*, 466 F.3d 1, 12 n.10 (1st Cir. 2006) (“[a]lleging a poor audit is not equivalent to alleging an intent to deceive”).

<sup>45</sup> *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385, 390 (9th Cir. 2002) (citations omitted); see also *Novak v. Kasaks*, 216 F.3d 300, 308 (2d Cir. 2000); *In re Suprema Specialties, Inc. Sec. Litig.*, 438 F.3d 256 (3d Cir. 2006).

<sup>46</sup> AU Sec. 328.03.

<sup>47</sup> *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*, PCAOB, Dec. 10, 2007, at p. 3.

<sup>42</sup> *Id.* at p. 4-5.

<sup>43</sup> *Id.* at p. 6.

fair value hierarchy of FAS 157 and the PCAOB guidance issued in connection therewith, auditors cannot permit management to use discretion to adopt a “model price” if a “market price” is available. Accordingly, the use of a “model price” must be supported by evidential matters in the audit workpapers demonstrating that no market prices exist for the securities being valued.

Auditor liability is not as straightforward in the true and documented absence of quoted market prices for the securities whose valuation is being tested. As described above, if quoted prices are not available for the identical securities being examined (Level 1 inputs), the next step is to develop a pricing model that utilizes Level 2 inputs such as quoted prices of similar securities, quoted prices for identical or similar securities in markets that are not active, other inputs that are observable for the securities (*i.e.*, interest rate and yield curves, volatilities, prepayment speeds, loss severities, credit risks, and default rates), and inputs that are derived principally from or corroborated by observable market data by correlation or other means.

While the use of Level 2 of the fair value hierarchy for fair value pricing of MBSs will not produce a price that can be matched against a table in a newspaper, the inputs into the pricing model can and should be verified. Thus, the failure of an auditor to obtain and understand those observable inputs and to check that the assumptions used were applied from the perspective of *market participants*, rather than an entity’s subjective opinions, would also suggest a deficient audit amounting to no audit at all. However, if the observable inputs were in fact tested and corroborated, it would be difficult for a plaintiff to meet the scienter standard in a claim against an auditor even if the valuations were, in fact, high.

Clearly the toughest claim to make against an auditor with respect to the fair value of MBSs would relate to the audit of an entity that used a valuation model with no observable inputs (Level 3 of the hierarchy). Likely the greatest exposure an auditor would have with respect to an audit of a Level 3 valuation would be the uncritical acceptance of management’s representation that no observable inputs existed to enable the entity to value the securities utilizing Level 1 or Level 2 inputs, without testing those representations. Accordingly, the auditor should still look for observable inputs and, if any such inputs are found, should test whether the entity’s valuations are reasonable in light of those observable inputs. Certainly, the existence of observable inputs and the failure of the reporting entity to use them would raise “red flags” that should be investigated further. The failure to do so could potentially satisfy the scienter requirement of a Section 10(b) claim against an auditor, especially in light of the PCAOB’s caution in its Staff Audit Practice Alert No. 2 in which auditors are cautioned that inputs “based on a company’s own data may be more susceptible to preparer bias because they may not be based on observable market inputs. In such cases, the auditor should be aware of the

increased risk of management bias and address the related risk of material misstatement.”<sup>48</sup>

## Recent Developments

In the midst of what has been termed the biggest financial crisis since the great depression, congressmen, banking lobbyists, and companies called for the suspension of the fair value accounting, arguing that it forces entities to report losses they never expect to incur.<sup>49</sup> Indeed, the \$700 billion financial bailout plan included a provision giving the SEC explicit power to suspend fair value accounting.<sup>50</sup> The accounting industry opposed any such suspension, at least in part, because of concern that dropping the rule would negatively impact their businesses.<sup>51</sup>

On Sept. 30, 2008, the SEC Office of the Chief Accountant and the FASB staff responded with a release that did not suspend fair value accounting but instead provided certain clarifications.<sup>52</sup> The release stated that when “an active market for a security does not exist, the use of management estimates that incorporate current market participant expectations of future cash flows, and include appropriate risk premiums, is acceptable.”<sup>53</sup> While the onus is still on the reporting entity to approach fair value from the vantage point of a market participant, the release seems to provide a little more “wiggle room” noting that in some cases unobservable inputs may be more appropriate than observable inputs and that the “determination of fair value often requires significant judgment.”<sup>54</sup>

The release also touched on the use of broker quotes and pricing services, noting that they may be an input when measuring fair value, “but are not necessarily determinative if an active market does not exist for the security.”<sup>55</sup> Thus, 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.”<sup>56</sup>

On Oct. 10, 2008, the FASB issued FASB Staff Position No. FAS 157-3, echoing the guidance set forth in the Sept. 30, 2008, release and providing illustrative examples.<sup>57</sup>

Thus, while the fair value rules have come under heavy fire, as of the date of this article, fair value is still the name of the game in the valuation of MBSs.

<sup>48</sup> *Matters Related to Auditing Fair Value measurements of Financial Instruments and the Use of Specialists*, PCAOB, Dec. 10, 2007, at p. 5.

<sup>49</sup> *SEC, FASB Resist Calls to Suspend Fair-Value Rules*, Sept. 30, 2008, Bloomberg.com; *Banking Group Urges SEC to override FASB Guidance on Fair Value Accounting* (4 APPR 916, 10/17/08).

<sup>50</sup> *Accounting firms urge SEC to keep fair value rules*, Oct. 3, 2008, Reuters.com, <http://www.reuters.com/article/governmentFilingsNews/idUSN0336352820081003>.

<sup>51</sup> *Id.*

<sup>52</sup> *SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting*, Sept. 30, 2008.

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> FSP FAS 157-3, Oct. 10, 2008.