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Normal Turbulence or Perfect Storm? Disparity in Fair Value Estimates

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Abstract

The use of fair value measures in financial statements embeds managerial assumptions about the future into the reporting process. This is particularly so for Level 3 measurements that are developed from financial models of future cash flows. This article documents a case where a firm bought a majority stake of 52% in November 2009 of a subsidiary where it already had an equity holding of 29% (i.e., acquired an additional 23%). The proportionate fair value implied for the 48% noncontrolling stake as well as the 29% prior equity holding in the acquired firm using Level 3 methodology was roughly triple the amount reported as Level 1 measures for these very same holdings. The discrepancy in valuation boosted the bargain gain at acquisition wiping out the retained earnings deficit of the parent firm. In addition, the acquirer reported a US$200 million (40%) impairment of the subsidiaries' primary asset (housing stock) in November 2009 whereas the subsidiary reported the unimpaired value in its year-end financial statements in December 2009. While we agree that Level 3 valuations potentially provide useful information to shareholders, they can fulfill this role only if the disclosures can be effectively audited. Our primary motivation in writing this article is to show that fair value disclosures are not being audited sufficiently rigorously in practice and to make some suggestions on how these rules may be improved.

Keywords

fair value, consolidation, bargain gain

Overview

This article examines several issues confronting regulators as they deliberate fair value measurements and modifications to accounting standards for financial instruments. The details of how fair values affected timeshare accounting is particularly timely, as the issues examined in this article are currently on the regulatory agenda. The Financial Accounting Standards

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Board (FASB) with Accounting Standards Update (ASU) 2011-4 and the International Accounting Standards Board (IASB) with International Financial Reporting Standards (IFRS) 13 have constructed a global framework for applying fair value measurements principles. However, these Standards do not provide guidance on how to incorporate management judgments in arriving at fair values. This article develops a case focusing on issues related to disparities in judgments on a single underlying asset. The data are based on actual reported financial statements, and therefore, particularly relevant. This should enable regulators to consider more carefully the material consequences of some of their decisions.

The theory underlying the use of managerial judgments in preparing financial statements arises from the basic principles of information economics. As management typically has private information about the future economic performance of their own firm, managerial judgments incorporated in financial statements allow some of this private information to be communicated to investors (Demski, Pattell, & Wolfson, 1984; Ronen & Sadan, 1981; Sankar & Subramanyam, 2006). Concern with using amounts derived from inactive markets is not new. Johnson and Storey (1982) expressed concerns as follows:

> Market prices in thin markets reflect utilities and values that only a few actual or potential buyers see in the assets involved, and the market prices at a particular time may result from expectations about their prospective potentials in perhaps one or two possible uses . . . The characteristics of exchange prices resulting from transactions in inactive or thin markets mean that their use involves a risk that they may not be very representative of the assets and liabilities involved. (pp. 63-64)

Agency problems, that is, conflicts between managerial interests and shareholder interests, could destroy the information value of managerial judgments in financial statements as documented empirically in Moses (1987), Tucker and Zarowin (2006), and Demski (1998). From a theoretical perspective, There are two fundamental areas where these agency conflicts arise: (a) executive compensation and (b) ''empire building'' by managers. By overstating performance, top executives are directly able to justify higher levels of pay and bonuses.[1] By acquiring other firms and managing a larger set of assets, top management is able to increase pay and perquisites in indirect ways, but to justify an acquisition or a merger, executives have an incentive to overstate the future benefits associated with these activities (Berkovic & Narayanan, 1993). While our study does not address the issues of agency conflict, it provides evidence of valuation flexibility that could be significant in situations where these conflicts are in, fact, present.[2]

Fair value disclosures have been shown to convey relevant valuation information to the market (Barth, Beaver, & Landsman, 1997; Nelson, 1996). However, there are several papers that argue that Level 3 fair value disclosures are not considered as relevant as Level 1 disclosures by market participants (Kolev, 2008).[3] In fact, Kolev (2008) suggested that some other researchers conclude that Level 3 disclosures are subject to intentional management bias.[4] Popular reports have argued that manipulation can also extend to Level 2 assets that are valued based on quotes from market participants rather than actual trades. A significant example was the manipulation of the LIBOR index. In this instance, leading British Banks strategically distorted the rates that they would *expect* to pay for borrowing from other banks affecting the value of LIBOR in such a way as to increase their own trading profits. The general conclusion drawn from empirical research is that agency problems significantly erode the informational content of fair value disclosures perhaps even to the point of uselessness (Shaffer, 2011, p. 31).

The key factor that preserves the informational value of reporting managerial judgments while minimizing the collateral damage arising from agency conflicts is a close monitoring of financial disclosures. Such monitoring can arise either from corporate boards that protect shareholder interests or from accounting regulations followed by external auditors. In this study, we provide an example where current regulations led two different management teams and auditors to arrive at significantly different fair values for exactly the same set of assets at almost identical points in time. That is, we provide an example where the management of a parent company and its subsidiary provided completely divergent Level 3 valuations for the subsidiaries assets, and both valuations appeared on contemporaneous financial statements.

The companies examined in this article are BFC Financial Corporation (BFC) and Bluegreen Corporation (BG). BFC describes itself as a publicly traded bank holding company, one of whose principal holdings is a controlling interest in BG, itself a publicly traded company. In November 2009, BFC increased its stake in BG from 29% to 52% by acquiring an additional 23% interest. The additional ownership in BG made BFC a majority owner and hence changed its status to that of a controlling interest. As a result of the acquisition of additional interest in BG, BFC reported a bargain gain of US$183 million in its year-end financial statements. Inclusive of this gain, BFC reported net income of US$25 million (see Table 1). BFC reported US$113 million in shareholder's equity as of December 31, 2008 (see Table 2); without the bargain purchase gain, BFC's losses during the 2009 year would have eliminated all opening date balance sheet equity. With the gain from the acquisition of a controlling interest in BG and an additional US$95 million in gains from other merger transactions (not examined in this article), BFC attained US$245 million in shareholder's equity before noncontrolling interests (see Table 3).

BG continued to be a publicly traded company, so a balance sheet as of December 31, 2009, provides results as reported on the acquiree's books. The contemporaneous issuance of parent and subsidiary statements provides us with the opportunity of comparing the fair value of the net assets as recorded by both the acquirer and the acquiree at almost identical points in time. Each of the fair value estimates involving certain assets/liabilities had to be made within days of the other. Thus, we can also evaluate whether there were differences in management judgments utilized by parent and subsidiary in arriving at fair values for the exact same set of assets.

Accounting Principles and Fair Values

As a principal source of its financing, BG securitizes the Vacation Ownership Interests (VOI) notes receivable using special purpose vehicles. This results in accelerating income from monetization of notes receivables (sales accounting). Additional income emanates from interest on held notes receivable and service fees. The retained (economic) interests (nonmonetized notes and service fee receivables) on the balance sheet of BG as reported as of December 31, 2009, totaled US$78 million (Table 4).

The retained interests are accounted for as available-for-sale securities, and so are reported as assets at fair value. When there is no current intent on BG's part to sell the retained interests as well as the financial ability to hold on to them, then changes in fair value of retained interests are reported as unrealized gains and losses through accumulated other comprehensive income (AOCI), except for the portions designated as actual credit losses. In 2007, BG earned a total of US$32 million which included US$40 million in profit from securitization of notes receivable. Interest income reported on retained interests

Table 1. Item 6. Selected Financial Data.

Dollars in thousands, except for per share data	For the years ended December 31 2009 (in US$)	2008 (in US$)
Statement of operations data (e)		
Revenues		
Real estate and other	39,276	16,870
Financial services	354,087	449,571
	393,813	466,441
Costs and expenses		
Real estate and other	206,892	76,470
Financial services	573,467	634,970
	780,359	711,440
Gain on bargain purchase of Bluegreen	183,138	—
Gain on settlement of investment in Woodbridge's subsidiary	29,679	—
Equity in earnings from unconsolidated affiliates	33,381	15,064
Impairment of unconsolidated affiliates	(31,181)	(96,579)
Investments gains (losses), interest, and other income	19,549	(5,722)
(Loss) income from continuing operations before income taxes	(151,980)	(332,236)
(Benefit) provision for income taxes	(67,218)	15,763
(Loss) income from continuing operations	(84,762)	(347,999)
Discontinued operations, net of income tax	(11,931)	19,388
Extraordinary gain, net of income tax	—	9,145
Net (loss) income	(96,693)	(319,466)
Less: Net (loss) income attributable to noncontrolling interests	(122,414)	(260,567)
Net income (loss) attributable to BFC	25,721	(58,899)
Preferred Stock dividends	(750)	(750)
Net income (loss) allocable to common stock	24,971	(59,649)

Note: BFC = BFC Financial Corporation. The table sets forth selected consolidated financial data as of and for the years ended December 31, 2005, through 2009. Certain selected financial data presented above are derived from our consolidated financial statements. This table is a summary and should be read in conjunction with the consolidated financial statements and related notes thereto which are included elsewhere in this report.

was US$8.7 million. In 2008, gains from securitization were only US$8 million, and in 2009, the activity dried-up completely. Mainly due to this reduction in securitization activities, BG experienced overall losses in both these years (Tables 5 and 6).

The remaining material assets are inventory and property and equipment. Inventory (typically units of housing for sale) reported at US$516 million is carried at lower of cost or fair value, and, in either case, reduced by estimated disposal costs. Equipment is carried at amortized cost and is tested for impairments. The recorded amount as of December 31, 2009, is US$86 million (Table 4, Figure 1). Notes payable of US$243 million are backed by the VOI notes receivables and are carried at cost on the books of BG. Table 7 presents the related contractual obligations and due dates. So in sum, the principal assets and liabilities that can be examined for differences in fair value estimates or are subject to mixed attribute on BFC and BG at the date of acquisition are

- Retained interest of securitized bundles of VOI notes receivable
- Notes receivable subject to applicable loan loss reserves, interest rate, and tenor
- Unsold or partially completed timeshares (Inventory)

Table 2. BFC Financial Corporate Consolidated Statements of Changes in Equity for Period Ended December 31, 2009, in Thousands.

	(Accumulated deficit) Retained earnings (in US$)	Accumulated other comprehensive income (Loss) (in US$)	Total BFC shareholders' equity (in US$)	Noncontrolling interest in subsidiaries (in US$)	Total equity (in US$)
Balance, December 31, 2008	(8,848)	(2,298)	112,867	262,554	375,421
Net income (loss)	25,721	—	25,721	(122,414)	(96,693)
Noncontrolling interests from acquisitions	—	—	—	71,444	71,444
Other comprehensive income, net of taxes	—	2,061	2,061	4,244	6,305
Merger transaction (Note 3)	—	—	94,979	(99,583)	(4,604)
Transfer of shares of Common Stock	—	—	—	—	—
Pro rata share of the cumulative effect of accounting changes recognized by Bluegreen on retained interests in notes receivable sold	485	—	485	1,575	2,060
Net effect of subsidiaries' capital transactions attributable to BFC	—	—	8,333	—	8,333
Noncontrolling interest net effect of subsidiaries' capital transactions	—	—	—	41,032	41,032
Cash dividends on 5% Preferred Stock	(750)	—	(750)	—	(750)
Share-based compensation related to stock options and restricted stock	—	—	1,363	—	1,363
Balance, December 31, 2009	16,608	(237)	245,059	158,852	403,911

Table 3. BFC Financial Corporation Consolidated Statements of Financial Condition (in Thousands, Except Share Data).

	December 31, 2009 (in US$)	December 31, 2008 (in US$)
Equity		
Class A common stock of US$0.01 par value, authorized 150,000,000 shares; issued and outstanding 68,521,497 in 2009 and 38,254,389 in 2008	685	382
Class B common stock of US$0.01 par value, authorized 20,000,000 shares; issued and outstanding 6,854,251 in 2009 and 6,875,104 in 2008	69	69
Additional paid-in capital	227,934	123,562
Retained earnings (deficit)	16,608	(8,848)
Accumulated other comprehensive income (loss)	(237)	(2,298)
Total BFC Financial Corporation ("BFC") shareholders' equity	245,059	112,867
Noncontrolling interests	158,852	262,554
Total equity	403,911	375,421
Total liabilities and equity	6,047,037	6,395,582

- Property (other than VOI) and equipment
- Notes payable (unsecuritized)

Of course, differences in carrying values could arise if the parent, BFC, has used fair value whereas the sub, BG, has used cost subject to impairment testing, that is, a mixed attribute environment. The next section lays out the valuation methodology used by BFC and BG and the rationale for the use of these methodologies.

Accounting for BFC's Acquisition of a Controlling Interest in BG

When control is obtained in a partial or step acquisition, assets and liabilities are recognized at 100% of their fair value. The previously held equity interest in the acquiree is remeasured at fair value, and the difference between the acquisition amount attributed to the aggregate of consideration transferred and the carrying amount is computed (ASC 805-30-30-1). If the total consideration exceeds the fair value of net assets, goodwill is recorded for the residual. Any excess of the fair values assigned to the net assets over the fair value assigned to the acquirer's interest (sum of the consideration transferred, equity interest previously held at fair value, and the noncontrolling interest at its fair value) is a bargain purchase. The bargain gain is recognized through income (ASC 805-10-25-10 and IFRS 3R.42). Bargain gains are not allocated to the noncontrolling interest, as the noncontrolling interest is already measured at its fair value.

The bargain gain reported on the books of BFC results from the consolidation of US$308 million in net assets, consisting of US$892 million in assets and liabilities of US$584 million. The amount paid for gaining control was cash consideration of US$23 million and fair value of original equity interest of US$25 million. After additionally attributing a fair value to noncontrolling interest of US$41 million, recognizing a loss of US$8.1 million on original equity interest, and eliminating US$1.5 million from equity representing unrealized losses on the original investment previously carried under the equity

Table 4. Item 8. Financial Statements and Supplementary Data. Bluegreen Corporation Consolidated Balance Sheets (in Thousands, Except per Share Data).

	December 31, 2008 (in US$)	December 31, 2009 (in US$)
Assets (in thousands)		
Cash and cash equivalents (including restricted cash of US$21,214 and US$23,908 at December 31, 2008, and 2009, respectively)	81,775	94,399
Contracts receivable, net	7,452	4,826
Notes receivable (net of allowance of US$52,029 and US$46,826 at December 31, 2008, and 2009, respectively)	340,644	309,307
Prepaid expenses	9,801	7,884
Other assets	27,488	35,054
Inventory	503,269	515,917
Retained interests in notes receivable sold	113,577	78,313
Property and equipment, net	109,501	85,565
Total assets	1,193,507	1,131,265
Liabilities and shareholders' equity (in thousands except per share data)		
Liabilities		
Accounts payable	24,900	14,846
Accrued liabilities and other	52,283	51,083
Deferred income	29,854	14,883
Deferred income taxes	91,802	87,797
Receivable-backed notes payable	249,117	242,828
Lines-of-credit and notes payable	222,739	185,781
Junior subordinated debentures	110,827	110,827
Total liabilities	781,522	708,045
Shareholders' equity		
Preferred stock, US$0.01 par value, 1,000 shares authorized; none issued	—	—
Common stock, US$0.01 par value, 90,000 and 140,000 shares authorized; 33,996 and 34,099 shares issued at December 31, 2008 and 2009, respectively	339	341
Additional paid-in capital	182,654	187,006
Treasury stock, 2,756 common shares at both December 31, 2008, and 2009, at cost	−12,885	−12,885
Accumulated other comprehensive income (loss), net of income taxes	3,173	−608
Retained earnings	209,186	212,376
Total Bluegreen Corporation shareholders' equity	382,467	386,230
Noncontrolling interest	29,518	36,990
Total shareholders' equity	411,985	423,220
Total liabilities and shareholders' equity	1,193,507	1,131,265

method and now being consolidated, a bargain gain of US$183 million was recognized (Table 8).

It is noteworthy that all assets are derived from Level 3 estimates except for cash and restricted cash. Liabilities are determined using Level 2 estimates. The fair value attributed to the noncontrolling interest and original equity interest is reported as a Level 1 measure. The use of Levels 3 and 2 for arriving at values of underlying net assets while using an

Table 5. Summary of Significant Financial Information Related to Our Off-Balance Sheet Facilities and Securitizations and the Related On-Balance Sheet Retained Interests During the Periods Presented Below (in Thousands).

	As of December 31		
	2008 (in US$)		2009 (in US$)
On-balance sheet			
Retained interests in notes receivable sold	113,577		78,313
Off-balance sheet			
Notes receivable sold without recourse	545,496		453,591
Principal balance owed to note receivable purchasers	498,809		411,369
	Years ended December 31		
	2007 (in US$)	2008 (in US$)	2009 (in US$)
Income statement			
Gain on sales of notes receivable[a]	39,372	8,245	—
Interest accretion on retained interests in notes receivable sold[b]	15,157	17,729	19,186
Servicing fee income	8,697	9,436	7,612

[a]Classified as Vacation Ownership Interests (VOI) sales, pursuant to timeshare accounting rules.
[b]Net of other-than-temporary decreases in the fair value of retained interest in notes receivable sold.

illiquid, infrequently traded price (nevertheless, reported as Level 1) leads to a considerable bargain gain at acquisition. That the bargain gain is accounted for as current period income may be considered the perfect storm for fair value accounting.

A simple calculation shows that the Level 1 valuation attributed to the prior equity stake and noncontrolling interests diverges radically from the Level 2 and Level 3 valuations attributed to the assets and liabilities of BG. As described earlier, the net assets of BG consolidated with BFC are measured at US$282 million (US$308 million less US$26 million attributable to noncontrolling interests in a BG joint venture). After acquisition, BFC holds 52% of the equity in BG while the noncontrolling interests hold the remaining 48%. The Level 1 valuation attributed to this 48% interest is US$41 million. Based on this Level 1 valuation, the 52% stake held by BFC should be approximately US$44.5 million in its entirety without deducting the consideration for acquiring this position—yet BFC recorded a bargain purchase gain of US$183 million on acquiring this 52% stake!

Furthermore, the June 30, 2012, Form 10-Q issued by BFC reports that in the first 3 months of 2011, there was a US$53 million loss on assets held for sale by Bluegreen Communities (cf. pp. 16, 19). This suggests that inventory was overstated by a similar amount at date of acquisition. Finally, BFC proposes to acquire the remaining interest of BG shareholders on November 11, 2011 (source: definitive proxy Registration No. 333-178703). The value of the noncontrolling interest in the registration statement is US$89.8 million, that is, the value attributed to noncontrolling interests more than doubled between November 2009 and early 2011 whereas the assets of the firm lost value.

We draw two inferences from these disclosures. First, if the valuation of assets at consolidation had reflected the values that were subsequently realized, the assets would have been reduced by US$53 million and the amount attributed to noncontrolling interests would

Table 6. Bluegreen Corporation Consolidated Statements of Operations (in Thousands, Except per Share Data).

	Year ended December 31, 2007 (in US$)	Year ended December 31, 2008 (in US$)	Year ended December 31, 2009 (in US$)
Revenues			
Gross sales of real estate	605,250	542,632	250,573
Estimated uncollectible VOI notes receivable	−65,242	−75,847	−31,205
Gains on sales of VOI notes receivable	39,372	8,245	—
Sales of real estate	579,380	475,030	219,368
Other resort and communities operations revenue	59,707	62,000	57,199
Fee-based sales commission revenue	—	—	20,057
Interest income	44,703	57,831	69,337
	683,790	594,861	365,961
Costs and expenses			
Cost of real estate sales	178,731	130,267	91,892
Cost of other resort and communities operations	42,459	40,917	37,970
Selling, general, and administrative expenses	377,552	369,700	189,630
Interest expense	24,272	20,888	36,132
Other expense, net	1,743	1,637	1,810
Restructuring charges	—	15,617	—
Goodwill impairment charge	—	8,502	—
	624,757	587,528	357,434
Income before noncontrolling interest, provision (benefit) for income taxes, and discontinued operations	59,033	7,333	8,527
Provision (benefit) for income taxes	19,177	753	−2,640
Income from continuing operations	39,856	6,580	11,167
Discontinued operations			
Operations of sold properties, net of tax	−209	−1	−440
Loss on disposal of properties, net of tax	—	—	−6,827
Loss from discontinued operations	−209	−1	(7,2670
Net income	39,647	6,579	3,900
Less: Net income attributable to noncontrolling interest	7,721	7,095	7,472
Net income (loss) attributable to Bluegreen Corporation	31,926	−516	−3,572

Note: VOI = Vacation Ownership Interests.

have increased by US$48 million reducing the bargain gain by a US$101 million to US$82 million. If a bargain gain of US$101 million had been accrued instead of the US$183 million, BFC would have reported a retained earnings deficit at the start of 2010 (see Column 6 of Table 2).

Second, there is an obvious internal inconsistency between the Level 3 valuation of the net assets of BG and the Level 1 value reported for the noncontrolling interests in 2009 and the prior equity holdings of BFC. A simple extrapolation of the cash paid for the 23% incremental acquisition (US$23 million), the valuation of the previously held 29% stake (US$25 million), and the valuation of the 48% noncontrolling interest (US$42 million) all

Inventory

Our inventory consists of completed VOIs, VOIs under construction, land held for future vacation ownership development and residential land acquired or developed for sale. We carry our completed inventory at the lower of i) cost, including costs of improvements and amenities incurred subsequent to acquisition, capitalized interest, real estate taxes plus other costs incurred during construction, or ii) estimated fair value, less cost to dispose. VOI inventory and cost of sales is accounted for under the provisions of timeshare accounting rules, which defines a specific method of the relative sales value method for relieving VOI inventory and recording cost of sales. Under the relative sales value method required by timeshare accounting rules, cost of sales is calculated as a percentage of net sales using a cost−of−sales percentage—the ratio of total estimated development cost to total estimated VOI revenue, including the estimated incremental revenue from the resale of VOI inventory repossessed, generally as a result of the default of the related receivable. Also, pursuant to timeshare accounting rules, we do not relieve inventory for VOI cost of sales related to anticipated credit losses (accordingly, no adjustment is made when inventory is reacquired upon default of the related receivable). For Communities real estate projects, costs are allocated to individual homesites in the Communities projects based on the relative estimated sales value of each homesite in accordance with ASC 970, which defines the accounting for costs of real estate projects. Under this method, the allocated cost of a unit is relieved from inventory and recognized as cost of sales upon recognition of the related sale. Homesites reacquired upon default of the related receivable are considered held for sale and are recorded at fair value less costs to sell.

During 2008 and 2009, we recorded charges totaling $5.2 million and $13.2 million, respectively, to reduce our carrying value of certain completed inventory in our residential communities' property (see Note 5 for further discussion). We also periodically evaluate the recovery of the carrying amount of our incomplete or undeveloped resort and residential communities' properties under the guidelines of ASC 360, which provides guidance relating to the accounting for the impairment or disposal of long−lived assets.

Property and Equipment

Our property and equipment acquired is recorded at cost. We record depreciation and amortization in a manner that recognizes the cost of our depreciable assets in operations over their estimated useful lives using the straight−line method. Leasehold improvements are amortized over the shorter of the terms of the underlying leases or the estimated useful lives of the improvements. Depreciation expense includes the amortization of assets recorded under capital leases.

Impairment of Long−Lived Assets

We evaluate the recovery of the carrying amounts of our long−lived assets under the guidelines of ASC 360. We review the carrying amounts of our long−lived assets for possible impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. If estimated cash flows are insufficient to recover the investment, an impairment loss is recognized equal to the estimated fair value of the asset less its carrying value and any costs of disposition.

Retained Interest in Notes Receivable Sold

When we sell our notes receivable either pursuant to our vacation ownership receivables purchase facilities (more fully described in Note 3) or through term securitizations, we evaluate whether or not such transfers should be accounted for as a sale pursuant to the accounting rules under ASC 860 for the transfers and servicing of financial assets and extinguishments of liabilities. The evaluation of sale treatment under ASC 860 involves legal assessments of the transactions, which include determining whether the transferred assets have been isolated from us (i.e., put presumptively beyond our reach and the reach of our creditors, even in bankruptcy or other receivership), determining whether each transferee has the right to pledge or exchange the assets it received, and ensuring that we do not maintain effective control over the transferred assets through an agreement that either: (1) entitles and obligates us to repurchase or redeem the assets before their maturity; or (2) provides us with the ability to unilaterally cause the holder to return the assets (other than through a cleanup call).

In connection with such transactions, we retain subordinated tranches and rights to excess interest spread which are retained interests in the notes receivable sold. We also continue to service the notes for a fee. Historically, we have structured the majority of such transactions to be accounted for as "off−balance sheet" sales. Gain or loss on the sale of the receivables depends in part on the allocation of the previous carrying amount of the financial assets involved in the transfer between the assets sold and the retained interests based on their relative fair value at the date of transfer.

We consider our retained interests in notes receivable sold as available−for−sale investments and, accordingly, carry them at fair value. Unrealized gains or losses on our retained interests in notes receivable sold are included in our

shareholders' equity as accumulated other comprehensive income, net of income taxes. The portion of other−than−temporary declines in fair value that represent credit losses are charged to operations.

We measure the fair value of the retained interests in the notes receivable sold initially and on a quarterly basis based on the present value of estimated future expected cash flows using our best estimates of the key assumptions – prepayment rates, loss severity rates, default rates and discount rates commensurate with the risks involved. Interest on the retained interests in notes receivable sold is accreted using the effective yield method.

Figure 1. Bluegreen's Accounting Policies (From 10-K, 2009).

impute a value of approximately US$100 million for BG; in contrast, the Level 3 valuation of the net assets is reported at US$282 million—almost 300% higher than the value imputed by the Level 1 measurements.

This inconsistency is even more striking in retrospect. If the Fair Value of assets were reduced at the time of acquisition by US$53 million, and the Level 3 valuation of management had been halved to US$31.5 million, the total Level 3 valuation of the net assets of BG would have been US$197 million. The noncontrolling 48% share would then have been valued at US$95 million, much closer to the eventual 2011 offer price of US$89.8 million than the US$41 million recorded as a Level 1 value in 2009. To sum up, the Level 3 valuations at the time of acquisition, although inflated in retrospect, were closer in value to the offer made in 2011 than the Level 1 valuations reported at that time, which in hindsight, appear significantly deflated. The combination of an inflated Level 3 valuation for the net assets with a deflated Level 1 valuation for the previously held equity interest and noncontrolling interest almost doubled the reported bargain gain in 2009.

Table 7. From Bluegreen 10-K, 2009.

	Payments due by period				
	Less than 1 year (in US$)	1 to 3 years (in US$)	4 to 5 years (in US$)	After 5 years (in US$)	Total (in US$)
Contractual obligations					
Receivable-backed notes payable	14,409	—	59,055	169,364	242,828
Lines-of-credit and notes payable	73,071	102,679	4,835	5,196	185,781
Junior subordinated debentures	—	—	—	110,827	110,827
Noncancelable operating leases	11,747	17,176	10,225	30,987	70,135
Total contractual obligations	99,227	119,855	74,115	316,374	609,571
Interest obligations[a]					
Receivable-backed notes payable	12,393	23,634	22,502	56,899	115,428
Lines-of-credit and notes payable	8,460	8,117	510	1,034	18,121
Junior subordinated debentures	9,309	13,613	11,307	119,434	153,663
Total contractual interest	30,162	45,364	34,319	177,367	287,212
Total contractual obligations	129,389	165,219	108,434	493,741	896,783

Note: The above table summarizes the contractual minimum principal and interest payments, respectively, required on all of our outstanding debt (including our receivable-backed debt, lines-of-credit, and other notes and debentures payable) and our noncancelable operating leases by period date, as of December 31, 2009, which excludes the extension contemplated by the Wachovia loan term sheet previously discussed (in thousands).
[a]Assumes that the interest rate on variable rate debt remains the same as the rate at December 31, 2009.

The key question, of course, is why the internal inconsistencies across the Levels 1, 2, and 3 valuations in 2009 (made more apparent in 2011) did not provoke a stronger challenge from the auditors particularly when managements' projections had such a significant impact on BFC opening retained earnings. Consistent with economic theory, we think the auditors should be given better guidance on how to challenge the methodology used in preparing the projections, or other bases used by management in arriving at estimates. However, the ability to recognize bargain gains through ''Day 1'' income may be a regulatory mistake creating incentives for management to strategically value assets in a way that is hard for the external auditor to correct. Our recommendation would be to require management and the auditor to review all proposed bargain gains. The bargain gains should be subjected to a probability threshold such as ''more likely than not'' with failure to achieve such a threshold resulting in deferral of the gain. In particular, if the gain is attributable to Level 3 nontraded assets such as ''value of management contracts'' it seems reasonable to defer the gain perhaps through the use of an allowance account. We do not recommend going back to the earlier accounting principle of offsetting gains against noncurrent assets.

Another indication of questions with the derivation of the bargain gain is revealed by the curious change in value of the noncontrolling interest. Ultimately, when BFC made an offer to buy out the noncontrolling interest, the price offered was very close to the tangible net assets of BG (i.e., all assets and liabilities with an adjustment on the value of management contracts). It is interesting to note that if you were a shareholder of BG and observed that the sale resulted in a bargain gain of this magnitude for the buyer, it raises the question of whether the consideration offered in 2009 to purchase a majority stake was adequate.

Table 8. The Aggregate Purchase Price Allocation and Fair Value of the Noncontrolling Interest in Bluegreen as of November 16, 2009 (in Thousands).

Amount in US$		Fair value hierarchy
Cash and cash equivalents	51,621	Level 1
Restricted cash	25,079	Level 1
Property and equipment	83,083	Level 3
Management contracts	63,000	Level 3
Real estate inventory	313,869	Level 3
Notes receivable	285,000	Level 3
Retained interests in notes receivable sold	29,250	Level 3
Other assets	40,983	Level 3
Fair value of assets	891,885	
Accounts payable and other liabilities	50,764	Level 3
Deferred income	10,996	Level 3
Deferred income taxes	29,784	Level 3
Lines of credit and notes payable	198,947	Level 2
Junior subordinated debentures	56,783	Level 2
Receivable-backed notes payable	236,359	Level 2
Fair value of liabilities	583,633	
Noncontrolling interest (Big Cedar Joint Venture)	26,200	Level 3
Net assets acquired	282,052	
Less: Cash consideration on acquisition of additional 23% interest	−22,939	
Less: Fair value of previously held equity interest	−25,126	Level 1
Less: Fair value of noncontrolling interest	−41,254	Level 1
Less: Loss on previously held equity interest	−8,074	
Less: Loss on accumulated other comprehensive income attributable to previously held equity interest	−1,521	
Bargain purchase gain	183,138	

Disparity of BG and BFC Management Estimates

We now look at the differences in fair value estimates rendered by the two management groups and their respective auditors. BFC, the parent, is audited by PWC while Ernst and Young audits subsidiary BG. The BFC estimate of net assets is determined from the step-up of net assets to fair value (see Table 8). The amounts reported by BG are cost-based, in the current mixed attribute reporting system, that is, they are either at cost or fair value based on the results of an impairment tests. Consequently, while BFC can estimate higher Fair Values than BG, any impairment in fair values below historical cost should be the same across both BFC and BG. As we shall show by example, this was not the case for BFC and BG.

Hans Hoogervorst, the chairman of the IASB said in a recent interview that,

> It is also remarkable that our standards can cause one and the same asset to have two different measurement outcomes, depending on the business model according to which it is held. For example, a debt security has to be measured at market value when it is held for trading purposes, but it is reported at historic cost if it is held to maturity; in this case, the business model approach certainly provides a plausible answer. Still, some may find it counter intuitive that a government bond that is held

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Management's assessment and our audit of BFC Financial Corporation's internal control over financial reporting also included controls over the preparation of financial statements in accordance with the instructions to the Consolidated Financial Statements for Savings and Loan Holding Companies (OTS Form H-(b) 11) to comply with the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA). A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As described in Management's Report on Internal Control over Financial Reporting, management has excluded Bluegreen Corporation from its assessment of internal control over financial reporting as of December 31, 2009 because it was acquired by the Company in a purchase business combination during 2009. We have also excluded Bluegreen from our audit of internal control over financial reporting. Bluegreen Corporation is an approximately 52 percent-owned consolidated subsidiary, whose total assets and total revenues represent $894.2 million and $29.6 million, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 2009.

/s/ PricewaterhouseCoopers LLP
Miami, Florida
April 12, 2010

Figure 2. Auditor's Report, BFC 2009.
Note: BFC = BFC Financial Corporation.

to maturity would be valued at a higher price than the same bond held in a trading portfolio, where it may be subject to a discount. In the exact sciences, such a dual outcome would certainly not be acceptable.

If a dual valuation outcome based on different business models is considered troubling, it is doubly troubling when dual outcomes arise out of separate valuations based on the same assets and the same business model as in the case of BFC and BG.

As shown in Figure 2, PWC indicates it did not audit the historical records of BG, but audited the adjustments made to those statements. While on the surface, this suggests that the financial statements of BFC are prepared presenting fair values of BG net assets as contrasted to cost on BG's books and records. However, as was shown, BG values inventory at the lower of cost or market, and its retained interests at fair value. Notes receivable are subject to a test for loan losses and property and equipment is subject to an impairment test. As such, we can compare the carrying amounts on the two sets of books, and when in this case there are differences, we can legitimately characterize those differences as disparities in carrying amounts.

Table 9 summarizes key differences in methodology on parent and sub at the acquisition date.

We have already noted the internal inconsistencies in the valuations reported by BFC at consolidation. The additional issue concerns differences in estimates provided by two management teams and two different external auditors acting for the parent, BFC, and the sub BG, respectively. BG's estimates of inventory at lower of cost or market exceeds the fair value measure of BFC by US$202 million, that is, by more than 60%. The obvious question is why the impairment recorded by BFC in November 2009 was not reported by BG in December 2009. There is also a US$26 million difference in notes receivable under a Statement of Financial Accounting Standards (SFAS) 5 contingency model and a Level 3 evaluation of notes receivable on BFC's books. Clearly, the models being used to calculate credit losses by BG is different from the future cash flows (Level 3) model used by BFC and results in a gain from impairment analysis. As with the case of bonds, the recording of gains arising from impairment of debt is economically questionable. In any event, the consequence of this impairment is to increase the net assets of BG and hence the Day 1

Table 9. Key Differences in Methodology on Parent and Sub at the Acquisition Date.

	BFC	Measurement basis	BG	Measurement basis	Difference
Inventory	314	Fair value Level 3	516	Lower of cost or fair value	(202)
Retained interest	29	Fair value Level 3	78	Fair value gain or loss AOCI	(49)
Notes receivable	283	Fair value Level 3	309	FAS 5 tested for credit impairment	(26)
Property and equipment	83.1	Fair value Level 3	86	Amortized cost	(2.9)
Notes payable	257	Fair value Level 2	287	Cost	30

Note: BFC = BFC Financial Corporation; BG = Bluegreen Corporation; AOCI = accumulated other comprehensive income; FAS = Financial Accounting Standards.

bargain gain recorded by BFC. The last issue concerns the difference in valuation of the retained interests. As this raised issues outside the valuation process, we discuss it separately in the next section.

Accounting for Qualified Special Purpose Entity (QSPE)–Held Assets and Debts

A second major change related to the value of financial instruments occurs on the books and records of both BFC and BG on January 1, 2010. As was seen previously, a major source of funding used by BG was securitizing notes receivable using a QSPE. The accounting for such securitzations was modified under SFAS No. 166 ''Accounting for Transfers of Financial Assets,'' which resulted in the demise of the vehicle and the consolidation of the QSPEs as if direct financings were utilized all along. The pronouncement was adopted retroactively as of January 1, 2010, by both parent and sub.

On BG's books, the adoption of consolidation accounting revealed a gap of US$61 million in assets (receivables) versus liabilities and hence reversal of previously recorded sales resulted in a US$61 million reduction in opening retained earnings (Table 10).[5] Assets increased by US$319.3 million representing consolidation of notes receivable previously held by the QSPEs and liabilities increased by US$380 million, primarily representing consolidation of nonrecourse debt also held by the QSPEs. Credit losses associated with nonrecourse debt are hard to quantify as the process of securitization allocates these losses differentially across tranches that are sold and tranches that are retained. To the extent that future losses in these consolidated QSPE positions may reduce payments to third-party investors, BFC may experience gains from nonpayment to QSPEs from the borrowings that underlie the securitization. For this reason, consolidation may misrepresent the true picture of assets and liabilities held in QSPEs.

Accounting for Retained Interests

The source of the write-down in retained interests on BG books is an increase in provision for loan losses on notes receivable and additional notes payable. Under current reporting, the retained interests were carried at fair value with credit losses being written-off against income. The remaining unrealized losses go through AOCI. With the consolidation of the QSPEs, the retained interests previously related to the QSPEs are eliminated as well as the unrealized losses in AOCI. This results in a US$60 million decrease in shareholders' equity for BG as follows.

Table 10. Equity Attributable to Bluegreen Shareholders.

	Total (in US$)	Common stock (in US$)	Additional paid-in-capital (in US$)	Retained earnings (in US$)	Treasury stock at cost (in US$)	AOCI (loss, net of taxes, in US$)	Equity attributable to noncontrolling interests (in US$)
Balance at December 31, 2009	423,220	341	187,006	212,376	(12,885)	(608)	36,990
Impact of adoption of ASU 2009-16 and 2009-17	(60,673)	—	—	(61,281)	—	608	—
Balance at January 1, 2010	362,547	341	187,006	151,095	(12,885)	—	36,990
Net (loss)	(6,318)	—	—	(7,857)	—	—	1,539
Stock compensation	1,134	—	1,134	—	—	—	—
Balance at March 31, 2010	357,363	341	188,14	143,238	(12,885)	—	38,529

Note 1: Recently Adopted Accounting Pronouncements.

In December 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update ("ASU") No. 2009-17, *Improvements to Financial* Reporting by Enterprises Involved With Variable Interest Entities ("ASU 2009-17"). ASU 2009-17 changes how a reporting entity determines when an entity that is insufficiently capitalized or is not controlled by the reporting entity through voting (or similar rights) should be consolidated. The determination of whether a reporting entity is required to consolidate another entity is based on, among other things, the other entity's purpose and design and the reporting entity's ability to direct the activities of the other entity that most significantly impact the other entity's economic performance. The new standard requires a number of new disclosures, including additional disclosures about the reporting entity's involvement with variable interest entities and any significant changes in risk exposure due to that involvement. A reporting entity is required to disclose how its involvement with a variable interest entity affects the reporting entity's financial statements. ASU 2009-17, which was adopted by us on January 1, 2010, did not impact our consolidated financial statements.

In January 2010, the FASB issued ASU No. 2010-06, which updates the Codification to require new disclosures for assets and liabilities measured at fair value. The requirements include expanded disclosure of valuation methodologies for fair value measurements, transfers between levels of the fair value hierarchy, and gross rather than net presentation of certain changes in Level 3 fair value measurements.

Note 2: Cumulative Effect of a Change in Accounting Principle.

On January 1, 2010, we adopted Financial Accounting Standards No. 166, *Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140* ("SFAS No. 166") or Accounting Standards Update No. 2009-16, *Transfers and Servicing ("ASC 860"): Accounting for Transfers of Financial Assets* ("ASU 2009-16") and SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)* ("SFAS No. 167") or Accounting Standards Update No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved With Variable Interest Entities* ("ASU No. 2009-17"). As a result of the adoption of these accounting standards we consolidated seven existing special purpose finance entities associated with prior securitization transactions which previously qualified for off-balance sheet sales treatment. We recorded a one-time, noncash, aftertax reduction to retained earnings of US$61.3 million, representing the cumulative effect of a change in accounting principle.

The consolidation of the seven special purpose finance entities resulted in the following impacts to our balance sheet at January 1, 2010: (a) assets increased by US$319.3 million, primarily representing the consolidation of notes receivable, net of allowance, partially offset by the elimination of our retained interests; (b) liabilities increased by US$380.0 million, primarily representing the consolidation of nonrecourse debt obligations to securitization investors, partially offset by the elimination of certain deferred tax liabilities; and (c) total Bluegreen Corporation shareholders' equity decreased by approximately US$60.7 million. In addition, the adoption of these standards also impacted our Statement of Operations during the 3 months ended March 31, 2010, as a result of the recognition of higher interest income from VOI notes receivable, partially offset by the absence of accretion income on residual interests that were eliminated, and increased interest expense from the consolidation of debt obligations.

Note: AOCI = accumulated other comprehensive income; SFAS = Statement of Financial Accounting Standards; VOI = Vacation Ownership Interests.

Table 11. Loan Loss Provisions.

Balance, December 31, 2009	US$ 46,826
One time impact of ASU No. 2009-16 and 2009-17(FAS 166/167)[a]	US$ 86,252
Provision for loan losses[b]	US$ 15,012
Less: Write-offs of uncollectible receivables	US$ (24,134)
Balance, March 31, 2010	US$ 123,956

Source: BG Form 10-Q 3/2010.

[a]On January 1, 2010, we adopted ASU No. 2009-16 and ASU No. 2009-17, which required us to consolidate our special purpose finance entities. See Note 2 in Table 10.

[b]Includes provision for loan losses on homesite notes receivable and an adjustment of US$10.7 million related to an increase in our existing allowance to reflect the expected performance of our notes receivable generated prior to December 15, 2008.

Notes Receivable (gross) increased by US$483 million (consisting of the US$319 million net increase in assets [Table 10] plus US$86 million increase in allowance [shown below] and US$78 million reported earlier as retained interest) with receivables net of allowance increasing US$397 million. Nonrecourse debt increased by US$380 million (Table 10) leading to a net value of US$17 million. As the retained interest had originally been reported at US$78 million, there was a net charge to retained earnings of US$61 million as a result of the consolidation (Table 10).

Table 11 sets forth the activity in our allowance for uncollectible notes receivable during the 3 months ended March 31, 2010 (in thousands).

BFC took the write-down at the date of acquisition. This raises a significant issue of why fair value estimates on BG financial statements as of year-end did not capture a similar impairment. BG only recognizes the decline one quarter later. On BFC's books, the fair values had already been recognized as of December 31, 2009, so retained earnings was reduced by only US$2.1 million (Table 12). Notes payable increased by US$411 million and notes receivable by US$377 million.

Reviewing the adoption impact of consolidating the QSPEs on BFC's book supports the acquisition date write-down of retained interests. Restricted cash of US$36 million and notes receivable of US$377 is sufficient to cover notes payable of US$411 million. This supports attributing any remaining shortfalls against retained interests. The question is why this was not captured sooner on BG books. The other question is nontransparency in previously accounting for such net assets as retained interests with off-balance sheet presentation as contrasted to consolidating the underlying assets and liabilities with the consolidation of the QSPEs. The use of the original value of the retained interest of US$78 million as reported by BG (see Table 9) would have led to a greater write-down of equity. QSPEs often overstated income by using fair values for retained interests which were typically nonmarketable (and hence, retained). Consequently, consolidation with QSPE's often led to write-downs of retained interest (Bryant, Lilien, & Sarath, 2010). Had these write-downs of retained interests been taken on a more timely basis, they would have flowed at least through AOCI on BG's books while the portions attributable to credit risk would have flowed through income. Even after the write-down of retained interest at the time of acquisition (November 2009) as reported in Table 8, BG continued to report much higher values for at least another quarter.

Consolidating the underlying assets and liabilities held in QSPEs has forced the write-down of retained interests to more accurate levels. This is exhibited in the valuations

Table 12. BFC Financial Statement: Net Changes in Equity 10-Q 2010.

	Additional paid-in capital (in US$)	(Accumulated deficit) retained earnings (in US$)	Other comprehensive income (loss) (in US$)	Total BFC shareholders' equity (in US$)	Noncontrolling interest in subsidiaries (in US$)	Total equity (in US$)
Balance, December 31, 2009	227,934	16,608	(237)	245,059	158,852	403,911
Cumulative effect of change in accounting principle (see Note)	—	(2,137)	925	(1,212)	(811)	(2,023)
Balance beginning of year, as adjusted	227,934	14,471	688	243,847	158,041	401,888
Net loss	—	(20,835)		(20,835)	(14,665)	(35,500)
Other comprehensive income (loss)	—	—	1,692	1,692	(1,392)	300
Net effect of subsidiaries' capital transactions attributable to BFC	814	—	—	814	—	814
Noncontrolling interest net effect of subsidiaries' capital transactions	—	—	—	—	790	790
Cash dividends on 5% Preferred Stock	—	(188)	—	−188	—	−188
Share-based compensation related to stock options	335	—	—	335	—	335
Balance, March 31, 2010	229,083	(6,552)	2,380	255,665	142,774	368,439

Note: Cumulative Effect of Change in Accounting Principle.

On January 1, 2010, BFC, Bluegreen, and BankAtlantic Bancorp adopted an amendment to the accounting guidance for transfers of financial assets and an amendment to the accounting guidance associated with the consolidation of variable interest entities (VIE's). As a result of the adoption of these accounting standards, Bluegreen consolidated seven existing special purpose finance entities (QSPE's) associated with prior securitization transactions which previously qualified for off-balance sheet sales treatment, and BankAtlantic Bancorp consolidated its joint ventures that conduct a factoring business. Accordingly, Bluegreen's special purpose factoring entities and BankAtlantic Bancorp's factoring joint ventures are now consolidated in BFC's financial statements, and resulted in a one-time noncash aftertax reduction to retained earnings of US$2.1 million, representing the cumulative effect of a change in accounting principle associate with the consolidation of Bluegreen's seven existing special purpose entities. No charges were recorded to retained earnings in connection with the consolidation of BankAtlantic Bancorp's factoring joint venture.

The consolidation of Bluegreen's special purpose finance entities resulted in the following impacts to BFC's Consolidated financial statements of financial condition at January 1, 2010: (a) assets increased by US$413.8 million, primarily representing consolidation of notes receivable net of allowance, partially offset by the elimination of retained interests; (b) liabilities increased by US$416.1 million primarily representing the consolidation of nonrecourse debt obligations to securitization investors partially offset by the elimination of certain deferred tax liabilities; and (c) total equity decreased by approximately US$2.3 million, including a decrease in the noncontrolling interest of approximately US$1.1 million.

Note: BFC = BFC Financial Corporation; QSPE = qualified special purpose entity.

reported by BFC and BG. However, an analysis of the loan loss reserves suggests that the current provisions may typically cover the entirety of expected losses. Although this is consistent with conservative accounting, it does not fit the spirit of fair value accounting as some of the credit losses may actually be picked up by third-party investors. In other words, the credit loss model will in many cases diverge from an expected loss based on future credit defaults.

Implications for Rule-Makers

On May 2011, the FASB issued ASU 2011-04, Fair Value Measurement (Topic 820) Amendments to Achieve Fair Value Measurement and Disclosure Requirements in U.S. Generally Accepted Accounting Principles (GAAP) and IFRS. The IASB similarly promulgated IFRS 13, Fair Value Measurement on January 1, 2012. These documents are an attempt by both the FASB and IASB to reach convergence on fair value measurement guidance. This article analyzes, both conceptually and through a specific example, the practical problems inherent in these Fair Value Standards.

There are fundamental issues of transparency in trying to communicate Level 3 estimates of value which involve models of future cash flows. The assumptions underlying these models cannot (yet) be communicated effectively in financial statements. As a consequence, investors are left in the dark regarding the managerial optimism (or pessimism) in the reported estimates. Therefore, the burden of ensuring the accuracy of these estimates rests with the auditor and financial regulators.

Rule-makers have to address the processes surrounding application of management judgment to fair value estimates. Judgments are critical in arriving at Level 3 estimates, and Levels 2 and 1 are also prone to errors when there are thinly traded securities or significant discretion in designating comparables. If audits of fair values estimates are to be effective, rule-makers must address the possibility that those engaged in fair value estimates ''see situations in their own eyes, perhaps, biased by what they wish to believe and wish to see happen.'' The analysis that we provide of the merger of BFC and BG, as well as of the subsequent financial reports of the consolidated entity, suggests that changes in current procedures are desirable.

SFAS 166 modified the financial components approach previously used in SFAS 140 and limited the circumstances in which a transferor de-recognizes a portion of the components of a financial asset. A qualified special purpose vehicle was used in structuring such transactions (QSPE). With the demise of the off-balance sheet QSPE under new accounting rules, the retained interest is eliminated and the vehicle is consolidated. The IASB is also deliberating a partial de-recognition model with the transfer of a proportionate interest in the cash flows. This is similar to participating interest in SFAS 167. In our case, we demonstrate significant differences in the fair value estimates attributed to the same retained interests as reported on the books of the acquirer and acquiree. Two managements and two Big Four auditors reported materially different amounts for the same underlying assets. This was clearly not the intent of SFAS 166 and suggests that procedural changes in how fair value estimates are eventually reported may be needed.

It is also important that regulators consider why the fair value of the retained interest on the acquiree's books exceeds that of the underlying notes receivable and collateralized payables much below the outcomes from a loan loss model. A loan loss model appears to be capturing the decline in value of the notes receivable faster than the fair value model used in accounting for retained interests. It is our belief that when one looks at loan disclosures and recent modifications in disclosures, the details of the underlying assets are much more transparent than fair value disclosures surrounding retained interests. The most common reason for retaining interests in securitizations is that they are not easily marketable; to permit fair value disclosures for these retained interests is, at least from a logical perspective, questionable.

Our results suggest that market-place focus on cosmetic earnings management may be secondary to the more pressing issue of nontransparency of estimates surrounding fair value disclosures. Even if there is no attempt to deceive, psychological biases of management as well as their valuation experts may be reflected in fair value disclosures making it difficult for investors to compare across firms. The only way such comparability can be achieved is through greater scrutiny in the audit process and perhaps a greater standardization of models. The fact that such standardization does not happen even across a parent firm and its subsidiary is surprising. Perhaps, a Public Company Accounting Oversight Board (PCAOB) round-table on how standardization can be achieved across firms and auditors is warranted.

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Notes

1. Shaffer (2011) suggested that the benefit provided by management's insight may not outweigh the problems introduced when conservatism is no longer employed as an accounting constraint or where fair value estimates are used to measure management performance.
2. A comprehensive analysis of the trade-off between informativeness and agency costs arising from managerial discretion is provided in Ronen and Yaari (2007).
3. Fair value disclosures are categorized into three tiers: (a) value based on trades in liquid markets, (b) value based on the value of traded assets that have similar economic features or from models with observable inputs, and (c) value based on models of future cash flows with estimated inputs (Shaffer, 2011).
4. Furthermore, the reliance on managerial assumptions in the valuation process opens the door to intentional bias, rendering mark-to-model estimates potentially misleading (Martin, Rich, & Wilks, 2006; Ronen, 2008; as cited in Kolev, 2008).
5. The effect of changes in accounting principles goes directly to equity and do not flow through income or accumulated other comprehensive income (AOCI).

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