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ACCOUNTING

Mark-to-market accounting

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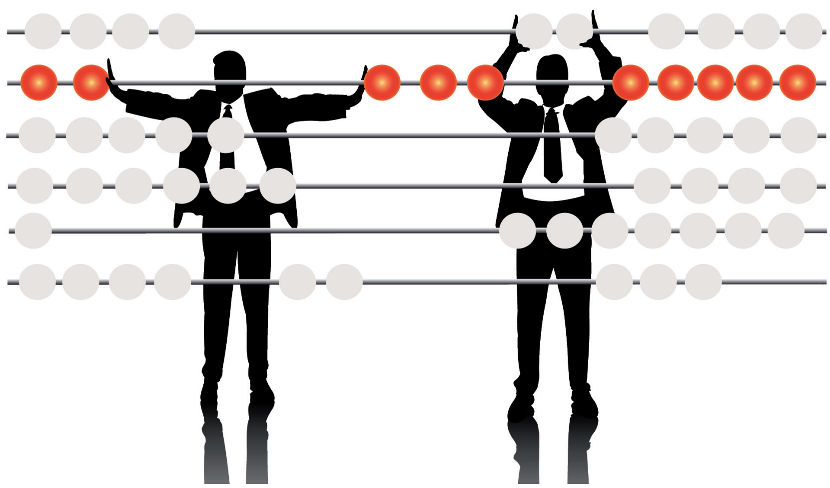

The near-collapse of the US banking system has its roots in several areas, but many economists were convinced that the inappropriate use of fair value accounting rules in an increasingly inactive market had played a significant role. As such, the Emergency Economic Stabilization Act gave the Securities and Exchange Commission (SEC) 90 days to examine the effects of fair value accounting, allowing them to suspend mark-to-market accounting if they saw fit. They did not, but acknowledged that the rules are not perfect. Subsequently, the SEC recommended that the Financial Accounting Standards Board (FASB) should develop further guidelines to bring clarity to mark-to-market methods. However, while the FASB works on those guidelines, fair value remains one of the most controversial areas in accounting.

Fair value in a financial saga

The issue of fair value accounting and its effects on the US market has polarised the opinions of lawyers, accountants and regulators during the last year. One side believes that valuing assets using fair value accounting methods is pointless in a falling, illiquid market, and will continue to make matters worse unless it is suspended. The other side, however, has lauded fair value for giving the US market an early warning of the turmoil that was to come. Anna T Pinedo, a partner at Morrison & Foerster, falls into the first camp, citing mark-to-market accounting as a barrier to the success of government stimulus plans. "US and foreign governments have taken unprecedented steps to combat the financial crisis. In the US, the Treasury has injected approximately $250bn of capital into financial institutions, the FDIC has expanded guarantees for bank liabilities, the Fed has cut rates and has introduced a number of credit and other facilities intended to provide liquidity to different segments of the market. However, despite all these emergency actions, the economy continues to weaken, and financial institutions continue to write down the value of their troubled assets." She notes that lingering concerns as to the value of these assets seem, at least for now, to be stronger than the government's emergency measures.

Of course, it is doubtful that fair value is the only culprit behind the financial crisis, but it is clearly having a significant effect, particularly for institutions which hold large portfolios of mortgage and asset-backed securities. Mark-to-market accounting values assets based on their resale values in current markets. In a market where liquidity is scarce, and where few investors are buying anything at all, marking to market will generally mean that the value of assets must be written down by their owner. Those who oppose fair value accounting say that its results are often wildly different from the intrinsic value of the assets, which is usually calculated by summing the future income generated by the asset, and discounting it to the present value. This suggests that fair value is either unsuitable for an illiquid market, or is not being applied correctly.

It could well be the case that this is exacerbating the cycle of writedowns. In the current market, financial institutions are writing down the value of their toxic assets at the end of each quarter. Every time this occurs, a new 'floor' for those assets is reached, causing other institutions with similar assets to do likewise. Critics of fair value believe that this is an important factor in the loss of investor confidence in the financial viability of these institutions. Until the market hits bottom, they are not interested in making a move. As such, there have been calls for fair value accounting to be suspended, although there have been concessions that doing so at this late stage may be pointless.

But these strong views have met with equally strong opposition. "Fair value accounting had no part in causing the financial crisis – poor lending and investment decisions are responsible," asserts Scott Ehrlich, a managing director at Mind the GAAP, LLC. "If anything, fair value accounting probably helped identify the bad business practices that led to the crisis sooner than other accounting methods would have. Fair value accounting is like the 'check engine' light in your car. It can tell you that something doesn't seem right and needs to be investigated, but it's certainly not the cause of the malfunction." Supporters of fair value maintain that while mark-to-market accounting is not perfect, it does a good job of approximating the worth of a company's assets at a point in time, thereby allowing the asset holders to predict where future losses might occur. Had fair value been suspended, many

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investors and creditors would have been denied this insight.

SEC and FASB assistance

In its recent study on mark-to-market accounting and its role in the financial crisis, the SEC highlighted some interesting points. On average, financial institutions used fair value measurements on 45 percent of assets and 15 percent of liabilities on their balance sheets. Furthermore, only 25 percent of those assets were significantly affected by fair value. Notably, the reported income of the financial institutions surveyed was still affected by the use of fair value measurements, but the report stopped short of connecting this with the recent spate of bank failures. The SEC observed "that fair value accounting did not appear to play a meaningful role in bank failures occurring during 2008. Rather, bank failures in the U.S. appeared to be the result of growing probable credit losses, concerns about asset quality, and, in certain cases, eroding lender and investor confidence. For the failed banks that did recognize sizable fair value losses, it does not appear that the reporting of these losses was the reason the bank failed."

Ultimately, the purpose of the report was to emphasise areas of fair value accounting which could be improved by the FASB. The main areas highlighted were split into two. The first is application guidance, which includes how to determine when a market is inactive or a transaction is distressed, and how to apply fair value to interests in alternative investments. The second is improving disclosures pertaining to fair value measurements. Based on the SEC report, and further input from its Valuation Resource Group, the FASB has started working on these elements. In a press release, it initially predicted that it will be able to provide further application guidance by the end of Q2 2009, and will be able to clarify disclosure in time for year-end financial reporting. However, it has promised in recent weeks to deliver those guidelines at least three months earlier due to pressure from Congress.

Until then, financial institutions which are currently struggling to apply fair value with any accuracy will have to rely on current FASB guidelines. The FASB prioritises inputs or assumptions used by market participants when pricing assets into three levels: level one constitutes observable, independent data, whereas levels two and three constitute the judgement of the institution in question, based on the best available information. "Level two inputs do not have observable market prices but have inputs based on them," explains Ms Pinedo. "They can be obtained by using prices that are not current, price quotations that vary substantially over time or among market makers, or in markets where little information is released publicly. Level two inputs can also include other observable factors relating to an asset or liability, such as interest rates and yield curves, prepayment speeds, loss severities, default rates, or factors derived principally from observable market data by correlation or other means." These will also need to be subject to adjustments if it is thought that factors specific to the asset or liability will affect their value. These include the location, condition, and the extent to which inputs relate to items that are comparable to the asset or liability. The activity in the market within which the inputs are observed is also a factor. If numerous adjustments are made, the level two input may have to be reclassified as a level three.

If there are no observable inputs available due to subdued market activity, the value of the asset or liability must reflect the reporting entity's own pricing assumptions. They must consider whether the asset is sold in a distressed sale, or whether the value of the asset is "other than temporarily impaired". Pricing in this manner requires reasonable judgement based on reasonably accessible evidence. Reporting entities are not required to seek out all available information pertaining to the assumptions of market participants, but they cannot ignore reasonably accessible information indicating that those market participants would use different assumptions.

However, determining asset values in this manner has proved challenging. As a result, the FASB is diligently working to provide additional guidelines. How effective the new guidelines will be remains to be seen, but Mr Ehrlich suggests that they "should include a few well developed principles and dozens of examples on how to apply those principles in practice. Specifically, the guidance should define an inactive market, and reaffirm that all available information, including past trading data, should be used in arriving at a reasonable estimate of fair value. The examples can then demonstrate how to apply these principles to common situations." He adds that the FASB should start its endeavours by looking at 'Measuring and disclosing the fair value of financial instruments in markets that are no longer active', a paper published by the International Accounting Standards Board (IASB) Expert Advisory Panel, which contains some interesting thoughts on how to determine whether markets are inactive, and how to value assets in such markets.

Finding another way

If nothing else, both sides of the fair value debate agree that change is required. "A number of commentators have suggested that FASB modify fair value accounting principles and introduce more flexibility for securities for which there is no active market. For example, one school of thought is to create a category for assets that are credit impaired and another category for assets that are liquidity impaired.

Regulators and accounting standards boards should consider carefully whether fair value accounting standards truly introduce greater transparency," says Ms Pinedo. However, the SEC's stance on fair value suggests that it is here to stay for the foreseeable future.

Supporters of fair value, on the other hand, believe that its use should be extended to cover instruments such as originated loans and held-to-maturity securities. "It is a wasted effort to work on potential alternatives for fair value accounting because no model will ever be perfect," asserts Mr Ehrlich. "I think the real issue is that we need to better educate preparers, auditors and users around both the advantages, as well as the limitations, of fair value measurements. For example, many investors just assume that fair value measurements are precise. But practically nothing in financial statements is precise – estimates are made around the timing and amount of revenues to recognise, the amount of depreciation to record, and a number of other things." Fair value is no different, and pushing for a perfect system will only end in frustration.

Nonetheless, this debate will continue to rage on. Indeed, it has seriously intensified in recent weeks. In mid-March, representatives from the FASB and SEC agreed before the House Financial Services committee to finalise changes to mark-to-market accounting within three weeks – considerably quicker than their original estimate. The action they will take is unknown, but Congress has made it clear that they do not approve of mark-to-market accounting in its current form. Speeding up the process of extending and clarifying the current guidelines is likely to have a positive effect. However, the FASB needs to ensure that its new guidelines are well-considered, lest they bring more confusion to an already delicate situation. ■

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Scott A. Ehrlich is the founder and Managing Director of Mind the GAAP, LLC.

Mind the GAAP provides training and consulting services on the application of U.S. GAAP and IFRS. Clients include Fortune 500 enterprises as well as four of the world's largest accounting firms.

As the head of Mind the GAAP, Scott is responsible for overseeing the operations of the company, as well as establishing the firm's strategic goals. Nonetheless, Scott remains actively and deeply involved with all of the company's clients. In particular, Scott performs the vast majority of the company's technical writing and delivers most training materials. Scott is also the primary face to clients when providing consultation on new or emerging accounting issues.

Prior to founding Mind the GAAP, Scott Ehrlich spent ten years with Arthur Andersen, including as a member of the firm's national practice. In this capacity, Scott primarily was responsible for creating and executing Andersen's strategy for improving the technical competency of both employees and clients.

Scott Ehrlich is Certified Public Accountant in the state of Pennsylvania and a member of the American Institute of Certified Public Accountants. He was awarded the state of Connecticut's Gold Medal Award for the highest score on the November 1993 CPA exam.

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