Fair Fight

Does market turmoil justify the suspension of fair value accounting rules?

BY LORI PIZZANI

KEY POINTS

- At the height of the U.S. financial market crisis, suspension of fair value pricing standards was considered but rejected.
- The U.S. SEC issued additional guidance on determining fair value for illiquid assets or frozen market conditions.
- A formal SEC study on fair value and its impact on the crisis determined that fair value requirements did not cause banks to fail.
- The same SEC study recommended that fair value standards not be suspended but indicated that further guidelines are needed.

The debate over the precise process, usage, and determination of fair value has definitely heated up in recent months.

In September and October 2008, at the height of the U.S. financial crisis and with credit markets frozen, opponents of fair value suggested that the concept was unnecessarily weighing down troubled banks' balance sheets by forcing them to value suddenly illiquid assets at unrealistic, fire-sale prices. Those sharp write-downs contributed to the failure of some banks and forced others into precarious financial situations, critics charged.

Proponents of fair value argued that blaming the financial system's troubles on fair value accounting standards was akin to "shooting the messenger." The fair value pricing of assets brought order to the accounting process and allowed financial institutions' toxic securities to be seen for what they really were.

"Exacerbating Economic Downturns"

As the U.S. Treasury and U.S. Congress considered how to shore up troubled financial institutions, suggestions were made that setting aside—even temporarily—requirements for mark-to-market valuations of assets was the correct approach.

On 30 September 2008, in a letter to then U.S. Securities and Exchange Commission Chairman Christopher Cox, 65 members of Congress implored the regulator to suspend mark-to-market valuations in light of deteriorating conditions. "In periods of market turmoil, financial institutions are forced to write down the value of long-term, non-trading assets below their true economic value," argued Congressional representatives. "The 'mark to market' rule, while well intended, has the unintended consequences of exacerbating economic downturns by hamstringing the ability of banks to make loans to consumers and businesses." The SEC was urged to adopt a friendlier mark-to-value standard that supporters said would more accurately reflect the true value of many assets sitting on banks' balance sheets.

On the same date, after lengthy consultations with members of the Financial Accounting Standards Board, the SEC's Office of the Chief Accountant released additional guidelines. These included using expected cash flows, placing less reliance on brokers' and/or pricing services' quotes in the absence of a true and transactional liquid market, and disregarding "distressed and forced liquidation sales" as orderly transaction prices to be relied on.

In October, with the passage of the Emergency Economic Stabilization Act of 2008, which allowed the U.S. Treasury to buy banks' troubled assets, the SEC was asked to further study mark-to-market accounting standards and FAS No. 157, *Fair Value Measurements*. While FAS No. 157 does not itself mandate mark-to-market or fair value accounting, it does define fair value, offers a framework (including three levels of obtaining fair valuations for assets and liabilities), and requires enhanced disclosures about the processes used to arrive at a reasonable fair value.

Issued in 2006 for financial reports released after 15 November 2007, FAS No. 157 was intended to clarify fair value and provide a single set of measurement principles that could be uniformly applied. The standard also prescribes three levels for determining fair value prices, from transparent and observable prices to using assumptions and other metrics for complex or opaque securities.

But when crisis hit, did such provisions make a bad situation worse?

In a 30 December 2008 report, the SEC's Office of the Chief Accountant (Division of Corporation Finance) found that "fair value accounting did not appear to play a meaningful role in bank failures during 2008." Furthermore, the report noted, "bank failures in the US appeared to be the result of growing probable credit losses, concerns about asset quality, and, in certain cases, eroding lender and investor confidence." Even for those banks that did record significant fair value losses, those losses do not appear to have caused the banks to fail.

The SEC study also concluded that suspending FAS No. 157 could result in a reversion to old valuation practices (such as returning to the historical cost basis), which could increase investor uncertainty and cause inconsistent valuation methods. The report recommended that fair value standards not be suspended but also recommended several ways to improve the standard through the further adoption of best-practice guidelines, including how to distinguish an inactive market from an active one, how to determine whether a transaction is distressed, and how to factor in a change in credit risk for the value of an asset/liability.

"No one could have predicted we'd be where we are today. FAS No. 157 did not contemplate such a frozen market, and the rule was not wholesome enough to handle this," says Cindy Fornelli, executive director of the Center for Audit Quality in Washington, DC. "But you don't abandon this in the face of a crisis." In her view, what is needed is for standard setters to review the standard in a thoughtful, methodical, and logical way and provide constructive ways to better implement it.

Misleading and Dangerous?

The market crisis was the perfect storm, according to Colleen Cunningham, global managing director of accounting and finance at Resources Global Professionals, a professional services firm. "I don't think we should suspend fair value when it's hard to do, but there is an inherent flaw in FAS No. 157 that makes it difficult to implement," she says. The concept of "market participants" is tricky, in her view, and forces companies to consider what others might pay for those assets but not necessarily the true value of the assets.

FAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

This requirement is, in Cunningham's opinion, a bit illogical for a company that has long-term assets on its books with no intention to sell them. "The market-participants approach never made sense to me," she adds, noting that this year that same standard will also be applied to nonfinancial assets and liabilities, such as business combinations. She suggests that values should be looked at according to the "user's intent."

The American Bankers Association (ABA) in Washington, DC, which represents members of the US$13.6 trillion banking industry, contends that the rules just don't work for illiquid markets. "The rules require that 'exit price' and 'market participants' be used for determining fair value, yet too few parties—other than those in distressed circumstances—are participating in markets in the current environment," the consortium told the SEC in a comment letter dated 23 September 2008. The ABA implored the regulator to allow the use of "intrinsic value" or "economic value" as proxies for fair value.

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"Fair value accounting is a fallacy and is misleading and dangerous when markets seize," says Bill McGinnis, Jr., CFA, principal of W. McGinnis Advisors LLC of Milwaukee, WI. "Fair value can only be found in liquid markets."

McGinnis asserts that there is a very big difference between price and value. "Firms have assets on their balance sheets that they have no intention of selling; they are distressed assets whose prices don't match values." Moreover, he doesn't think fair values should be presented on income statements or balance sheets; instead, they should be relegated to financial statement footnotes.

The Root of the Problem

Proponents of fair value insist that there should be a single standard with no deviation or regulatory waiver allowed.

"If you open up the door for something like this, it becomes easy to rationalize and it becomes difficult to walk back out that door," says Patrick Finnegan, CFA, director of the Financial Reporting Policy Group for the CFA Institute Centre for Financial Market Integrity. CFA Institute—along with the Center for Audit Quality, the Consumer Federation of America, and the Council of Institutional Investors—sent a joint comment letter in support of fair value to the SEC this past September.

"I cannot imagine any scenario where waiving fair value would be a good idea," says Espen Robak, president of Pluris Valuation Advisors in New York. "We've already been through one of the largest market dislocations in our history and there's no reason to relax regulations."

Still, Robak acknowledges that FAS No. 157 poses certain challenges. Finding observable prices for a highly liquid security is relatively straightforward. For less liquid securities, determining fair value can be more challenging. "Auditors have been put in a difficult position, having to scrutinize all kinds of measurements to determine if they have a reasonable or unreasonable scope," Robak says.

"The challenge to defining what fair value is has made the world much more problematic for auditors and accountants," agrees Randall Schostag, CFA, president of Minnesota Business Valuation Group in St. Paul, MN. "The primary problem is that, historically, we've gone back to simply looking at market quotes." But, he adds, a whole body of knowledge exists that uses other valuation methods and easily could be tapped through technological advances.

From the point of view of the CFA Centre, such concerns are beside the point. "We don't believe financial reporting was at the root of the problem. It was bad risk management," says Finnegan. "Financial statements shouldn't be tampered with."

Lori Pizzani is a freelance financial writer based in Brewster, New York.

RECOMMENDED RESOURCES

"Fair Value Supporters Urge SEC Not to Suspend Mark-to-Market Accounting Rule"
CFA Institute press release (15 October 2008)
(www.cfainstitute.org)

"Fair Value Regulatory Updates: What Regulators Are Saying about the Global Financial Crisis"
CFA Institute Centre for Financial Market Integrity
(www.cfainstitute.org/centre/news/what_regulators_are_saying.html)

"Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting"
(www.sec.gov)