Mark-to-Market Accounting and the Evolving Guidance

Recent Authoritative and Non-Authoritative Guidance on Fair Value

by

Gary R. Johnstone, CFA, CPA/ABV

Mark-to-Market Accounting and the Evolving Guidance

Presentation Overview

- ✓ FAS 157 - Fair Value Measurement Framework
- ✓ Authoritative Guidance
  - ✓ Financial Accounting Standards Board (FASB)
- ✓ Non-Authoritative Guidance
  - ✓ Speech by Mr. Robert Herz, Chairman, FASB
  - ✓ Meeting Notes from Financial Crisis Advisory Group (FASB and IASB)
- ✓ Presentation Summary and Observations

FAS 157 – Fair Value Measurements Framework

- ✓ Fair Value is not new, the framework (guidance) is new (Fair Value project added to FASB agenda in June 2003; Final Statement issued in September 2006).
- ✓ "Fair Value" New Definition - Fair Value is 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.
  - ✓ Orderly (Market) Transaction
  - ✓ Market Participants
  - ✓ Exit Price (notion)
- ✓ Additional Disclosures Required – Provide information about the reliability of information (i.e., disclose to users the source of the inputs to valuation methodologies used to measure fair value). Market-based indications of value are the most reliable. Under GAAP, you do not have an asset unless it can be reliably measured.
  - ✓ Levels 1 Input (Observable) – Quoted prices in active markets.
  - ✓ Level 2 Input (Somewhat Observable) – Quoted prices in active markets that are directly or indirectly related to the subject asset or liability.
  - ✓ Level 3 Input (Unobservable) – Based on the best information available (e.g., the reporting unit's own assumptions about market participants' pricing assumptions).

Recent Authoritative Guidance from Financial Accounting Standards Board

- ✓ Guidance from Financial Accounting Standards Board (FASB)
  - ✓ FASB Staff Position - FAS 157-3: Valuing Certain Financial Assets in Inactive Markets (7 pages - October 10, 2008)
  - ✓ FASB Staff Position - FAS 157-4: Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (27 pages - April 9, 2008)

FAS 157-3: Valuing Certain Financial Assets in Inactive Markets

(October 10, 2008)

- Objective: Provide guidance on how to determine fair value <u>when the market for an asset is not active</u>.
- Some Issues Addressed:
  - How should the reasonableness of data be judged when relevant observable inputs do not exist?
  - Observable inputs in a market that is not active…how should that data be considered?
  - How should broker quotes or pricing services be considered when assessing observable and non-observable inputs?
- Answer: Determining fair value in a dislocated market depends on the facts and circumstances and <u>may require the use of significant judgment</u> about whether individual transactions are forced liquidations or distressed sales. And…disclose more.

Recent Non-Authoritative Guidance

- ✓ December 8, 2008 speech by Mr. Robert Herz, Chairman, FASB to AICPA National Conference
  - ✓ "There are issues with fair value, particularly in illiquid markets"
  - ✓ "fair value in financial reporting is hardly new"
  - ✓ "the idea that in down markets assets should be written down to lower of cost or market or lower of cost or net realizable value has been a fundamental concept in accounting for a century or more"

(Cont.) Speech to AICPA by Mr. Robert Herz, Chairman, FASB

- ✓ “as the extent of problems in the U.S. housing market become more evident and the credit crisis deepened and widened….more financial assets…for which there may have previously been active markets…have been increasingly illiquid”
- ✓ “under such circumstances, deriving fair value estimates often has had to rely on unobservable inputs (what FAS 157 terms Level 3 estimates)”
- ✓ “many investors clearly have indicated that such estimates provide more relevant and useful information than alternatives that ignore current economic conditions, including lack of liquidity, and that can introduce management bias in the estimation process”
- ✓ “there is no question that implementing fair value in illiquid markets can be challenging and difficult and there are important questions to be asked”

Mark-to-Market Accounting and the Evolving Guidance

(Cont.) Speech to AICPA by Mr. Robert Herz, Chairman, FASB

- ✓ "those demanding a suspension or modification of fair value requirements claim that its use has contributed to an unnecessary downward spiral in the financial condition of financial institutions and the stability of financial markets"
- ✓ "they seem to miss the basic point that accounting and financial reporting are meant to inform investors and the capital markets and that straying from that objective or subordinating that objective to any other corporate, industry, social or economic objective other than sound and transparent reporting, can also cause financial stability due to the loss of investor confidence in the reporting of companies"
- ✓ "changing the accounting does not make the underlying problem go away"
- ✓ "another key lesson learned and relearned is that sound markets require a proper infrastructure to facilitate the flow of information, ascertain price discovery, support the necessary clearing

Other Recent Non-Authoritative Guidance

- ✓ Financial Crisis Advisory Group (FASB and IASB) Meeting Notes (March 9, 2009)
  - ✓ "Most constituents agree that the current mixed attributes model for accounting and reporting of financial instruments under IFRS and US GAAP is overly complex and otherwise suboptimal"
  - ✓ "Some constituents (mostly investors) support reporting all financial instruments at fair value"
  - ✓ "a few respondents noted that bank lending, poor risk management, and greed lay at the heart of the financial crisis, not financial reporting"
  - ✓ "as discussed at FCAG meetings, transparency is the fundamental objective of accounting and financial reporting"
  - ✓ "the majority view was that mark-to-market accounting only played a positive role, if any, in bringing the financial crisis to light"
  - ✓ "most constituents agreed that it is premature and inappropriate to move to a full fair value"

After all the talk

FASB Eases Mark-to-Market Rules

By Kara Scannell

U.S. accounting rule makers made it easier for banks to limit losses, but in an unexpected move they bowed to critics and backtracked on one proposal that would have let companies ignore market prices in some cases.

The vote by the Financial Accounting Standards Board followed a debate in which members of Congress pushed for steps to help banks weighed down by troubled assets, while some investor groups warned that the plans would allow executives to cover up losses. The rules change spurred Thursday's stock-market rally (see related articles on pages A1, C10 and below).

For the most part, the board ratified proposals it had put out for comment two weeks earlier, including changes that would lessen the need for banks to take an earnings hit when assets run into trouble. Financial stocks led the market up in the morning on the expectation that the rules would be approved, but faded and ended roughly on a par with the broader market.

Bankers argue that the "mark-to-market" principle of valuing assets at market prices is sometimes flawed because markets have ceased to function. They say that can lead to unnecessary alarm about the financial system's stability, an argument lawmakers have echoed.

One member of the five-member accounting standards board tried to address criticisms that the body had bowed to political pressure.

"We are an independent standard setter and it's important that we maintain our independence," said Lawrence Smith. But he said the board can't "ignore what's going on around us" as banks plead for help.

Under one of the changes adopted Thursday, the definition of an asset that is "other than temporarily impaired" will change. Once an asset gets that designation, it triggers a write-down in value that feeds through to the bottom line. In the case of banks, that may put capital below regulatory requirements.

Currently, to avoid the designation, management must assert that it has the intent and ability to hold on to the asset until its value recovers. Under the new rule, adopted by a 3-2 vote, companies could avoid the classification by stating that they intend to hold on to the asset and that it is more likely than not that they will, a looser standard.

Some investor groups warned the plans would allow executives to cover up losses.

Patrick Finnegan, director of financial reporting policy for the CFA Institute, said the move gives managers too much room to fudge the truth. "Financial statements are not there to reflect management's assumptions," said Mr. Finnegan, whose group runs a self-study program for financial analysts.

The new rule draws a distinction that is especially relevant to mortgage-backed securities. The market for these securities has largely dried up, but banks say that most homeowners still are making mortgage payments.

The rule says that once an asset is other than temporarily impaired, only losses related to the underlying creditworthiness would affect earnings and regulatory capital. Losses attributed to market conditions would be disclosed and accounted for elsewhere.

Business groups mostly commended the changes, but said they aren't enough. "Significant problems remain with asset valuations, and guidance is needed for auditors," the U.S. Chamber of Commerce said in a statement.

Some investors were relieved that FASB backtracked from one of its proposals, which would have allowed companies to ignore all market prices when coming up with a value for securities once a market was determined to be inactive.

FASB instead said that more weight should be placed on transactions when a market is operating in an orderly fashion and less when the market is less active.

Financials Lead the Charge As Dow Gains 216.48 Points

By Peter A. McKay

Optimism about the economy sent stocks higher, with the Dow Jones Industrial Average moving above the 8000 level for most of the day and the Nasdaq Composite Index finishing up 1.6% this year.

The Dow fell back a bit at the end of the session to finish up 216.48 points, or 2.8%, at 7978.08, its third consecutive gain. The industrials are up 6.1% over three days and on pace for the best four-week rally since 1938. The Dow remains down 9.1% in 2009.

Thursday's rally began in the morning with financial stocks, in

Thursday's Markets

DJIA		7978.08	▲ 216.48
Nasdaq		1602.63	▲ 51.03
Oil/barrel		$52.64	▲ 4.25
10-year Treasury		Price	▼ 27/32
		Yield	2.753%
Dollar	▼ vs. euro		$1.3443
	▲ vs. yen		¥99.54

Free updates at WSJMarkets.com

would boost shares of trucking companies, airlines and railroads. The S&P 500-stock index rose 23.30 points, or 2.9%, to 834.38, led by gains of more than 5% in its industrial and con-

FAS 157-4: Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly

(April 9, 2009)

- ✓ Objective: Provides additional guidance for FAS 157 when the volume of and level of activity for the asset or liability have significantly decreased (i.e., how to identify circumstances that indicate a transaction is not orderly). Regardless of the level of activity and the valuation technique, the objective of fair value remains the same.
- ✓ Responding to the S.E.C. Study – Study on Mark-to-Market Accounting (December 30, 2008):
  - ✓ Additional measures should be taken to improve the application and practice related to existing fair value requirements (particularly as they relate to Level 2 and Level 3 estimates)
  - ✓ Fair Value requirements should be improved through application and best practices guidance for determining fair value in illiquid or inactive markets.

FAS 157-4: Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly

- ✓ **In the Board's view, a significant decrease in the volume and level of activity for the asset or liability is an indication that transactions or quoted prices may not be determinative of fair value because in such market conditions there may be increased instances of transactions that are not orderly.**

  <u>In those circumstances, further analysis of transactions or quoted prices is needed and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with Statement 157.</u> (emphasis added)

FAS 157-4: Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly

- In those circumstances, further analysis of transactions or quoted prices is needed and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with Statement 157.

  Statement 157 does not prescribe a methodology for making significant adjustments to transactions or quoted prices when estimating fair value. A change in valuation technique or the use of multiple valuation techniques may be appropriate (for example, the use of a market approach and present value technique). (emphasis added)

  When weighting indications of fair value resulting from the use of multiple valuation techniques, a reporting entity shall consider the reasonableness of the range of fair value estimates. The objective is to determine the point within that range that is most representative of fair value under current market conditions. A wide range of fair value estimates may be an indication that further analysis is needed.

More FAS 157-4: Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly

- ✓ The reporting entity's intention to hold the asset or liability is not relevant in estimating fair value. Fair value is a market-based measurement, not an entity-specific measurement
- ✓ Even if there has been a significant decrease in volume and level of activity, it is not appropriate to conclude that all transactions are not orderly (that is, distressed or forced). Circumstances that may indicate a transaction is not orderly include, but are not limited to the following:
  - ✓ The seller is in bankruptcy;
  - ✓ The seller marketed the asset or liability to a single market participant; and
  - ✓ The transaction price is an outlier when compared with other recent transactions for the same or similar assets or liabilities.

FAS 157 – "Fair Value" Defined: Then and Now

Fair Value is 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.

Fair Value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions.

More FAS 157-4: Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly

- ✓ Financial assets such as residential mortgage-backed obligations that are not held as part of trading activity (i.e., management has asserted that it has the intent and ability to hold on to an asset until its value recovers) would not trigger a write-down until the asset is deemed to be "other than temporarily impaired".

Presentation Summary and Observations

- ✓ Since early 2008, FASB has responded with two FAS 157-related staff position papers giving more guidance to companies and their auditors about (1) what to do when markets are inactive (historically, the most reliable source of valuation data) – answer: you should rely more on other indications of value – and (2) how to identify when a transaction is not orderly (that is, distressed or forced) and how to respond to it in your determination of fair value – answer: place little weight on the value indication if the transaction is determined to be non-orderly.
- ✓ In FSP FAS 57-4, FASB also responded to external pressure by providing financial institutions a potential way to limit their losses subject to management's credible assertions about their intent and ability to hold the asset until its prices recover.
- ✓ GRJ Observations:
  - ✓ Accounting regulators respond to external pressure.
  - ✓ Auditors want more third-party appraisers involved – less reliance on the company's assumptions and calculations – in the determination of fair value.
  - ✓ Slower convergence of international accounting standards around fair value (i.e., full fair value vs. mixed attribute model).
  - ✓ More disclosures – disclose, disclose, disclose.