MARK TO MARKET

Does this accounting rule ***fix problems*** *or* ***create them****?*

By Ramona Dzinkowski

The multiple and complex causes behind the current global economic turmoil, and the credit crises more specifically, were perhaps never so clearly and vehemently articulated as at an October 2008 roundtable at the U.S. Securities & Exchange Commission (SEC).

After three hours of debate, the general conclusion around the table was that the buck stopped with everyone. Like the classic whodunit, *Murder on the Orient Express*, the entire cast was to blame: mortgage brokers, the architects of synthetic financial derivatives, rating agencies, regulators, and last, but certainly not least, the accountants. More specifically, it was the required application and audit of Statement of Financial Accounting Standards (SFAS) No. 157, "Fair Value Measurements," the U.S. Generally Accepted Accounting Principles (GAAP) requirement that mandated banks and other investors to estimate the current market value (mark-to-market/fair value accounting) of low-quality mortgage-backed securities and related complex-structured products like collateralized debt obligations (CDOs) and structured investment vehicles (SIVs) at a time when either no markets for those vehicles existed or when they were highly distressed.

The resulting write-downs and decline in capital helped to spawn one liquidity emergency after another plus the failure of some of America's largest financial institutions. Financial market contagion spread quickly around the world. So problematic was mark-to-market accounting to the U.S. and global financial infrastructures that the $700 billion U.S. bailout plan passed by Congress authorized the SEC (or rather confirmed its authority) to suspend SFAS No. 157 at its discretion, in the public interest.

Participants Respond

Perhaps most critical of the rule was William Isaac, past chairman of the U.S. Federal Deposit Insurance Corporation (FDIC). According to Isaac, mark to market is the primary cause of the worldwide financial crises and "should be withdrawn immediately." He said, "Hundreds of billions of dollars have been lost because of these rules" and pointed to the senselessness of the U.S. Treasury handing out capital while the SEC and the Financial Accounting Standards Board (FASB) are destroying it by means of "paper losses, not real losses." "…And that's why we're in deep trouble in the economy right now," he added. "It's due to the accounting system, and I can't come up with any other explanation." He also questioned the fundamental principles of applying SFAS No. 157 to the financial services sector, suggesting that the rule doesn't accurately reflect the business model of many financial institutions since it presumes a sale when, in many cases, the assets are intended to be held over time.

Isaac said in commenting on a previous FDIC study into mark to market, "…We rejected going there for three reasons: One, mark-to-market accounting could only be applied to a small portion of the balance sheet, on the asset side. Essentially, marketable securities can be

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marked to market; the rest of the assets in the bank are not marked to market, still aren't today, and the liabilities aren't marked to market. And let's say interest rates go up, government bond prices go down on the asset side; if they get marked to market and you don't do anything on the liability side, you've created a very false impression about the bank because the liabilities, the demand accounts, the checking accounts, the savings accounts, the fixed-rate CDs are all going up in value, and you're not taking that into account. And the bank clearly has the ability to fund those assets that have gone down in value because they have liabilities that are increasing in value very significantly. Second, we believe that mark-to-market accounting would interfere with banks performing their fundamental function, which is to take relatively short-term deposits and convert them into relatively long-term loans to businesses and consumers. So banks, necessarily, must have a mismatch if they're going to do their job. Banking by its very nature is going to create a structural problem, and today's structural problem is not unique. Banks necessarily will have a mismatch between their assets and liabilities. Third, we felt that mark-to-market accounting would be pro-cyclical, extremely pro-cyclical, and would make it very difficult for regulators to manage future banking crises."

When it was pointed out that SFAS No. 157 provides for judgment in marking down assets, Isaac credited auditors' liability in the U.S., and the fear of litigation, with the rigid application and audit of 157. He explained: "I believe we've put too much pressure on accountants by subjecting them to huge liabilities when companies fail due to market conditions and faulty business strategies. One important consequence is that the profession has reacted by implementing rigid rules that leave little room for judgment and wisdom. I believe we should consider insulating auditors from liability when they are using reasonable business judgment, and I will tell you that I'm part of the cause of the accounting profession's problems because when I was chairman of the FDIC, I authorized a lot of suits against accountants. I wish I hadn't done it."

Risk Is Key

Others who did support mark-to-market accounting tended to agree that the high personal risk to corporate officers in America may have prohibited the use of broader judgment in applying SFAS No. 157 and accounting standards in general. Ray Ball, Sidney Davidson Professor of Accounting at the Graduate School of Business, University of Chicago, and proponent of fair value accounting, said, "We have to ask why, when faced with unusual circumstances, were they [filers] unwilling to exercise a large amount of judgment?…With a 20-year jail sentence here under Sarbanes-Oxley, it certainly makes you act conservatively."

In his recommendations to the SEC, Richard Murray, managing director and chief claims strategist of SwissRe in New York and Zurich, further underscored the impact of the fear of personal culpability on the willingness of corporate officers to use judgment in applying mark to market, saying, "We wish to encourage that the inhibiting influence of liability be avoided in this condition." Murray also pointed to a lack of direction from the Public Company Accounting Oversight Board (PCAOB) on the subject, commenting that "There is no present guidance available from the PCAOB that would assist auditors in determining what the scope of their legitimate judgment is. We have urged that the PCAOB undertake that…" He also suggested reexamining auditor and officer liability under the current circumstances, saying, "I know the concept of safe harboring is an unpopular phrase in many quarters, but it may be an essential component, at least in the short term, [that will allow] the guidance to in fact operate in the real world as it was designed to."

Is SFAS No. 157 at Fault?

So to what extent is accounting, i.e., SFAS No. 157, being blamed for the current economic problems in the U.S.? Isaac claims that mark to market is responsible for limiting the banks' lending capacity by "some $5 trillion."

Final calculations, however, are still in the works. The SEC, directed by the U.S. Emergency Economic Stabilization Act of 2008 that was signed into law during the first week of October, was attempting to determine the impacts by January 2, 2009. More specifically, the study focused on the effects of such accounting standards on a financial institution's balance sheet, the impacts of such accounting on bank failures in 2008, the impacts of such standards on the quality of financial information available to investors, the process used by the FASB in developing accounting standards, the advisability and feasibility of modifications to such standards, and alternative accounting standards to those provided in SFAS No. 157.

Meanwhile, the FASB and the International Accounting Standards Board (IASB) have attempted to stress the importance of the use of judgment in applying fair value accounting. Both released guidance in October 2008 on how to determine fair value when markets are illiquid: FASB Staff Position (FSP) 157-3, "Determining the Fair Value of a Financial Asset When the Market for that Asset Is Not Active," and IASB Staff Summary "Using Judgment to Measure the Fair Market Value of Financial Instruments When Markets Are No Longer Active."

While it's likely to be a myopic assessment of the facts to state that fair value accounting is the primary cause behind global economic woes and market volatility that we see today, it seems fairly safe to say that it was probably as guilty as the rest of the prime suspects in the great economic whodunit of 2008. What then, if anything, is a better accounting option for the U.S. (and perhaps the world) in the current economic and legal climate? Not surprisingly, two camps emerge, one in favor of maintaining fair value accounting, but with certain improvements, and the other eliminating it immediately.

The Debate Continues

Vincent Colman, U.S. assurance managing partner and National Professional Services group leader at PricewaterhouseCoopers, LLP, suggests, in the near term, refining fair value reporting and related disclosures of fair value measurement: "Consider separating, for accounting purposes, the periodic changes in fair value into two components: incurred credit losses and other changes in fair value, including, for example, liquidity discounts. Second, consider converging the guidance for reporting financial asset impairments by recognizing, first, incurred credit losses in income and all other changes in fair value and other comprehensive income until the asset is sold or matures. Third, consider changes in the format of the income statement to allow for more visibility to the income effects of items reported at fair value and the inclusion of other comprehensive income on the face of the income statement." He adds, "We believe these actions will help enhance transparency and usefulness, providing a more consistent framework for recognizing impairment losses and by locating all changes in fair measurement items in a single financial statement."

In contrast, Aubrey Patterson, chairman and CEO of BancorpSouth, believes that although there are certain situations where fair value is useful, "If the business model is not focused on fair value, then using it as the basis of accounting…can be misleading the users of financial statements." He therefore calls for an immediate halt of fair value (and its extreme mark-to-market accounting), as applied to all financial instruments, until the following issues are fully examined: "Do the current requirements to use fair value actually improve financial reporting? If it's a better model, what is the rationale for limiting it to financial instruments? If fair value continues to be limited to financial instruments, how does this impact financial institutions vs. other kinds of industries? That is, does it make our earnings and capital more volatile, thus increasing the cost of capital for financial institutions vs. other industries? Does it reduce the confidence level the customers have in the reports of financial institutions vs. other industries?"

He also asks that the regulators and standards setters examine whether the move to fair value has been appropriate at all or whether historical amortized cost is more appropriate with an accompanying disclosure. Finally, he calls for the expeditious examination of the accounting guidance for other than temporarily impaired assets, commenting that, "Essential to the elegance of accounting theory as many of us have studied and viewed it over the years is the concept of a going concern where the financial condition is depicted by measure of the flow of economic activity between stock measurements at discrete points in time. This is, to me, at the core of financial accounting, and, to preserve this flow and stock concept, it's my view that footnotes may be a preferred venue for many of these fair value measures, and especially so in financial institutions."

So is there a middle ground between fair value for all and eliminating it for financial instruments? Damon Silvers, associate general counsel at the AFL-CIO, believes that we should move our focus from the accounting standards setters to the financial market and financial institution regulators when looking for the best solution. He suggests, "At least, as an initial matter, the approach ought to be looking more toward safety and soundness, [looking to] regulators to act in an anti-cyclical matter around capital issues." Silvers also recommends that any accounting application of mark to market has to be considered with a view as to whether those assets are actually going to be bought or sold on markets. Otherwise, he states, "We'll make a complete hash of financial statements…investors and the public won't actually be able to tell from looking at central numbers like income what is really happening in the business…which of these movements in asset values are likely to ever be realized. And that could clearly detract from information available to investors and the value of financial statements as a whole."

Ultimately, the extent to which fair value accounting, more specifically mark-to-market accounting, is culpable for the current economic downtown remains a matter of ongoing debate. But one thing is clear: Its role in the crises hasn't gone unnoticed. The SEC expects a solution to the problem from both the FASB and the IASB—before 2011—that America can live with, or the move to International Financial Reporting Standards (IFRS) could be at risk. At the same time, the European Union has increased the pressure on the IASB to reconsider the application of the fair value standard as it applies to the banking industry across Europe.

Time will tell how this next episode will play out. **SF**

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