

Mark to Market: Is it the Solution, or Is It the Problem?

Fair Value financial reporting is being blamed for the subprime meltdown, bank failures, the credit crunch and the current recession. Global warming is about the only thing not being blamed on Fair Value and Mark-to-Market (“MTM”). Before we are done, however, MTM will likely be blamed for global warming, obesity and the collapse of Detroit’s Big 3 domestic automakers.

Rarely have technical accounting, valuation and financial reporting issues received so much attention from politicians, think tank specialists, columnists and even TV journalists. Combined, these voices have raised the temperature of the discussion, while at the same time shedding very little light on the issues.

It should be no surprise that the public - unhappy with market turmoil, bailouts, tight money and a plunging stock market - is ready to point the finger at any and all participants within the business sector. President Obama ran on a platform of “Change” and the public desperately is searching for change in the financial markets. Since it is easy to blame MTM, if you don’t really understand it, cries for a mandatory ‘change’ in accounting rules are receiving a surprising amount of traction.

The following quote from a November 13, 2008 letter by the American Bankers Association written to FASB puts the basic issue into perspective:

Recording OTTI [Other Than Temporary Impairment] that is based on credit impairment is non-controversial in the banking industry – financial institutions fully understand and support the need to record such impairment. However, there has been and continues to be much controversy over **recording losses that are based on the market’s perception of value (fair value), which often results in recognizing losses that exceed credit losses or recording losses for instruments that have experienced no credit problems and are fully performing in accordance with their terms.** [Emphasis added] The erosion of earnings and

capital due to a market's perception of losses or due to a lack of liquidity that drives values lower is misleading to investors and other users of financial statements.

WHAT IS MARK TO MARKET ACCOUNTING?

For many years companies were able to show on their balance sheet the cost of securities they owned. GAAP seemingly said one should never anticipate gains (writing assets up) until they are realized. Meanwhile, losses should be recognized as soon as possible. This appeared to be a 'one-way' street: 'good news' (gains) was hidden from creditors and shareholders while bad news (losses) was recognized. The rule about taking losses 'immediately' really meant that write downs had to be taken only when a decline in market value of securities was considered "other than temporary". Since it was hard to define a 'temporary' decline in market price, effectively many companies shoes to retain original cost value on the balance sheet. As supplementary information many companies would disclose the current market price(s) of the traded securities they owned. In this way shareholders and creditors could get a picture of the 'real' economics of the business.

Further, by showing original cost on the balance sheet and current market values in the footnotes or in parenthesis, the company avoided reporting gains and losses from changes in the market price of securities unless, and until, they were actually sold. Companies were happy with this approach, and there were few complaints from financial analysts, because it was easy to adjust the balance sheet for those who wished to make that effort.

A few journalists, academics and analysts complained, however, that this approach permitted companies to 'cherry-pick' gains and losses. By selling stock with a built in profit, the company would report an increase in income and EPS. If there had been some windfall and the company wanted to offset the gain they could always sell securities that traded below the actual cost. This combination of choosing when to recognize gains and losses was referred to as 'earnings management' and was criticized severely.

At the same time as this debate was being held, the policy makers at FASB in Norwalk, CT were coming to a revolutionary change in financial reporting. Many members of the Association will remember that the

original mantra of accounting was to ‘match’ revenues and expenses. This was the gold standard of accounting for those who studied accounting as an undergraduate more than 10 or 15 years ago. In that environment the balance sheet was of secondary importance. In many respects the balance sheet was a residual for carrying expenditures as assets prior to their being matched up with the appropriate revenues. Balance of which was very difficult to understand or explain.

FASB, in its conceptual framework project, came to the belief that matching, *per se*, was not important. Far better, the Board stated, to put emphasis on the balance sheet. Get the balance sheet right and income for the year would be the difference between opening and closing net worth or equity. This new conceptual framework has gradually been put in place as FASB issues each new Standard.

Starting with SFAS 107 and 115, and concluding with SFAS 133, the Board has mandated that almost all financial instruments should be valued at Fair Value (“FV”), and that *changes* in the market value of securities whose prices are marked to market should be reflected in the P&L or equity. Changes in market value therefore must now be directly reported.

Some two years ago FASB issued SFAS 157. This new Standard, contrary to popular opinion, does not require further, or additional, use of FV in financial reporting. What it did do is mandate that whenever Fair Value is required, that it must be performed in accordance with the definition of Fair Value now embodied in GAAP.

A NEW DEFINITION OF FAIR VALUE – UNINTENDED CONSEQUENCES

For many years, in fact almost 120 years, the business community has had a single definition of Fair Market Value (“FMV”), and this must not be confused with the FASB’s new definition of Fair Value. For reference, the standard definition of FMV reads as follows:

Fair Market Value is defined as the price for which property would exchange between a willing buyer and a willing seller, each having reasonable knowledge of all relevant facts, neither under compulsion to buy or sell, and with equity to both.

This seems pretty straightforward, and it is, because the definition really has only a few key requirements:

- An ‘exchange’ for property, usually an asset, derived through negotiation
- Willing buyer(s)
- Willing seller(s)
- Equal knowledge on both parts
- No compulsion
- Equity to both

We will discuss these concepts below. But first look at the definition of FV as incorporated by FASB in its recently issued SFAS 157:

“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” SFAS 157 ¶ 5

The key concepts of Fair Value as defined explicitly by FASB are, simply put:

- Sale [not exchange]
- Market Participants [sale to an unknown “market participant”]
- Orderly transaction
- Definition applies to liabilities as well as assets

The difference between these two definitions can best be understood in the concept of an art auction.

Suppose there is an auction of a Picasso painting at Sotheby’s or Christies. The auctioneer starts the bidding at \$20 million and four rounds of bidding later the highest bid is \$29 million. All of a sudden, out of the blue, someone bids \$30 million and there are no further bids. The auctioneer hammers down his gavel and there is now a lucky buyer of the Picasso, who is committed to pay \$30 million, disregarding taxes and commissions.

Now what is the Fair Market Value of the Picasso? What is the Fair Value of the same picture? One clue: The two answers are not the same!

Under the Fair Market Value definition given above the value is considered to be \$30 million. There was an exchange of \$30 million between a willing

buyer (nobody held a gun to the head of the last buyer) and a willing seller who obviously had placed the painting on consignment in the first place. We assume both buyer and seller are knowledgeable about Picasso's art, and current selling prices for comparable paintings. Finally there appears to be equity for each since each participated willingly in the transaction.

Surprising as it may seem, under the FASB definition of Fair Value the painting is worth only \$29 million, not \$30 million. At least as seen from the perspective of FASB, the new buyer immediately suffers a \$1 million impairment loss! How can this happen? Very easily, if you follow the FASB's logic in its SFAS 157 definition of FV.

Test the auction results against FASB's definition of FV and you will find that their concept of value is premised solely on an immediate **sale** to another 'market participant'. Now, assuming all the world's potential buyers of the Picasso had attended the auction, we know for sure that there is at least one prospective buyer, (a 'market participant') at \$29 million. Further we know that there are no other market participants at \$30 million, other than the lucky winner of the bidding war. This is true, or the bidding would have continued.

While counter-intuitive, the instant impairment loss flows directly from the SFAS 157 definition of Fair Value, not from "marking to market" the painting. Under Fair Market Value definition of value we have \$30 million, which is what was paid on a willing basis. On the Fair Value (FAS) definition of value we have \$29 million, which was less than was paid on a willing basis.

It is very clear:

If you change the ***definition*** of Fair Value you change the amount determined as the Fair Value.

BANKS VS. FAIR VALUE AND MARK-TO-MARKET

It is well beyond the scope of this article to summarize the financial meltdown that began with subprime mortgages being issued to borrowers

and the subsequent paper used as collateral for financial instruments sold by the issuers. The responsibility of the credit rating firms for granting the highest possible ratings to pools of mortgages that themselves were subprime is hard to understand, much less explain. The desire of investors for extra yield, and a lack of understanding of the risks assumed by investing in those securities, certainly compounded the situation.

At some point within the past 18 months, many financial institutions, including Bear Stearns, Lehman Brothers and Merrill Lynch, found that they held on their books enormous quantities of securities. These securities while rated AAA by Moody's and Standard & Poor's started to show serious default rates as individual borrowers were either unwilling or unable to keep up to date on monthly mortgage payments.

Very quickly the losses cascaded through the system and, in a manner similar to a game of musical chairs, the final holders of what have been called "toxic securities" started to feel real pain.

Under GAAP this 'pain' then became a trigger that caused auditors, as well as corporate management, to test the carrying values of the securities for potential impairment. Remember, trading securities have to be marked to market every financial period, but securities that are being held to maturity must be written down to market only if the current market price decline "is other than temporary". The prices for subprime financial instruments were continuing to tumble lower, and it was difficult (if not impossible) for anyone to argue, "Well this current decline is just temporary. Let's see if the housing market improves, borrowers resume making payments (instead of walking away from the homes) and then our securities will bounce right back!"

So, as prices for subprime paper kept going lower, two things were happening. Companies were reporting losses due to the decline in market value. The losses in turn reduced the capital cushion that firms have to have on hand because every dollar of loss reduced net worth directly. Declining net worth had to be rebuilt. If a company has zero net worth, this is one of the tests for bankruptcy; as net worth kept declining there was tremendous pressure on the holders of these now almost unsalable (that is, unsalable at a 'reasonable' price) to obtain new capital.

One way to shore up the balance sheet was to convert securities into cash. The only way to accomplish this is to sell the securities to someone else, someone who can and will pay you. All of a sudden there were more sellers than buyers at the price levels that sellers hoped for.

Economics 101 says that when there are more potential sellers than buyers, the only way for the market 'to clear' is for prices to go down to a level at which buyers will respond. Securities markets in the United States, in the last half of 2007 and all of 2008, once again proved that the Law of Supply and Demand was alive and well. In short, the basic tenet of Economics 101 had **NOT** been repealed.

Many of those adversely affected by the events of the past year and a half are pleading for a major change in accounting. A 'simple' change to GAAP, they assert, would have precluded the prior problems and would allow future recovery to go that much faster. All that Congress, or the SEC, or FASB would have to do is repeal SFAS 157 dealing with Fair Value. According to these market participants, including the American Bankers Association, it was marking securities to Fair Value that caused the problem! Repeal Fair Value, and 1) Mark-to-Market problem would never have happened and 2) would permit a rapid recovery from today's levels.

HOW REPEALING FAIR VALUE WOULD "SOLVE" THE PROBLEM

Many bankers have chosen to make the argument that it was the FASB's Mark-to-Market requirement that caused much of the problem, not necessarily that their prior investments in subprime mortgage backed securities and credit default swaps were poorly thought out.

The theory is that if Fair Value were repealed, then Mark-to-Market would be easier to meet because the 'market' would now be something much higher. There had been a 'death spiral' as reported sales prices drove prices lower, which forced more sales and so on. Repealing Fair Value would make MTM **look** a lot better, there would then not have to be forced sales because capital would not be eroded. With sufficient capital potential not being wiped out, lenders to Wall Street would once again jump on board and all would be right with the world. And all that is required is a temporary suspension of SFAS 157!

If only things were that simple.

There is no question but that prices for subprime securities were in a death spiral. The lower prices caused still more sales and the more sales caused still lower prices. That is incontrovertible.

But blaming this all on Mark-to-Market requirements misses the point. Critics of abolishing SFAS 157, those in effect supporting the present system, argue that not disclosing current prices is like breaking a thermometer if you think it is too hot. It's the heat, not the thermometer that causes discomfort. Similarly, it was low prices for subprime securities that caused the financial discomfort, not marking them to market.

The argument that knowing the 'truth' is better than disguising things simply to look better is hard to contradict. Marking security prices to market makes sense – but if and only if the 'market' is accurate.

WHAT IS THE *REAL* MARKET?

If there is a good market price, and you have assets that are not only readily available for sale, but likely to be sold, then disclosing the current market prices should be mandatory.

There are two separate concepts incorporated into the above sentence, and each is important:

- There is a functioning market with willing buyers and sellers not under compulsion
- There are assets that could and would be sold into that market

Look at each of the two requirements. Taken separately, each is necessary, but not sufficient, to support MTM accounting.

- There has to be a functioning market for the quoted prices to reflect real value. The problem over the past six months is that many of the reported sales were forced or liquidating. Forced or liquidating sales do **not** represent Fair Market Value, and according to the FASB and SEC really don't reflect Fair Value. The trouble is that when Merrill Lynch sells some \$30 billion (face value) of securities at \$.22 on the

dollar, some observers believed that was a market price in accordance with the definition of SFAS 157. The problem is that the FASB use of the term ‘orderly transaction’ appears to be misinterpreted by many companies.

The term “willing seller” in the FMV definition would be a lot easier to interpret. There is little doubt that Merrill Lynch was an *unwilling* seller, being forced to sell securities, almost irrespective of price, in order to improve its capital position. The business press, in fact, commented at the time that they were lucky to obtain any bid, because the real question was how the buyer (a hedge fund) was ultimately going to make out. The Merrill transaction was “orderly” in the sense that the buyer paid the seller. But the whole thrust of the FASB definition on ‘exit value’ meant that it was easy to interpret the \$.22 cents on the dollar as Merrill’s ‘exit price.’ In effect this is the argument made by the American Bankers Association (“ABA”) in another part of the letter from which we quoted above.

The ABA argument really faults the major accounting firms for trying to apply ‘rules’ as to what is the Fair Value of a particular security and determining by that rule when an impairment exists and must be recorded. Yet there are no formal rules in GAAP as to the determination of “the market”. The real determination of Fair Value or Fair Market Value involves judgment.

The need for judgment is the reason that full Fair Value accounting can never be successfully arrived at. Liquidation values differ from going concern values. Who will tell a company what assumption to make, whether FV should be determined on liquidation or going concern assumptions? Yet without specifying the assumption, how could you compare Company A which values everything at going concern, with Company B in the same industry which values everything at liquidation value?

Both values can fulfill the SFAS 157 definition of Fair Value, depending on who you assume is the ‘Market Participant’ who would be the buyer

- Determining the Fair Value of assets that will not be sold appears to provide little useful information to investors and creditors. The overriding purpose of financial reporting, according to FASB's own Conceptual Framework, is to provide information about future cash flows.

If there are not going to be future cash flows, because the management has determined that the assets are not for sale, how does provision of FV information aid in investor decision-making. One can argue that management perhaps *should* be willing to sell any and all assets, but we have not reached the point where creditors and shareholders actually run the company. In fact the only time that creditors do get to make such decisions is after the company has filed for bankruptcy.

To assert that financial reporting should be based on a bankruptcy model that everything is for sale, surely would destroy the real underlying value of any going concern. There is a vast difference between valuing assets for the purpose for which they were acquired, and valuing them as though they would or could be liquidated.

THE ROLE OF PROFESSIONAL JUDGMENT IN VALUATION

The issue that the American Bankers Association and others complain about, that Mark-to-Market accounting is the cause of the financial reporting problems for financial institutions, misses the point. The real issue is in trying to make FASB's definition of Fair Value, that focuses on sales to 'Market Participants', provide useful and valid data. The FASB definition of FV is flawed, as discussed above. The single-minded application of auditors in interpreting recent transaction as representative of Fair Value simply adds to the problem.

In effect the FASB, and auditors, implicitly assume that Fair Value is a single objective amount that, with sufficient effort, can 1) be determined by management; 2) reviewed by auditors; and 3) disclosed to investors and creditors. It is this flawed assumption that lies at the heart of the untold discussions among all the participants in the financial reporting world.

The fact is that the ‘value’ of any asset is never a precise figure. Values can be determined, objectively and without bias, but only within a **range**. This range may be plus or minus 10% of the midpoint. Accountants can not work with ranges; they need a single dollar amount that can be processed through Journal Entries to the financial statements.

There are no black boxes for valuation where you input variables and out pops an answer. The very essence of valuation is the professional judgment of the appraiser. Different appraisers will arrive at somewhat different indications of value. Ordinarily if two appraisers are given the same assignment, and the same basic assumptions (liquidation value or value in-use) they will usually be within the 10%, plus or minus, mentioned above.

Unfortunately the FASB, when drafting SFAS 157 chose not to listen to professional appraisers. We warned the Board, and the staff, that their definition was flawed and would cause problems. The Board and staff ‘listened’, but then chose to go their own way. That, of course, is their prerogative. They make the rules. The rule they came out with, SFAS 157, is fundamentally flawed. The definition of Fair Value, now enshrined in GAAP, underlines the Board’s lack of understanding of how appraisers actually do their work. The problems now facing the Government, Investors, and Financial Institutions have been wildly exacerbated by SFAS 157.

The issue, however, is not Mark-to-Market accounting but the definition of Fair Value used to derive the so-called ‘market’. Until SFAS 157 is changed, and auditors are willing to accept the professional judgment of appraisers, the problems hitting the headlines will continue. Readers may not like it but things will have to get worse before there can be true improvement. Neither FASB nor auditing firms are noted for flexibility!

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