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Is It Fair to Blame Fair Value Accounting for the Financial Crisis?

by Robert C. Pozen *Robert C. Pozen*

Investors and corporate executives don't agree on how to value distressed assets. But maybe they don't have to.

What was the primary cause of the current financial crisis? Subprime mortgages, credit default swaps, or excessive debt? None of those, says Steve Forbes, chairman of Forbes Media and sometime political candidate. In his view, mark-to-market accounting was "the principal reason" that the U.S. financial system melted down in 2008.

Do accounting rules actually pack such a wallop? For readers not schooled in financial jargon, marking to market is the practice of revaluing an asset quarterly according to the price it would fetch if sold on the open market, regardless of what was actually paid for it. Because the practice allows for no outdated or wishful-thinking valuations, it is a key component of what is known as fair value accounting. And it is at the center of the hottest accounting debate in decades.

Many bankers pilloried fair value accounting when the sudden seize-up of credit markets in the fall of 2008 drove the clearing prices for key assets held by their institutions to unprecedented lows. Economist Brian Wesbury represented the views of that group when he declared, "Mark-to-market accounting rules have turned a large problem into a humongous one. A vast majority of mortgages, corporate bonds, and structured debts are still performing. But because the market is frozen, the prices of these assets have fallen below their true value." Wesbury and Forbes argue that marking to market pushed many banks toward insolvency and forced them to unload assets at fire-sale prices, which then caused values to fall even further. Persuaded by such arguments, some politicians in the United States and Europe have called for the suspension of fair value accounting in favor of historical cost accounting, in which assets are generally valued at original cost or purchase price. (See the sidebars "What They're Fighting About Overseas" and "Rewriting History in Europe" for accounts of the key battles being waged outside the United States.)

What They're Fighting About Overseas (Located at the end of this article)

Rewriting History in Europe: What a Difference an Amendment Makes (Located at the end of this article)

Yet mark-to-market accounting continues to have its proponents, who are equally adamant. Lisa Koonce, an accounting professor at the University of Texas, wrote in *Texas* magazine: "This is simply a case of blaming the messenger. Fair value accounting is not the cause of the current crisis. Rather, it communicated the effects of such bad decisions as granting subprime loans and writing credit default swaps.... The alternative, keeping those loans on the books at their original amounts, is akin to ignoring reality." Shareholder groups have gone even further, asserting that marking to market is all the more necessary in today's environment. The investment advisory group of the Financial Accounting Standards Board (FASB) stressed that "it is especially critical that fair value information be available to capital providers and other users of financial statements in periods of market turmoil accompanied by liquidity crunches." In this view, if banks did not mark their bonds to market, investors would be very uncertain about asset values and therefore reluctant to help recapitalize troubled institutions.

Which camp has the right answer? Perhaps neither. We do not want banks to become insolvent because of short-term declines in the prices of mortgage-related securities. Nor do we want to hide bank losses from investors and delay the cleanup of toxic assets—as happened in Japan in the decade after 1990. To meet the legitimate needs of both bankers and investors, regulatory officials should adopt new multidimensional approaches to financial reporting.

Before we can begin to implement sensible reforms, though, we must first clear up some misperceptions about accounting methods. Critics have often lambasted the requirement to write down impaired assets to their fair value, but in reality impairment is a more important concept for historical cost accounting than for fair value accounting. Many journalists have incorrectly assumed that most assets of banks are reported at fair market value, rather than at historical cost. Similarly, many politicians have assumed that most illiquid assets must be valued at market prices, despite several FASB rulings to the contrary. Each of these myths bears close examination.

Myth 1: Historical Cost Accounting Has No Connection to Current Market Value

Fair value proponents argue that historical costs of assets on a company's balance sheet often bear little relation to their current value. Under historical cost accounting rules, most assets are carried at their purchase price or original value, with minor adjustments for depreciation over their life (as in the case of buildings) or for appreciation until maturity (as in the case of a bond bought at a discount to par). A building owned by a company for decades, therefore, is likely to appear on the books at a much lower value than it would actually command in today's market.

However, even under historical accounting, current market values are factored into financial statements. U.S. regulators require all publicly traded companies to scrutinize their assets carefully each quarter and ascertain whether they have been permanently impaired—that is, whether their market value is likely to remain materially below their historical cost for an extended period. If the impairment is not just temporary, the company must write the asset down to its current market value on its balance sheet—and record the resulting loss on its income statement.

Permanent impairments of assets happen frequently under historical cost accounting. In 2008 alone, Sandler O'Neill & Partners reports, U.S. banks wrote down more than $25 billion in goodwill from acquisitions that were no longer worth their purchase price. In an example outside the banking field, Cimarex Energy declared a loss for the first quarter of 2009, despite an operating profit, owing to a noncash impairment charge of more than $500 million (net of taxes) against its oil and gas properties.

The point is that, even under historical cost accounting, financial institutions are ultimately forced to report any permanent decrease in the market value of their loans and securities, albeit more slowly and in larger lumps than under fair value accounting. Most bank executives resist such write-downs, arguing that the impairment of a given loan or mortgage-backed bond is only temporary. However, as the financial crisis drags on and mortgage default rates continue to rise, bankers will face increasing pressure from their external auditors to recognize losses on financial assets as permanent.

Myth 2: Most Assets of Financial Institutions Are Marked to Market

Those who heap blame on the head of fair value accounting like to imply that financial institutions saw a majority of their assets marked to the deteriorating market. In fact, according to an SEC study in late 2008, only 31% of bank assets were treated in this fashion, and the rest were accounted for at historical cost.

Why? Under fair value accounting, management must divide all loans and securities into a maximum of three asset categories: those that are held, those that are traded, and those that are available for sale. (See the exhibit "Which Bank Assets Are Marked to Market?") If management has the intent and ability to hold loans or securities to maturity, they are carried on the books at historical cost. Most loans and many bonds are held to maturity; they will be written down only if permanently impaired.

Which Bank Assets Are Marked to Market? (Located at the end of this article)

By contrast, all traded assets are marked to market each quarter. Any decrease in the fair market value of a bank's traded assets reduces the equity on its balance sheet and flows through its income statement as a loss. As a simple illustration, suppose a bank buys a bond for $1 million, and the bond's market price declines to $900,000 at the end of the next quarter. Although the bank does not sell the bond, the left side of its balance sheet will show a $100,000 decrease in assets, and the right side will show a corresponding $100,000 decrease in equity (before any tax effects). This decrease will also flow through the bank's income statement and be reported as a $100,000 pretax quarterly loss.

The accounting treatment of the third asset category—assets available for sale—is more complex. Although debt securities in this category are marked to market each quarter, any unrealized gains or losses on them are reflected in a special account on a bank's income statement (where it is called other comprehensive income, or OCI) and aggregated over time on its balance sheet (where it is called accumulated OCI). Because of this special treatment, unrealized losses on them do *not* reduce the bank's net income or its regulatory capital. (Held-for-sale loans, meanwhile, must be booked at the lower of cost or market value, with any decline reported as a loss on the income statement. But they make up a very small percentage of this category.) The SEC found in its study that nearly a third of those 31% of bank assets marked to market were available-for-sale debt securities. Accordingly, the percentage of assets for which marking to market affected the bank's regulatory capital or income was just 22% in 2008—far from a majority.

Myth 3: Assets Must Be Valued at Current Market Prices Even If the Market for Them Is Illiquid

Fair value accounting would be straightforward if all financial assets were what FASB deems Level 1—highly liquid and easy to value at direct market prices. Since they do not always have these characteristics, however, FASB created a standard, FAS 157, which allows for two other levels. (See the exhibit "How Liquid Is That Asset?")

How Liquid Is That Asset? (Located at the end of this article)

Whenever possible, the standard states, assets should be valued according to the Level 1 method: on the basis of observable market prices. But the standard recognizes that market prices are not always available, in which case it allows financial executives to value assets by using observable market inputs, the Level 2 method. These inputs could include, for instance, trading prices and discounts for securities similar or related to the ones being valued. When not even such inputs are available, as with, say, an investment in a private equity fund, the asset should be valued under Level 3.

When trading assets are classified as Level 3, because of illiquid markets or for other reasons, financial executives are allowed to value them by "marking to model" instead of marking to market. In marking assets to model, executives may use their own reasonable assumptions to estimate fair market value.

When the debt markets froze during the fall of 2008, FASB released a staff paper clarifying the application of fair value accounting to illiquid markets. That paper emphasized the flexibility of standard 157 and made companies aware that they could reclassify trading assets from Level 2 to Level 3 as markets became more illiquid. FASB also stressed that companies did *not* have to use prices from forced or distressed sales to value illiquid assets.

However, these rulings did not provide enough comfort for bankers watching the market value of their toxic assets plummet; they complained loudly to their elected representatives, who threatened to legislate accounting standards unless FASB provided more relief. As a result, in April 2009 FASB quickly proposed and adopted a new rule, which detailed criteria for determining when a market is illiquid enough to qualify for mark-to-model valuation. The rule was designed to allow more securities to be valued by bank models instead of by market indicators. On the same day, FASB issued yet another rule on how to account for securities when they were permanently impaired. The rule said that only the credit-loss portion of such impairments would affect a bank's income and regulatory capital, with the rest (such as unrealized losses related to illiquidity) going into the special account for other comprehensive income.

Those two retroactive rulings made it possible for large U.S. banks to significantly reduce the size of write-downs they took on assets in the first quarter of 2009. The rulings improved the short-term financial picture of these banks, although they also led bank executives to resist sales of toxic assets at what investors believed to be reasonable prices.

Three Recommendations for Realistic Reporting

Once we get beyond the mythmaking and arm waving, it becomes clear that historical cost and fair value accounting are much closer to each other than people think. Nevertheless, the differences between the two forms of accounting may be significant for a

particular bank on a specific reporting date. In these situations, the bank executives' understandable desire to present assets in the best light is likely to conflict with investors' legitimate interest in understanding the bank's potential exposures. So let us consider how banks might issue financial reports that would capture the complex realities of their financial situations.

Enhance the credibility of marking to model.

Given FASB's two recent pronouncements on Level 3 assets, there is no question that banks will increasingly value illiquid securities by marking them to model. During the first quarter of 2009, Level 3 assets at the 19 largest U.S. banks increased by 14.3%, as compared with the prior quarter. Because banks are allowed to make reasonable assumptions based on their own estimates for rates of return on subprime loans, mortgage-backed securities, and other troubled assets over several years, mark-to-model valuations will usually be higher than those based on recent trades of similar assets. Marking to model lets banks paint a relatively optimistic picture of their financial condition.

This is sure to give rise to real investor skepticism about the accuracy of bank valuations of troubled assets. As Warren Buffett has pointed out, mark to model can degenerate into "mark to myth."

How can we counter that skepticism and keep valuations defensible? To help investors understand how it arrived at values for assets marked to model, a bank should disclose a supplemental schedule listing Level 3 assets and summarizing their key characteristics. Most important, a bank should disclose enough detail about the assumptions underlying its models to allow investors to trace how it reached valuations.

Unlink accounting and capital requirements.

The most fundamental criticism of fair value accounting is that it drives banks to the brink of insolvency by eroding their capital base. In the view of many bankers, fair value accounting has forced an "artificial" reduction in asset values that are likely to rebound after the financial crisis subsides. To investors, on the other hand, nothing is more artificial than proclaiming that an asset is worth a price no one is actually willing to pay. The typical investor, moreover, is less confident that decreases in the market value of many bank assets are the temporary result of trading illiquidity, not the lasting result of rising defaults.

It may not be necessary to reconcile these different perspectives. Both could be accommodated if banks were required to fully disclose the results under fair value accounting but not to reduce their regulatory capital by the fully disclosed amounts. As explained before, if a bank holds bonds in the available-for-sale category, they must be marked to market each quarter—yet unrealized gains or losses on such bonds do not affect the bank's regulatory capital. Accounting and capital requirements could be unlinked in other areas, too, as long as banks fully disclosed the different methodologies. Unrealized quarterly gains and losses on bonds in the trading category, for example, could be accurately reflected on the balance sheet and income statements of the bank. But for regulatory purposes, its capital could be calculated on the basis of the average market value of those bonds over the past two quarters. This combination would provide investors with disclosure regarding the current market prices for these bonds, while reducing the quarterly volatility of banks' regulatory capital.

Calculate earnings per share both ways.

Even if regulators were to further unlink bank capital calculations from financial results under fair value accounting, bankers would still be concerned about the volatility of quarterly earnings. A bank whose total net revenue—from fees and net interest income—was quite stable might see its overall earnings fluctuate significantly from quarter to quarter, thanks to changes in the current market values of its actively traded bonds and other assets. And that volatility might depress the bank's stock price if not fully understood by investors looking for stable earnings.

Could the interests of bankers and investors be reconciled with regard to the bank's income statement? Yes, if the bank published two versions of its earnings per share (EPS) each quarter—one calculated with fair value accounting and the other without. Suppose the bank reported EPS of 54 cents for the quarter, comprising net operating income of 62 cents per share and a loss of 8 cents per share due to unrealized losses in the market value of its bond portfolio. The bank would also publish a second EPS of 62 cents per share, with an explanation that this second EPS excluded those unrealized losses.

The publication of two EPS numbers each quarter along these lines was recommended in 2008 by the SEC's Advisory Committee on Improvements to Financial Reporting (which I chaired). The table taken from this report (see "Is a New Financial Statement the Solution?") shows a partial reconciliation of a hypothetical company's net income under fair value accounting (YYY in the table) with its net cash flow, which excludes fair market adjustments (XXX). Stripping out a company's cash flow from its income statement is the type of exercise undertaken by many securities analysts to better understand a company's financial situation.

Is a New Financial Statement the Solution? (Located at the end of this article)

If banks followed the committee's recommendation, we could have the best of both worlds. Investors would better understand what portion of a bank's net income came from operating earnings and what portion came from movements in the securities markets. At the same time, bank executives could better explain how their banks were earning stable profits from core operations, regardless of the quarterly price fluctuations in their securities holdings.

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To cut through this complex debate and implement these needed reforms, politicians and business executives must recognize that there is no single best way to value the assets of financial institutions. Some assets may be more accurately measured under fair value accounting, while others may be better measured under the historical cost approach. For the foreseeable future, banks will continue to be subject to a mixed-attribute system, combining both methods. Accordingly, we should develop reporting formats—such as presenting two calculations of EPS—that help clarify the different types of income included in the same financial statement.

It is also important to remember that financial statements are scrutinized by various groups for different purposes. Investors use these statements to assess downside risks and potential for earnings growth, regulators to ensure that banks have sufficient capital and income to withstand losses on loans or other assets. Given these different objectives, federal regulators should unlink financial reporting from capital requirements for banks.

Fair value accounting did not cause the current financial crisis, but the crisis may have been aggravated by common misperceptions about accounting standards. Some investors incorrectly assumed that most bank assets would be valued at

market prices, as bond prices were nose-diving. Other investors failed to realize that the sharp markdowns of bonds available for sale would not put banks in violation of regulatory capital requirements. If we can make these accounting complexities clearer by adopting a multidimensional approach to financial reporting, both companies and investors should be better equipped to respond intelligently when financial markets are next thrown into turmoil.

What They're Fighting About Overseas

In July 2009 the International Accounting Standards Board (IASB) proposed simplifying accounting for financial instruments by eliminating one category of assets—assets available or held for sale—so that all assets would be recorded at either fair value or historical cost. A financial instrument would be assessed at fair value unless it met two tests: It had only "basic loan features," and it was "managed on a contractual yield basis."

As proposed, basic loan features mean contractual cash flows of principal and interest. A loan may have prespecified rate resets in response to changes in the issuer's credit quality. Most financial derivatives would not meet this first test.

Managing on a contractual yield basis usually means holding financial assets to their contractual maturity date. According to the IASB, the actual operation of a firm's business model, rather than management's intention to trade or hold to maturity, determines whether a financial instrument meets this test. Nevertheless, the IASB made clear that occasional sales of instruments with basic loan features would not trigger a wholesale switch to fair value accounting for all such instruments as long as these sales were consistent with a general "originate and hold" business model.

The elimination of the category of available or held for sale makes sense from a simplification perspective. It is difficult to identify which assets belong in this category, and the respective rules for the treatment of securities and loans in the category are different. However, financial executives are concerned that some assets now in this category will be shifted into the trading category. If that happens, quarterly changes in the fair market value of those assets would hit banks' quarterly income statements for the first time.

The impact of the IASB proposal on quarterly earnings will be the key factor in whether the EU decides to adopt it. The question is, Will financial assets now classified as available for sale be moved to the trading category or the held-to-maturity category? The proposal will face tough sledding if changes in the fair value of assets have a larger impact on the income statements of banks than they do under current IASB rules.

Rewriting History in Europe: What a Difference an Amendment Makes

Like the leaders of the U.S. Congress, the leaders of the European Union have pushed hard to suspend the application of fair value accounting during the financial crisis. French president Nicolas Sarkozy, for example, reportedly maintained that it must be halted because it puts the balance sheets of European banks "at the whim of speculators."

But European politicians have much more leverage over the International Accounting Standards Board than Congress has over the Financial Accounting Standards Board, its U.S. counterpart. Before a new IASB standard can go into effect in Europe, it must be "endorsed" by three EU bodies—the European Parliament, the European Commission, and the EU Council of Ministers. Because of these three potential vetoes, the IASB is highly sensitive to threats from EU politicians to legislate their own accounting standards for European companies. By contrast, newly adopted FASB standards are automatically applicable to U.S. companies unless overridden by the SEC.

In October 2008, EU officials urgently requested that the IASB allow European banks to shift their assets from the categories of trading or available or held for sale to the held-to-maturity category—in other words, from fair value accounting to historical cost accounting. In its rush to meet this request, the IASB put aside its normal due process and issued a final amendment to its accounting standard without any prior notice or public consultation.

The amendment allows European banks to shift their bonds and marketable loans from a fair valued category to a historical cost category under "rare circumstances." Although those are the same words used in the comparable U.S. accounting standard, SEC officials have suggested that "rare circumstances" means almost never. By contrast, the IASB announced a broad interpretation, declaring: "The deterioration of the world's financial markets that has occurred during the third quarter of this year is a possible example of rare circumstances." In addition, the IASB allowed European banks to backdate a reclassification to the third quarter.

This IASB amendment had an immediate impact on the financial statements of European banks. In the third quarter of 2008, Deutsche Bank avoided more than €800 million in losses from write-downs in its bond and marketable loan portfolios by shifting assets to a more favorable category. Through the magic of relabeling, Deutsche Bank reported a third quarter profit of €93 million, instead of a loss of more than €700 million. More generally, European banks shifted half a trillion dollars from other categories to held to maturity—boosting their profits by an estimated $29 billion in total for 2008. Some critics asked, How could actively traded bonds now be accounted for at historical cost if they were not purchased with the intent to hold them to maturity? Perhaps the profit picture was not as rosy as suggested by the financial reports of European banks.

Which Bank Assets Are Marked to Market?

Most securities are classified as "held to maturity," and therefore, under U.S. GAAP, are carried on balance sheets at historical cost. Only in the event of permanent impairment will a change in their value affect banks' income and regulatory capital.

	TRADING SECURITIES	HELD-TO-MATURITY SECURITIES	AVAILABLE-FOR-SALE DEBT SECURITIES
Balance Sheet	Recorded at fair value. Changes in value affect equity.	Recorded at historical cost. Changes in value affect equity only in the event of a permanent impairment.	Recorded at fair value. Changes in value are reflected in a special account, accumulated other comprehensive income.
Income Statement	Unrealized gains and losses affect income and earnings.	Unrealized losses affect income only in the event of a permanent impairment.	Unrealized gains and losses are reflected in a special account, other comprehensive income, that is excluded from earnings.
Regulatory Capital	Unrealized gains and losses affect regulatory capital.	Unrealized losses affect regulatory capital only in the event of a permanent impairment.	Unrealized losses affect regulatory capital only in the event of a permanent impairment.

How Liquid Is That Asset?

Only the most liquid securities subject to fair value accounting must be valued at direct market prices, according to Financial Accounting Standard 157.

	LEVEL 1 ASSETS	LEVEL 2 ASSETS	LEVEL 3 ASSETS
Liquidity Standard	Most liquidity	Moderate liquidity	Least liquidity
Valuation Method	Valued at direct market prices, based on active trading of identical instruments	Valued using observable market inputs	Valued using a financial model, such as a discounted cash flow model

Is a New Financial Statement the Solution?

If banks published a reconciliation of their net cash flow with their net income under fair value accounting, investors would be able to clearly see what portion of operating income came from operating earnings and what portion came from movements in the securities markets. The table below illustrates how this would work.

	A Cash flow statement	B Cash flows not affecting income	C Accounting accruals other than remeasurements	D Recurring fair value changes	E Remeasurements other than recurring fair value changes	F Income statement (A+B+C+D+E)	
			NONCASH ITEMS AFFECTING INCOME				
OPERATING							
Cash received from sales	2,700,000		75,000			2,775,000	Sales
	0			(1,000,000)		(1,000,000)	Loss on trading securities
	0		(9,000)			(9,000)	Depreciation expense
	0				(15,000)	(15,000)	Impairment expense
INVESTING							
Capital expenditures	(500,000)	500,000				0	
FINANCING							
Interest paid	(125,000)		(100,000)			(225,000)	Interest expense
Net cash flows	XXX					YYY	Net income

This table and explanation are based on pages 33–34 of the Final Report of the SEC Advisory Committee on Improvements to Financial Reporting (August 1, 2008).

Column A

Cash received ($2.7 million) by the company represents the majority of sales recorded in the income statement this period.

Column B

Cash spent to purchase equipment ($500,000) is recorded as an asset under U.S. GAAP. It is not treated as an immediate expense and does not affect current income (except through depreciation).

Column C

Accounting accruals reflect routine bookkeeping entries. For instance, sales made on credit ($75,000) near the end of the period represent revenue in the income statement, even though it will not be collected until a later date. Depreciation expense ($9,000) is recorded to allocate part of a previously acquired asset's original cost to the current period.

Column D

Recurring fair value changes describe items measured at fair value every period (quarterly and annually). In this case, the company recorded a loss ($1 million) on its actively traded investment securities owing to a market downturn. U.S. GAAP requires adjusting these securities to fair value each period even if they are not sold.

Column E

Remeasurements other than recurring fair value changes identify adjustments recorded only after a triggering event or when management decides that a decrease in value is other than temporary. For example, owing to unforeseen events, the company recorded a goodwill impairment charge ($15,000).

Columns A, C, & F

The company reduced its net income in column F by 100% of the interest expense it incurred under a lending arrangement this period ($225,000). But it paid only a portion of its obligation in cash ($125,000) in column A, leaving the remainder ($100,000) in column C to be paid at a later date.

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