

Fair Value Accounting – Dispelling Some Myths

Recent turmoil in financial markets as a result of the global financial crisis has increased the focus on fair value accounting.

In this brief, The Accounting Committee of the ASF provide an overview of the fair value accounting concept, its role in the current market and current issues being experienced by securitisation industry players.



What is the fair value problem?

Mark-to-market accounting is designed to provide investors with a higher degree of transparency over the value of assets. It requires companies to record their assets and liabilities at their current market values, which the accounting standards refer to as fair value¹ (FV).

For issuers of Asset Backed Securities, most Australian securitisation structures successfully avoid the mark-to-market accounting (MtM accounting) for their securitised asset pools and related funding instruments by using the “good old” cost accounting principles. The only time when these entities experience some of the fair value challenges is when valuing their derivatives portfolio used to manage risks of the structure.

On the investors' side, life is however not that simple. Those, applying MtM Accounting (some by choice, some mandatorily), find that determining the fair value of their investments in the current markets is a lengthy and costly exercise.

Why is that so? The answer to this question is simple – currently, there is little or no secondary market for structured investments, which would provide reliable, up-to-date market value information. Finding the answer to the key question ‘What is the fair value?’ often requires complex financial modelling, which takes into account factors such as:

- Amounts and timing of future cashflows generated by the pool of securitised assets;
- Level of losses and their absorption by the individual structured layers;
- Waterfall rules;
- Presently prevailing margins / spreads required by the market on similar assets / transactions.

As each securitised product is unique in its characteristics, there is no uniform set of assumptions that can be applied to determine the above inputs easily. At the same time, historically available data tends to provide little relevance for current conditions.

Those investors, who purchased the assets with a long term horizon and do not plan to sell them in near future, tend to find the resulting interim fair value of little benefit to them or their stakeholders.

Due to the increase in market volatility and fall in business confidence as a result of the global downturn, asset values have decreased significantly over the last 12 to 18 months. This has led to increasing criticism of the fair value concept of accounting as it has been accused of exacerbating the magnitude of the economic cycle or in some commentators' eyes, even triggering a financial system meltdown.

Common criticisms of fair value include:

- It has a tendency to create a spiral of diminished values as forced asset sales exacerbate decline in all remaining assets;
- Fair valuation losses will eventually reverse, as assets are held until maturity. Volatility in reported results is therefore misleading;
- Modelling leaves too much room for management discretion and potential abuse;
- Unrealised losses and volatility in performance causes financiers to lose confidence and inflate spreads.
- The “tainting rule” constraints around the Held to Maturity classification force entities to apply fair value accounting.

¹ As per the Australian Accounting Standards Board Standard No.139 the Fair value is the amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

The response to the criticism of fair value:

- Fair value provides the most relevant information for investors;
- Subprime losses would impact the entities regardless of the valuation method used;
- Illiquidity is a reality of the current markets and should be reflected in the financial statements as it arises;
- It is a commercial reality that values and prices are depressed. Fair value losses are not the cause of the financial crisis they are a consequence of it.

Categories of financial assets

The accounting framework offers several options for recording and valuing financial instruments, driven by their nature and the entity's investment intention. Resulting from these, financial assets can be categorised into one of the following:

Category	Definition
Fair Value through Profit and Loss (FVTPL)	<ul style="list-style-type: none"> - Purchased for resale in short term - Held for short-term profit-taking; - Derivatives; - Designated as FVTPL: <ul style="list-style-type: none"> ▪ To eliminate measurement mismatch; ▪ Because managed on FV basis.
Loans and Receivables (L&R)	<ul style="list-style-type: none"> - Non-derivative financial assets with fixed or determinable payments; - Not quoted in an active market; (Includes interest in pool of L&R).
Held to Maturity (HTM)	<ul style="list-style-type: none"> - Non-derivative financial assets with fixed or determinable payments; - With fixed maturity; - When entity intends and has ability to hold them until maturity; - Do not meet definition of L&R.
Available for Sale (AFS)	- Those not classified in any of the above categories.

In most cases, investors in securitisation markets find that they have a choice of more than one of the above. The category they choose, impacts the way the investment is carried on the balance sheet as well as whether the income, gains and losses affect profit and loss (P&L) or equity reserves:

Cat.	Asset at	P&L	Reserves
FVTPL	FV	All (fees, interest, FX, MtM)	-
L&R	Amortised cost	All (fees, interest, FX, realised gains / losses, impairment)	-
HTM ²			-
AFS	FV	Some (Fees, interest, FX, realised gains / losses, impairment)	MtM (Unrealised gains / losses)

As can be seen from the above table, only FVTPL and AFS categories require MtM accounting, while the other categories offer a much simpler amortised cost model.

Why do some entities appear to be able to avoid fair value accounting?

The turbulent market conditions, evidenced by loss of liquidity and occurrence of numerous forced sales of assets, caused difficulties in determining fair value of assets. This motivates entities to prefer L&R or HTM categories rather than FVTPL and AFS.

Banks investing in asset backed securities are able to use their 'banking book' to shelter the investments from the need to mark-to-market. This gives them the ability to defer recognition of losses related to the recent decrease in market values, until recovery occurs in the future. This way, they were able to eliminate the fair value

² The main difference between the L&R and HTM classification are:
a) HTM "tainting rule" (sale of securities prior to maturity triggers inability to use HTM for 2 years);
b) L&R assets cannot be quoted in an active market.



volatility in their earnings, apart from losses triggered by impairment.

Funds, which usually manage the investments and monitor their performance on a market value basis, use the FVTPL category. In a lot of cases, this is a voluntary decision, as there may be situations where nothing prevents them from classifying assets into L&R or HTM and holding the investments at amortised cost less impairment. However, fair value accounting is often seen as the best and only way to achieve “equity” between incoming and outgoing investors in a Fund. Superannuation funds have no alternative to marking their assets and liabilities to market.

So when is applying MtM accounting unavoidable?

- All derivatives;
- All positions entered into for speculative, short-term profit-taking purposes and those classified by a bank in a ‘trading book’;
- Investments in insignificant amounts of share capital³.

How can you avoid it?

- Know and document your investment strategy – long term investments in structured notes where underlying assets are debt instruments can be classified as L&R (provided they are not quoted in an active market) or HTM (subject to the tainting rules) and carried at cost less impairment.

This is illustrated in a recent case study. In February 2009, HSBC managed to issue funding for its Singapore listed Cambridge Industrial Trust, using a tranching structure, rather than tranching securities structure. The press highlighted several advantages of this approach, including “... banks will not need to mark-to-market the exposure they take on the loan. On a standard CMBS, investors would be trading the instrument and obliged to mark the security to the most recent traded price.”

³ Investments in share capital, which provide the investor a significant influence or control over the entity, are subject to different accounting treatment.

To explain:

- This press comment assumes that the issued securities are actively traded in a quoted market and consequently the L&R category is not permitted. In the current illiquid markets, this assumption could be rebutted.
- If the investor is taking a position with a view to holding it to maturity, then MtM accounting could have been avoided by choosing the HTM category even in the case of issuance of securities rather than loans. Presumably the holder did not wish to run the gauntlet with the tainting rules.

How to derive fair value?

The Australian accounting standards provide a ‘fair value hierarchy’ for the entities to follow when determining fair values. The three tiers reflect the decreasing level of liquidity and the increasing significance of subjective inputs used in making the measurements:

Tier	FV determination
1) Price quoted in active markets	- Quote from Bloomberg, Reuters, Datastream, etc.
2) Observable market data for the respective or similar assets exist. (Yield curves, volatilities, past transactions, etc.)	- Using valuation technique such as discounted cash flow models; Black Scholes models, etc; - Reference to prices traded at in past transaction.
3) Inputs are based on unobservable data. (Mortality rates, unemployment rates, probabilities of default, collateral values, etc.)	- Discounted cash flow model generated by the entity; - Monte Carlo simulation.

The majority of RMBS securities that were originated in Australia in recent years are at present not actively traded in the market. A limited recent transaction history is available, however, its relevance is questionable due to a number of those transactions having been executed under a “fire sale” scenario.

Implications of illiquid and distressed markets on determining fair value

The International Accounting Standards Board (IASB) Expert Advisory Panel recently issued guidance on how to determine a fair value if a market is no longer active. It states that transaction prices in inactive markets might be inputs when measuring fair value, but may not be determinative.

The characteristics of an inactive market were described as:

- Significant decline in the volume and level of trading activity;
- Available prices vary significantly over time or among participants;
- Prices are not current.

The panel warned that determining whether a market is inactive is a matter of judgment and exhibition of the above indicators does not necessarily mean the market is inactive.

The following are the key elements of the guidance:

- Regardless of the level of activity, transaction prices that do not represent distressed transactions cannot be ignored when measuring fair value using a valuation technique. Significant adjustments may however be required based on unobservable data.
- When markets become inactive, it is not appropriate to conclude that all sales are distressed sales. At the same time, it is not appropriate to conclude that all transactions are determinative of fair value.
- Regardless of valuation technique used, an entity must include appropriate risk adjustments that market participants would make, such as for credit and liquidity.

The panel also provided indicators of a forced transaction:

- Legal requirement to transact
- Necessity to dispose of an asset immediately and there is insufficient time to market the asset to be sold
- Existence of a single potential buyer as a result of the legal or time restrictions imposed

As FV is supposed to be a reflection of a price resulting from an orderly transaction, forced / distressed / fire sales are not to be considered determinative and therefore do not form part of a fair value measurement.

Standard Setters Response

As a reaction to increased volatility in the financial markets and difficulties in determining fair values for illiquid instruments, the Australian Accounting Standards Board (AASB) in October 2008, issued two amendments⁴ to AASB Standard 139 *Financial Instruments: Recognition and Measurement*.

The amendments are a response to calls from constituents, particularly within the European Union, to create a ‘level playing field’ with US GAAP regarding the ability to reclassify certain financial assets currently measured at FV.

The amendment for example allows (under certain circumstances) an entity to reclassify financial assets from FVTPL and AFS to L&R category. The main benefit is an elimination of the volatility to earnings caused by MtM accounting as well as elimination of issues faced when trying to reliably estimate fair values at each reporting date.

In 2009, the topic of MtM accounting continues to be widely discussed, mainly in the US.

Recently, the Fed chairman has said that regulators should consider relaxing MtM accounting rules. At the same time, Banks

⁴ The amending standards are:

a) AASB 2008-10: *Reclassification of Financial Assets*;

b) AASB 2008-12: *Reclassification of Financial Assets – Effective Date and Transition*.

and Wall Street firms, which are holding vast quantities of mortgage-backed securities for which there is no market and hence no market price, have been lobbying intensely for months for relief from mark-to-market rules and other forms of flexibility.

In response, the Financial Accounting Standards Board (FASB) has indicated as recently as last month that it had started two projects to further improve fair value accounting in illiquid markets and that it hoped to complete the work by the end of the second quarter. FASB also said it has plans to work with the London-based International Accounting Standards Board on a broad review of impairment rules.

Concluding comments

The current market conditions have presented a number of challenges to the securitisation industry, which, together with MtM accounting, was accused of causing the meltdown.

Lack of liquidity and distress of the financial markets has meant that the fair value concept has been more difficult to follow and has also lead to stressing of company balance sheets and annual results.

To this end, the standard setters have acted to bring a greater convergence between international financial reporting and US accounting practices. Further guidance is promised to be made available to the industry in the upcoming months.