point of view

A proposal to improve fair value accounting*

Refining the accounting for impaired bonds may address some challenges of reporting fair value in illiquid markets

Highlights

The proposal offers four advantages for reporting losses on non-trading debt securities:

1. **Credit and non-credit losses would be reported separately and prominently in a redesigned income statement.** This enhances transparency by providing more information about changes in fair value.
2. **Only incurred losses are recorded in net income.** This is consistent with accounting for credit losses on loans and eliminates an inconsistency in how incurred losses are reported.
3. **Continues to report debt securities at fair value.**
4. **Reduces effect of temporary market volatility on net income.** Swings in earnings will be moderated in both falling and rising markets—essentially buffering the extremes of bull and bear emotion.

Why change fair value accounting?

The financial crisis has exposed numerous flaws in the financial markets—as well as some shortcomings of fair value accounting for debt securities.

Critics contend that reporting fair value during illiquid markets needlessly creates earnings volatility and destroys bank capital. They have called for its temporary suspension.

Standard setters are addressing the challenges associated with fair value accounting by reevaluating accounting and reporting standards for financial assets. Input from market participants has been widely solicited and is being considered; amendments to existing standards have either been issued or are under consideration.

This proposal offers standard setters a way to address some of the concerns of critics while maintaining the benefits of fair value accounting.

Frozen markets presented a challenge to fair value accounting

When markets function with normal liquidity, determining fair value is easy. During illiquid markets, fair value becomes more difficult to establish. It requires making significant judgments and estimates, which, according to critics, makes these assessments subjective and unreliable.

Reassessments follow the crisis

By any measure, America's current financial crisis—and the federal government's response—has been astonishing. Governments and businesses are currently managing challenges neither the US nor world economy has seen in 70 years.

Five of the country's major investment banks have disappeared via bankruptcy, acquisition or conversion to commercial banks. To date the Federal government has committed more than $6.5 trillion to stabilize the financial markets with more expected from the Obama administration. The crisis has now advanced through the economy exposing systemic vulnerabilities across business sectors around the world.

The crisis has spurred scrutiny of nearly every corner of the financial services industry, including investment banks, commercial banks, mortgage brokers, hedge funds and rating agencies. The reevaluation also covers a wide array of financial products, including mortgage-backed and asset-backed securities, credit default swaps and derivatives.

Fair value accounting, as the standard for valuing and reporting certain financial assets, primarily loans and debt securities held by financial institutions, is also receiving scrutiny.

Understanding fair value reporting

Under fair value, financial assets are reported at current or market value (commonly referred to as "mark to market"). Market value is the price at which buyers and sellers would be willing to transact for a particular asset.

When markets function with normal liquidity and robust capital flows, fair value is simple: the current market price for a particular asset is the one reported based on transactions occurring that day.

The heart of the debate: Procyclicality and illiquidity

Illiquid markets make it more challenging to determine fair value. Moreover, some contend fair value may promote a downward spiral in asset prices, or procyclicality, because potentially temporary losses are recorded.

During down markets, banks must write down assets to reflect current market value. These write downs reduce regulatory capital. To increase capital, some banks may sell undervalued assets into the depressed market. These sales place further downward pressure on asset values, which in turn may trigger further write downs and more sales.

Moreover, during times of severe market illiquidity, when few or no buyers exist, an implied market value is estimated. This is usually accomplished through valuation models. Models often require significant judgment and estimation, which, critics say, may make them subjective and unreliable.

Mending is better than suspending fair value

Critics have therefore called for suspension of fair value accounting during illiquid markets. They contend these models lead to excessive and punitive write downs. Yet the SEC's recent fair value accounting study noted no linkage between fair value accounting and bank failures. It also asserts that suspending fair value may reduce the transparency of and confidence in financial reporting.

Standard setters have responded vigorously to the challenges associated with fair value accounting. They have solicited input from a broad range of market participants. Their efforts have led them to revise some standards and consider changing other standards.

A few key refinements will better serve users without diluting fair value's integrity

"Any fundamental change to fair value reporting runs the risk of reducing confidence among investors … [But] several areas [refinements in reporting and disclosures] could be evaluated in regard to reporting periodic changes in fair value without compromising the core principles."

Vincent P. Colman
Managing Partner, Assurance
PricewaterhouseCoopers LLP

SEC Roundtable on
Mark-to-Market
Accounting

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During recent forums held on fair value accounting, the accounting profession presented an idea to help address an inconsistency in how impairment charges are recorded for financial assets.

Impairment for financial assets

Different methods exist to report impairments in the value of financial assets. Reporting often depends on legal form—whether the asset is a loan or bond, such as a mortgage-backed or asset-backed security.

Under current practice, loan impairments reflect only credit related losses (those related to a borrower's inability to make principal and/or interest payments). Impairment charges for debt securities reflect both credit and non-credit related impairment.

In normally functioning markets, this inconsistency went unnoticed. However, with severe market illiquidity, impairment charges for many debt securities contained a significant illiquidity or non-credit component—in some cases the majority of the impairment was non-credit related. This inconsistency, together with its impact on the financial markets, is now at the forefront of the fair value debate in financial, regulatory, and public policy circles.

Advancing a proposal to refine fair value accounting

To address this issue and more clearly report the nature of impairment of debt securities, the idea proposes:

- Separating impairment charges into two components: losses related to declines in expected cash flows (or incurred credit losses) and all other changes in fair value.
- Reporting incurred credit losses in net income and all other impairment losses in other comprehensive income (OCI). OCI is a holding account for temporary unrealized changes in fair value of various financial assets and liabilities until they reverse themselves or result in realized gains or losses.
- Changing the income statement format to provide greater visibility for the income effects of items reported at fair value; and include OCI information on the income statement below net income.

Many benefits exist

These refinements offer an improved approach that:

- Provides greater consistency and comparability in reporting declines in the fair value of loans and securities for financial institutions.
- While reflecting only incurred losses in net income, would disclose all changes in the fair value of debt securities on the face of the income statement.
- Provides more information about the causes of changes in fair value, including both credit and non-credit factors.
- Removes liquidity and other transitory charges from the net income of institutions with a "buy and hold" investment strategy.

No panacea

The proposal is not intended to be a panacea that addresses all fair value concerns. The suggested refinements represent one method to address an inconsistency in impairment accounting and further the effort to improve fair value accounting for financial assets.

This method has been discussed at roundtables sponsored by FASB, IASB, and the SEC. Favorable comments have been received from the accounting profession, bank regulators and preparers. Investor feedback received has been mixed, tending toward skeptical, as some expressed concern about the possibility of reduced transparency for impairment charges. These concerns are discussed in the following Q&A.

Key questions are raised by critics of the proposal...

Here is our perspective.

Q&A

Q: Won't this plan reduce fair value information flowing through the income statement thus reducing transparency?

A: The proposal provides transparency while maintaining the integrity of fair value accounting. Fair value changes and impairments are disclosed fully on the balance sheet and income statement. New information about any impairment charge (credit versus noncredit) is disclosed on the face of the income statement.

The proposal also provides more consistency. Credit-related changes are reflected in net income and all non-credit-related changes in fair value (holding gains and losses) are reflected in OCI. This approach is consistent with existing treatment of holding gains and losses for available for sale securities contained in FAS 115.

Q: How will this proposal affect regulatory capital?

A: The proposal does not diminish or reduce the information currently provided to regulators for use in regulatory capital evaluation. However, it acknowledges the interplay between financial and regulatory reporting, which serve different purposes — informing investors versus safety and soundness of an institution. Regulators have and will continue to use financial reporting information in a manner that best serves their regulatory mandate.

That being said, as a byproduct, the proposal would indeed, under current regulatory rules, reduce stress on regulatory capital during times of market illiquidity.

Q: Doesn't the proposal suggest a level of precision in measuring credit and non-credit losses that simply does not exist and may be misleading to users?

A: Estimating losses will always be subjective and imprecise. This enhanced measurement and reporting of credit and non-credit losses, while imperfect, will be more directionally accurate and useful than current practice.

Q: Won't this idea allow institutions to hide losses or massage earnings to create more favorable results?

A: The proposal increases transparency by providing more information about the causes of changes in fair value—both credit and non-credit factors. Removing liquidity and other transitory charges from the net income of institutions with a "buy and hold" business model may reduce distortion from excessive market pessimism in distressed markets and excessive market optimism in euphoric markets.

Q: How does this proposal address the inherent inconsistency in the current "mixed attribute" model used in fair value accounting—assets are marked to market but most liabilities are not?

A: The proposal is an effort to begin to address some—but not all—of the shortcomings of fair value accounting. Resolving other issues, such as the mixed-attribute model, will require extensive debate involving many constituencies and both the FASB and the IASB as they all continue their efforts to improve fair value reporting.

Contact information

To have a deeper discussion about how this proposal might affect your business, please contact:

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