Fair Value Accounting and the 2007/2008 Financial Crisis

Name

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Abstract

Many factors have been quoted with regard to the recent disastrous global financial crisis that stemmed from the US and trickled down to the global economy in 2007 and 2008. Some of the major causative agents that have been linked to the crisis include sub-prime mortgages, credit default swaps and excessive debt, among others. However, some new insights have been added to the growing accounting debate. Opponents of fair value accounting have pointed to a strong link between mark-to-market accounting and the recent financial crisis arguing that the approach does not reflect the true picture of companies' financial position on the financial statements. Proponents of fair value accounting, on the other hand, maintain that the approach did not in any way accelerate the financial crisis but it rather communicated the ramifications of making bad decisions such as issuing subprime loans as well as writing down credit default swaps. They further argue that maintaining assets in the accounting books at their original value is uttermost ignorance of reality. This paper dissects through the two divergent perspectives with a clear analysis of fair value measurement in some selected companies listed on the Australian Securities Exchange (ASX).

Introduction

Many factors have been quoted with regard to the recent disastrous global financial crisis that stemmed from the US and trickled down to the global economy in 2007 and 2008. According to Herring (2008), some of the major causative agents that have been linked to the crisis include sub-prime mortgages, credit default swaps and excessive debt, among others. However, some people like Forbes Media chairman, Steve Forbes appear to have a different school of thought. In his view, Forbes maintains that mark-to-market accounting was the major reason that accelerated the meltdown of the US financial system in 2008. His position on the crisis has spurred intense academic debates with regard to the connection between the crisis and accounting rules. According to Lehner (2012), mark-to-market accounting entails revaluing assets quarterly based on the price they would fetch in the market without regarding their initial price. It is also known as fair value accounting and it overrules outdated or abstract valuations. When credit markets were seized up abruptly at the turn of 2008, many bankers overlooked fair value accounting. This consequently declined the clearing prices for major assets held by financial institutions to unprecedented levels. This paper explores the diverse views regarding the relationship between fair value accounting and the recent financial crisis.

The link between fair value accounting and the recent financial crisis

The connection between the recent financial crisis and fair value accounting has taken center in most accounting debates of our time with some positing that fair value accounting had a lot to do with the crisis and others negating any correlation between the two on the other end. As reported by the *Texas Magazine,* Pozen (2009) indicates that proponents of fair value accounting did not in any way accelerate the financial crisis but it rather communicated the ramifications of making bad decisions such as issuing subprime loans as well as writing down credit default

swaps. As such, maintaining the loans in the accounting books at their original value is uttermost ignorance of reality. Moreover, stakeholders such as shareholders have gone a step further and strongly asserted that fair vale accounting is overwhelmingly relevant in today's business environment (Zack, 2009).

In fact, according to the guidelines provided by the Financial Accounting Standards Board (FASB), it is very important to disclose fair value information to capital providers as well as other users of financial information particularly in periods of market fluctuations characterized by liquidity crunches. Based on this argument, Davies (2010) maintains that if financial institutions didn't base the value of their bonds on market prices, there would be a lot of uncertainty amongst investors with regard to asset values and hence they would exhibit reluctance in recapitalizing financially distressed institutions.

However, according to Pozen (2009), the mark-to-marketing accounting framework has thrown a major problem from the frying pan to the fire. Most financial products such as mortgages, corporate bonds as well as structured debts are still doing well but given that the market is frozen, the prices of these assets have dropped below their intrinsic value. Firstly, proponents of fair value accounting argue that negligible correlation exists between historical cost accounting and current market value for assets on the balance sheet. The historical cost accounting framework requires that assets be treated at their original value with minor adjustments for depreciation or appreciation. This therefore implies that an asset like a building would appear on the balance sheet at a much lower value than it would actually fetch given the prevailing market prices. However, fair market values are considered when preparing financial statements even under historical accounting guidelines (Duska, Duska & Ragatz, 2011).

According to regulations in the US, all publicly quoted companies are required to undertake a comprehensive scrutiny of their assets quarterly and indicate whether they have been permanently impaired or not. In the event that the impairment is permanent, the company's books must reflect the assets at their current market value and report the associated loss on its income statement. Under historical cost accounting, permanent asset impairment occurs quite often. In 2008, for instance, as Pozen (2009) reports, commercial banks in the US wrote down over $25 billion in goodwill from acquisitions whose value was not anywhere near their purchase price. Outside the banking industry, Cimarex Energy reported a loss during the first quarter of 2009 even though its books showed an operating profit which was attributable to a noncash impairment charge amounting to over $500 million (exclusive of taxes) against its oil and gas properties.

This clearly proves that even under historical accounting banks are ultimately compelled to report any permanent decline in the market value of their loans and securities even though more slowly but in larger sums as compared to fair value accounting. In most cases, bankers reject such write-downs maintaining that the impairment of a certain loan or mortgage-backed debt is just temporary (Australian School of Business, 2011).

Secondly, proponents of fair value accounting argue that a majority of the assets held by financial institutions are marked to market. According to a survey done by the US Securities and Exchange Commission (SEC) during the latter part of 2008, merely 31% of bank assets were treated using this approach with the rest being treated based on historical cost accounting guidelines. This is because fair value accounting requires banks to group all loans and securities into at most three categories including: held assets, traded assets and available-for-sale assets. If a bank intends to hold loans or securities to maturity, they are reflected in the books based on

their historical cost. As such, Kallapur (2008) argues that most loans and bonds are held to maturity and they can only be written down on the occasion of permanent impairment.

On the contrary, all traded assets are marked to market on a quarterly basis and any decline on their market value consequently declines the company's equity as reflected on the balance sheet translating to a loss in the income statement (Graham & Carmichael, 2012). The treatment of the more complex available-for-sale assets entails reflecting unrealized gains or losses in a special account on the income statement referred to as "other comprehensive income" (OCI) which is accumulated over time on the company's balance sheet. Due to this special treatment, unrealized losses don't decrease the bank's net income even if any decline is reported as a loss on the income statement.

Finally, fair value accounting requires that assets ought to be valued at the prevailing market prices regardless of the liquidity for their market – even if it is illiquid. Mark-to-market accounting would be relevant if all financial assets were Level 1 assets as per FASB's guidelines – highly liquid and simple to value at current market prices. However, since financial assets may not always bear these attributes, the FASB created specifications that factor in other two levels to offset such divergences. According to the FASB, financial assets should be valued based on Level 1 standards which entail valuing them according to observable market prices. In the event that market prices are unavailable, banks can use the Level 2 method which encompasses asset valuation based on available market inputs. The third level is used when market inputs are unavailable (Caprio, 2013).

By classifying trading assets into Level 3 due to their illiquid nature, banks are in a position to value them based on the "marking to model" approach rather than the marking to market approach. According to Wenke (2009), the marking to model criteria allows banks to

deploy their individual assumptions in assessing the market value of assets. When the fall of 2008 was characterized by frozen debt markets, the FASB clarified the use of fair value accounting framework to illiquid markets emphasizing that companies could regroup trading assets from Level 2 to Level 3 as illiquidity in the market increased. However, this intervention did nothing to comfort banks as the market value for their assets plunged. As a result, the FASB recommended new guidelines in 2009 highlighting the circumstances that could warrant mark-to-model valuation in illiquid markets.

Application of fair value measurement to selected companies in the ASX

Admiralty Resources Limited

According to its 2010-2011 financial reports, the company adopted the historical cost accounting approach in the preparation of its financial statements. However, in some cases such as the revaluation of available-for-sale financial assets, investment properties, derivative financial instruments, certain categories of property plant and equipment and financial assets and liabilities at fair value through profit or loss, a different approach was used. The reports have clearly stated that various assumptions were made regarding the treatment of its various assets and liabilities. With regard to asset impairment, the company reviews the carrying amounts of its tangible and intangible assets at each reporting date to ascertain whether there are any signs indicating impairment loss suffered by the assets. If there is an indication pointing to a loss, the asset's recoverable amount is estimated in order to establish the degree of the loss.

Moreover, the company classifies its financial assets valued at prevailing market prices based on the three above mentioned levels. An asset is categorized entirely depending on the minimum level of valuation inputs that is significant to fair value. In this regard, considerable judgment is required to establish what amounts to significance to fair value and hence the

category in which the financial asset is grouped can be subjective. Additionally, valuation models such as discounted cash flow analysis and adjusted observable inputs are used to estimate the market value of financial assets placed in Level 3 (Admiralty Resources Limited, 2011).

Aurora Funds Limited

The company's application of fair value measurement has aspects that are similar to those of Admiralty Resources Ltd. According to Aurora's 2010-2011 financial reports, the historical cost accounting framework was used to prepare the financial statements. In addition, critical accounting estimates involving a high degree of complexity and judgment were made. With regard to asset impairment, intangible assets such as goodwill whose useful life is indefinite are not subjected to amortization and are tested for impairment every financial year. Other assets are tested for impairment in the event that indications point to an inability to recover the carrying amount. For the purposes of determining impairment, assets are classified at the lowest levels which have separately distinguishable cash inflows which are entirely not influenced by cash inflows from other assets. The company's financial assets at fair value through profit or loss are those held for trading.

Available-for-sale assets which mainly comprise marketable equity securities are regarded as non-derivatives that are either classified in this category or not designated in any of the other asset categories. They are subsequently quoted at fair values with gains or losses emanating from adjustments in the fair value of assets being reflected in profit or loss within other income or other expenses in their relevant period. In the case of a financial asset not at fair value through profit or loss, the company values it at its market value in addition to transaction costs directly related to the purchase of the asset during initial recognition (Aurora Funds Limited, 2011).

The future of fair value accounting in financial reporting

In as much as a thin line lies between historical cost accounting and fair value accounting, the difference between the two approaches may have considerable impacts with regard to a particular bank on a particular reporting date (Ciulla, 2012). Since the evidence linking fair value accounting to the recent financial crisis appears substantial, commercial banks ought to undertake the following measures in future as far as financial reporting is concerned:

Enhance the validity of the “marking to model” approach

Bearing in mind the recent recommendations by the FASB regarding the treatment of Level 3 assets, it is undoubtedly clear that financial institutions have overwhelmingly been valuing illiquid assets based on the marking-to-model approach (Rezaee & Riley, 2010). For instance, Level 3 assets held by the 19 largest banks in the US rose by 14.3% in the first quarter of 2009 as compared to the immediate previous quarter. Allowing banks to make realistic assumptions according to their own estimations of rates of return on mortgage-backed securities, subprime loans as well as other troubled assets will ensure that financial institutions’ financial records reflect a relatively accurate picture of their financial position. Most importantly, financial institutions should adequately disclose the details of the assumptions underlying their models to enable investors arrive at informed valuations.

Disconnect accounting from capital requirements

Benjamin, Niskkalan & Marathamuthu (2012) maintain that the major weakness of fair value accounting is that it accelerates insolvency by eroding the capital base of banks. Most bankers believe that fair value accounting compelled an artificial devaluation of assets that have rebounded after the deceleration of the financial crisis. On the other hand, it is very impractical from an investor’s point of view to claim that an asset is worth a value it cannot command in the

market. Typically, investors are less certain that declines in the market prices of bank assets are occasioned by temporary illiquidity rather than permanent increase in defaults. Reconciling these divergent perspectives may not be necessary since both could be appropriate if financial institutions were compelled to reveal the outcomes under mark-to-market accounting rather reduce minimize their regulatory capital by the fully disclosed amounts. As mentioned above, if a bank holds the available-for-sale asset category, it must mark them to market quarterly. However, according to Badertscher, Burks & Easton (2010), unrealized gains or losses on such assets have no impact on the regulatory capital of the bank.

Conclusion and recommendation

The academic and policy debate regarding the link between fair value accounting and the recent financial crisis has yielded diverse perspectives, with some pointing to a link between the two and others negating the existence of any correlation between the two. Generally, proponents of fair value accounting argue that mark-to-market accounting did not in any way accelerate the financial crisis, but it rather communicated the ramifications of making bad decisions such as issuing subprime loans as well as writing down credit default swaps. On the other end, opponents of fair value accounting maintain that no link exists between two since fair market values are considered when preparing financial statements even under historical accounting guidelines. As such, they recommend that banks should adopt a more realistic approach that includes valuing assets based on their own assumptions and judgments.

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