

# [Mark to market accounting](https://assignbuster.com/mark-to-market-accounting/)

[](https://assignbuster.com/)[Finance](https://assignbuster.com/essay-subjects/finance/), [Market](https://assignbuster.com/essay-subjects/finance/market/)

In this paper I review the history of fair value accounting and the ethics behind whether fair value accounting gives an accurate picture or is it causing a need for higher capital requirements and necessary concern with investors. There Is a need for transparency. It is Accounting Standards and Ethics that helped restore the Investors trust after the corporate scandals, now with financial Institutions wanting to suspend the mark-to- market accounting It would further decrease the trust Investors have.

Mark-to-Market Accounting and Ethical Issues Accounting standards and ethics are directly related, we see this when we look at the issue of mark-to-market accounting. Is it ethical to not truly disclose the true value of assets, or the paper that is being held? Should financial institutions be able to suspend the FAST 157 (accounting for fair values) due to their lack of not wanting to disclose their losses or have a need for further capital requirements? Is fair value accounting causing the concern and the problem for the current financial crisis?

Are there further ethical Issues that are of concern when companies do not want to disclose potential losses that they are holding on their books? Background of Mark-to-Market / Fair Value Accounting Accountants and regulators have always discussed whether the changes in market value assets should be incorporated into accounting reports or not. This is contentious in that accounting reports are used in the regulatory process: The numbers reported have direct implications for the supervision and regulation of the firm.

This could be in terms of capital requirements or even contributions to pension plans. Companies even have concerns on whether or not accounting rules will affect the volatility of earnings. When we look to understand what we are talking about in historical cost accounting and fair value accounting, we have to realize that accounting for assets at fair value and accounting for them at book are the exact opposite. When we refer to fair value accounting It shows the changes to the balance sheet and measures how the changes effect the firm based on the changes In fair value.

Historic cost accounting on the other hand relies on cash flow to measure changes in the financial condition of a company. Fair value accounting puts more sheet and focuses on net income. Fair value accounting provides a measure of changes in resources available to shareholders. Both assets and liabilities reflect future cash flows and the profits and losses generated by the asset revaluations are recognized at one time. When firms are operating a loss under the historic cost accounting but a profit under fair value it was possible to borrow equity to fund current operations through expected gains.

Complaints against fair value accounting are:

1 . Many feel that asset valuations under fair value accounting are easily manipulated. This is partially true, however it is also possible to manipulate earnings with accrual accounting.

2. Some argue that earnings are volatile under fair value accounting. A firm does have the ability to make footnotes in the financial statements if they feel the earnings are volatile. The main point though is if asset values are changing that rapidly then it is likely to be information that is of interest to owners and stakeholders of the firm.

3. In the SEC study (SEC, 2008) it is mentioned that there is concern that fair value is inconsistent between the fair value accounting model and the typical company's business model. This objections implies that a company may be cash poor with valuable assets, this ignores the fact that a company can use temporary financing to fund current operations with future cash flows.

4. Valuations may be flawed or imperfect. This is an understandable objection, because some assets are more easily valued than others. That does not mean though that fair value method should not be used when the alternative method is Just as flawed.

When we look at a benefit of the fair value accounting method we see that a firm will behave differently, and will take this method into consideration when they are purchasing this asset. The decisions tend to be less risky if they know that they will have to devalue the asset in the future. Bad decisions would be something that they would have to identify publicly with future marking to market. Companies would no longer have amotivationto sell assets for the benefit of recognizing an accounting gain. Historically a major financial event or crisis prompts reconsideration of accounting rules governing reported asset valuations.

The credit crisis in 2008 generated reconsideration. In the sass's the savings and loan crisis prompted accounting rules move away from historical cost accounting. Had there been a fair value accounting system in place in the sass's the savings and loan crisis would have not taken years to realize. The banks had made long term mortgage loans and borrowed short term. When the interest rates increase they suffered economic losses, yet they were using the historical cost accounting which resulted in a delay in the realization of this crisis. In 1993 SEAS 115 created an accounting structure for debt and equity securities that is still used today.

SEAS 115 states " Debt securities that the enterprise has the positive intent and ability to hold to maturity are classified as held to maturity securities and reported at amortized cost. Debt and equity securities that are bought and held to principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, tit unrealized gains and losses included in earnings. Debt and equity securities not classified as either held-to-maturity securities or trading securities are classified as available-for-sale securities and reported at fair value, with unrealized gains and shareholder's equity. (SEC, 2008) Under the SEAS 115, debt securities that are seen as a permanent loss are required to be marked to market with the loss showing on the income statement. The SEAS 157 defined fair value as the " price that would be received to sell an asset or paid to transfer the liability in an orderly transaction teens market participants at the measurement date. " (SFA, 2006) SEAS 1 59 (2009) expanded the range of assets that fair value treatment could be used on. This meant fair value could be used on available-for-sale assets, and gains or losses on those assets would flow to the income statement.

It permitted firms to market their own liabilities to market. The Significance of Mark-to-Market Accounting Why is mark-to-market accounting even an issue: This has come about as many banks, brokers and mutual funds became inter-related investing in financial products. These products were difficult to determine true values. At times these assets were thinly traded, meaning it was an asset that could not be easily sold, traded, or exchanged for cash without impacting the price substantially. This is why the mark-to-market rule started becoming an issue.

Financial institutions were not selling tangible items that could be easily bought and sold and a true valuation could be determined. Prior to the economic crisis, this was not an issue as there was never a reliance on these products and how to accurately determine an actual price. Previously financial institutions were in the business of trading traditional products such as Equities, Fixed Income, Currency or Commodities. It was not until the financial institutions started trading paper in a whole new market, that the ability to properly value these assets became an issue.

The reason this was an issue was because the paper being traded in essence was garbage paper that had little value. " Accounting is a way of portioning economic results by time periods. It doesn't affect the cash flows, but tries to allocate economic profits proportional to release from risk. If we were back in the era where the financial instruments were simple, then the old rules would work. But once you introduce derivatives, and securities that are called bonds, but are more akin to equity interest, you need to mark them to market. (Marker, 2008) If these assets are not marked to market, than you are left with a company who made capital allocations as well as investment decisions that was kept undisclosed from their owners (the shareholder) as well as investors. In the case of the financial institutions, they had garbage on their books in the form of bad mortgage loans and bad investment decisions that nobody wanted to admit to the original error of investing in such assets. The key players in the financial sector knew the situation existed and needed to admit that their business model and decisions were flawed.

By admitting this, it would affect their investors, and change their capital requirements. Financial institutions created a false appearance of having more attractive returns. The higher risk and creating a risky potentially higher return paper was part of this process that was very misleading. Financial institutions suspended the FAST 157 amounts as an attempt to hide the truly flawed business model from investors, regulators and even the public. This resulted in an inability to guru out what the liabilities were relative to the assets.

If FAST 157 is suspended it invest blindly. Their decisions would not be based on disclosure of and institutions holdings, but purely on speculation not knowing what their assets were backed by if anything. Institutions currently have other methods to deal with their thinly traded paper that is hard to truly value. They could sell the paper at market price, whatever price that is that someone is willing to pay for it. They can write down the values to zero and then later if they are able to recover any value they can show a mark up in true quarters. Related article:

" you don't listen to me because you are always talking on the phone with her."

Suspending the mark to market accounting of this paper is not the most ethical solution to this problem. Suspending the true value of the loss is an unacceptable solution to the current economic crisis. Japan learned this in their economic crisis that not taking the write down only delays the process. When they chose to not disclose the true scenario of their insolvent banks it prolonged their recession that ended up lasting a decade. " Suspending mark-to-market accounting, in essence, suspends reality. " -Beth Brooke, global vice chair, at Ernst & Young

Financial institutions continued to apply pressure to lift the current mark to market pricing ever since the crisis began, " Banks began lobbying Congress to do away with mark-to-market, arguing that they couldn't lend because it had bled away so much capital. Congress in turn put the heat on the Financial Accounting Standards Board, a group of five ; beer-accountants based in Connecticut who write all the rules. After months of pressure, including threats to take away its authority, the FAST caved and voted to loosen the rule" (Phillips, 2009) >" As the debate intensified in late

September of 2008, SEC Staff and the FAST staff issued a Joint press release clarifying the application of SEAS No. 157. 4 This Joint release clarified the measurement of fair value when an active market for a security does not exist. On October 10, 2008, the FAST issued FAST Staff Position (" FSP') 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active (" FSP FAST 157-3"), which further clarified the application of fair value measurements. (United States Securities and Exchange Commission, 2008) This change allow financial institutions to use their significant Judgment" in order to value their assets. With this change is the concern of many that this will allow banks to disguise their garbage paper, which is what led to the financial crisis in the first place. On April 2, 2009, FAST voted to revise SEAS 157 this changed the fair value calculations when a market is inactive. This rule was to " Affirm that the objective of fair value when the market for an asset is not active is the price that would be received to sell the asset in an orderly transaction. That is, not a forced liquidation or distressed sale) between market participants at he measurement date under current market conditions. The Board also said that it would " require an entity to disclose a change in valuation technique and the related inputs resulting from the application of the FSP and to quantify its effects. "(FAST - Staff Position) What this was saying is that if the market was deemed inactive, the banks would have the authority to use their own Judgment to determine if an asset has suffered a decline in fair value.

This could in return cause regulatory capital and asset values to be artificially elevated, which is what got the banks into the problem n the first place. " It'll help big banks like Cit recoup billions in losses. But it does little to solve the underlying problem: piles of troubled assets no one wants. (Phillips, 2009) " The SEC determined that the suspension of fair value, returning to historical cost measurements, would adversely impact debt and equity security valuation. Withholding current (fair) value information would introduce greater uncertainty, information asymmetry among market participants, and further lessen market liquidity.

In our currently depressed markets, suspending fair value would result in moving useful information from investors at a time of great uncertainty and risk, when it is needed most. Also, suspending fair value rules would not relieve companies from recognizing impairment losses" (Seas, Ford, 2009) When we think about ethics, we believe that ethics should provide the ultimate guidance to accounting professionals. " The ethical standard is fairness (honesty, freedom from bias). Fair value accounting requirements have existed for a number of years.

Only recently, when market values necessitate write-downs have preparers questioned the relevance of these measurements. When bull markets existed, no one objected to fair value rules. As suggested by the SEC study findings, fair value accounting has increased the quality and relevance of financial reporting for investors. Investors have indicated that fair value provides more relevant information, reflecting current economic reality that should not be replaced by other alternative accounting measures, such as historical cost. (Seas, Ford, 2009) An investor's confidence is gained by having transparency when it comes to the asset value of their investments. If we took that transparency away there would be greater concern and uncertainty eating to instability in the financial markets. " Accounting firms argue that such a change would deceive investors about troubled loan values and the value of mortgage-backed assets. Ultimately, the point of fair value accounting is to provide accurate information to investors--companies should account for their assets at their real values. Goldman Cash Group Inc.

CEO, Lloyd Blanking, upheld mark-to-market accounting and argued that it should be even more rigorous. Goldman, which has largely avoided the current financial crisis, cites adherence to fair value accounting ales as " a key contributor to our decision to reduce risk relatively early. " He states that if financial institutions had properly valued their positions/commitments at the outset, they could have substantially reduced their risk exposure. " (Seas, Ford, 2009) The ethical issue is will the suspension of fair value accounting, only mask the real problem?

Avoiding asset write-downs and losses may help out in the short term, but like Japan is this going to continue to prolong the economic crisis that we are facing. Avoiding the write down is a temporary fix that will meet the regulatory capital acquirement and allows the banks to report earnings but could result in further unwanted surprises down the road. " Financial institutions had no problem in using mark-to-market to benefit from the drop in prices of their own notes and bonds, since the rule also applies to liabilities. And when the value of the securities loans they held was soaring, they eagerly embraced mark-to-market.

Once committed to that accounting discipline, though they were obligated to continue doing so for the duration of their holding of securities they've marked-to-market. The question here s: are firms equally as willing to forego mark-to-market for valuing the same illiquid securities in client accounts for margin loans as they are for their proprietary trading greed will always exist. This is where other regulatory agencies will come into play. " The PEPCO has recently issued audit alerts addressing risks associated with fair value measurements. Disappointingly, the most recent guidance from the FAST leaves gab in reporting Level 3 fair values.