

Initial Thoughts: Overview of the FASB “Mark-to-Market” Announcement

The announcement last Thursday (April 2, 2009), which is the Financial Accounting Standards Board (FASB) staff’s recommendation to the FASB Board, boils down to two important points:

- » In certain situations, companies will now have more discretion in determining “fair value”; and
- » In certain situations, they will be allowed to record write-downs on their balance sheets with less of a hit to earnings.

The announcement **does not**, however, discard the objective of fair value accounting, nor does it allow application of the new guidelines retroactively to year-end 2008 financial statements.

This suggests that while write-downs taken so far will not be quickly reversed, the pace of further write-downs (and the consequent hits to capital) will likely slow, and their drag on earnings should be mitigated. Arguments as to whether the new guidelines will better reflect economic reality will undoubtedly continue. Bulls will likely continue to believe that certain items on banks’ balance sheets are worth more than their carrying value, and bears that the items are worth less – but in either case, in our opinion, the optics for future financial statements will be improved.

As mentioned above, fair value accounting isn’t going away:

“The staff recommends that the board emphasize that . . . even when there has been a significant decrease in market activity for the asset, the fair value objective remains the same. Fair value 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 the measurement date in the current inactive market.” *

Instead, the staff was attempting to clarify confusion over whether the goal should be, in their words, the determination of:

- a. Fair value in the current inactive market;
- b. A hypothetical fair value in an active market (that is, a “normally active and functioning market”); or
- c. The midpoint between (a) and (b).

The staff’s answer is that:

“Determining fair value in a market where there has been a significant decrease in volume and level of activity for the asset at the measurement date is inherently complex, depends on the facts and circumstances and involves significant professional judgment.”

Avoiding Unlimited Subjectivity in Asset Valuation

For those either hoping for, or fearful of, completely subjective discretion for management to value assets, the staff shuts down what they fear could be a slippery slope away from any use of market data. Specifically, the staff feared the following line of argument:

- » Apply FASB’s recommendations on factors that could indicate that a market is not active;
- » Add the assumption that all transactions occurring in such a market are “not orderly” or “distressed”; and
- » Conclude, therefore, that such transactions can be disregarded in the valuation process.

Instead, the staff would put the burden on entities

* Quotes and excerpts are from (Financial Accounting Standards Board, Board Meeting Handout, April 2, 2009)

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to weigh the evidence (using a list of possible circumstances the staff identifies) in order to determine whether the transaction was “not orderly”. Where that burden is met, however, the guidance is emphatic:

“Quoted prices that are not representative of an orderly transaction are not determinative of fair value nor are they determinative of market participant risk premiums.”

In our opinion, this is the crux of what opponents of mark-to-market were seeking.

Along with this approval of increased subjectivity, look for additional disclosure requirements to be included in the final version. The staff reports that nearly all those who contributed comments on the Exposure Draft were in agreement that the current level of valuation methodology disclosure is insufficient.

No Retroactive Valuation

The ability of entities to apply these judgements retroactively would be eliminated if the recommendations are adopted, since the proposal is for the changes to be effective:

“. . . for periods ending after June 15, 2009 with early application for periods ending after March 15, 2009. **Retrospective application would not be permitted**” [emphasis added].

Thus, broadly speaking, the first portion of the proposed guidelines pertains to allowing entities more latitude for imparting “professional judgment” into the valuation process – presumably in order to avoid the need to record write-downs which are not economically justified, but are triggered by price action in a dysfunctional market environment. The second portion, in contrast, addresses the specific ways in which write-downs that are, in fact, justified impact the entity’s financial statements. Specifically,

the proposed changes weaken the rules requiring such negative impacts to be reflected in earnings.

Financial Accounting Standard 115 Valuations

Since Financial Accounting Standard (FAS) 115** was issued in 1993, the accounting impact of fluctuations in the market value of a security has differed according to which of three categories an entity has assigned it:

- » **Trading** - Changes in the market value of securities in the trading category flow through earnings by way of the income statement.
- » **Available-for-Sale** - Changes in the market value of securities in the available-for-sale category do not impact earnings, but instead appear as a change in shareholders’ equity through “other comprehensive income”.
- » **Held-to-Maturity** - Securities in the held-to-maturity category, in contrast to the other two categories, do not have to be marked-to-market.

This freedom from income statement and balance sheet volatility comes at a cost, however. The held-to-maturity category requires the entity to demonstrate that it has both the intent and ability to hold the security until maturity, and failure to do so can potentially require restatements affecting that entity’s entire held-to-maturity portfolio.

When a decline in the value of a security is the result of more than mere market fluctuations (what FASB refers to as an “other-than-temporary impairment”), however, FAS 115 requires the amount of the write-down to be included in earnings (even for available-for-sale and held-to-maturity securities). The proposal, however, significantly changes this.

First, it effectively blurs the distinction between

** FAS 115 did not apply to loans – so an MBS was subject to it; an individual (un-securitized) loan was not – a distinction which continues in the current proposals.

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available-for-sale and held-to-maturity categories by changing the hold-to-maturity requirement that an entity assert “that it has both the intent and ability to hold an impaired security until recovery” to having to assert:

“... that (a) it does not have the intent to sell the security and (b) it is more likely than not that it will not have to sell the security before recovery of its cost basis”.

If an entity intends to sell the security, the accounting treatment is unchanged – the write-down hits earnings. If, on the other hand, the entity can meet the lower “more likely than not” standard of intention to hold the security, then the entity would now be allowed to separate the total impact of the other-than-temporary impairment into a credit component (which is recognized in earnings) and the rest (which is recognized in “other comprehensive income”).

Moreover, the staff recommends that the board require credit losses:

“... to be based on an entity’s estimate of the decrease in expected cash flows.”

This is crucial. Why? Because much of the criticism of how fair value accounting and mark-to-market accounting have been applied has focused on situations where principal and interest continue to be paid (the securities continue to perform, in other words) but the “last-trade” nevertheless took place at a significant discount to par due to market turmoil. But under this guideline, no decrease in expected cash flows implies no “credit” component, and therefore no write-down impact on earnings.

The bottom line of this portion of the proposal is that while the severe drop in prices for many securities will still be reflected in an entity’s balance sheet, it will be in other comprehensive income – not in earnings. And even then, the guidance on determining when markets are not active, and which transactions are distressed should lessen the frequency of severe write-downs by reducing the “emphasis on the so-

called ‘last-transaction-price’ when markets are not active.”

Conclusion

In conclusion, while these proposed changes do not at first blush appear to alter the underlying economics, but instead merely improve the optics of the accounting, their intent, and likely consequence, extends much further. Here’s why: the ultimate value of many of the securities that will be impacted should these proposals be adopted by the FASB board is path dependent. In other words, it is not simply that a matter of time will tell whether these assets are money good. The risk aversion hysteria which has defined financial markets for much of the recent past will continue to impact the broader economy. A vicious circle has developed in which plunging prices of financial assets spill over into the broader economy, resulting in declines in output and employment, which lead to increased loan delinquencies and defaults, which in turn feed continued risk aversion hysteria and drive financial asset prices down further.

In order for this process to reverse, at some point market participants will need to emerge who are willing to commit capital behind their belief that the sell-off in certain sectors of the market is overdone. For individual assets, there are good arguments that availability of financing is one necessary condition for this to happen (and the U.S. Treasury and Federal Reserve have introduced programs which seek to meet this need). However, in order for market participants to invest in the financial institutions themselves, two kinds of confidence are necessary, that:

- » Bank assets will in the end prove to be worth more than where they are currently valued; and
- » The financial institutions will remain solvent long enough for such value to be realized.

When all is said and done, the FASB staff proposal

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seems targeted at buying bullish investors additional time for their trade to work out and/or prolonging the day of reckoning bearish investors claim is inevitable. From this perspective at least, they seem likely to succeed.

-Eric Maisel, CFA

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