Fair value accounting and stressed markets

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Agenda

- The context
- Recent directives on fair value accounting
- Issues for the capital markets

Financial stability directives and stressed markets are challenging the aims of fair value accounting

"New accounting rule pushes Deutsche Bank into profit"

Fair value reclassification eases Deutsche Bank's profit & loss figures

Accountancy Age, 31 Oct 2008

- **Harmonisation of global accounting standards on financial instruments**
  - SFAS 133/ 138 (*2000*)
  - IAS 39 /AASB 139 (*2005*)
  - IFRS 7 / AASB 7 (2008)
- **Measurement relies on classification**
- **Accounting fair value guidance:**
  - Active market:
    - quoted price/ inputs
  - No 'active' market:
    - valuation technique (or mark-to-model)
    - management's internal assumptions
- **Under fire in 2008..a case of shooting the messenger or exposing limitations?**

What constitutes ‘fair value’ under AASB 139?

- **Measurement objective:**

  “to arrive at the price at which an orderly transaction would take place between market participants at the measurement date”

- **Valuation approach must:**
  - **take account of orderly (active) markets; and**
  - **address adjustments for credit and liquidity risks**

- **Standard developed in an era of sustained growth in securities markets**

- **Changed market conditions**
  - **use of model inputs sourced from stressed markets**
  - **how to deal with complex and ‘opaque’ financial products**
    - **structured credit / asset backed securities**
    - **mark-to-market or model?**

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IASB's response to date

- IASB Expert Advisory Panel report "*Measuring and disclosing the fair value of financial instruments in markets that are no longer active*"
  - Released Oct 2008
  - Does not recommend new requirements
  - IASB Staff Summary: Still a matter of judgement!
- Observations:
  - More effort involved in the valuation process
  - Intuitive factors to consider:
    - No or minimal volumes with non-systematic prices
    - Absence of 2-way quotes
    - Impact of forced sale transactions on observed prices
  - Mark-to-model not the same as Enron's 'hypothetical future value'!
    - Must calibrated parameters to observable market data

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‘Public interest’ dominates recent directives
- Lifting the veil or throwing a TARP over the problem?

- **SEC**
  - **US Emergency Economic Stabilization Act of 2008**
    - Section 132 Authority to suspend mark-to-market accounting (SFAS 157)
    - Section 133 Study on mark-to-market accounting affecting financial institutions
- **European Commission**
  - **Actively lobbying for amendments**
  - **In Oct 2008, IAS 39 / AASB 139 amended**
    - Certain non derivative securities can be reclassified from MtM classifications to ‘Held to Maturity’
    - Consistent with SFAS 115 with one important difference
    - Look-back option: Retrospectively reclassify at 1 July 2008 (if elected before 1 Nov 2008)
- **G20 Summit on Financial Markets and the World Economy**
  - **Immediate Actions by 31 March 2009 included:**

> **“ The key global accounting standard bodies should work to enhance guidance for valuation of securities, also taking into account the valuation of complex, illiquid products, especially during times of stress”**
>
> *Press Release – 15 November 2008*

Issues for the capital markets

- **Valuations in 2008 are erratic but are they misleading?**

  “ ***Accounting is not the cause of the credit crisis, but it is important that market participants should have confidence in the information presented within financial statements***”

  Sir David Tweedie, Chairman of IASB (2008)

  - **Arguably, volatility in financial statements reflect changes in risk appetite, risk pricing and scarcity of capital**
  - **Suspending fair value accounting does not change the economics**
    - **Potential to prolong investor uncertainty**

- **Disclosure is important but not a substitute**
  - **IFRS 7 / AASB 7 prescribe reasonable disclosures**
  - **Issue has always been quality and extent of disclosure**
    - **ED released in Oct 2008 to align AASB 7 with SFAS 157**
  - **Targets mark-to-model use**


Where to from here?
Watch this space...

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