Sentimental Accounting: Is it time to question mark to market?

Vinod Kothari

Just as we take a very basic look at our life style when we fall sick, a crisis is the best time to question some very basic rules that we work under. The subprime crisis has put questions before lots of institutions and instruments – securitization, rating agencies, mortgage origination process, etc. Questions also need to be raised to something that became a part of the world of complex accounting rules - fair value accounting, or what in popular parlance is called mark-to-market (MTM) accounting.

The MTM rule is not an age-old accounting convention; rather, it is an exception to the age-old accounting rule called historical cost convention. Several bankruptcies in 1995-1998 period – collapse of Barings Bank in 1995 upto to the big-time failure of Long Term Capital Management drew consensus of accounting standard setters that historical cost is not the most relevant information for users of financial statements as they would be interested to know the current value of the assets of the entity. Lots of discussions went on both sides of the Atlantic, and finally rules were created for fair value accounting by both International Accounting Standards Board (IASB, formerly IASC), and the Financial Accounting Standards Board (FASB). In essence, these rules require mark to market accounting for most financial assets, including derivatives. The FASB's rules are contained in several accounting standards, of which FAS 115 and FAS 133 are the major ones. IASB's rules are contained in IAS 39.

The essence of these rules is that for most financial assets that an entity holds, except loans originated by it and assets that it surely intends to hold to maturity, the assets are fair valued or marked-to-market. Gains or losses on valuation are taken either to current earnings or, in some cases, to shareholders' equity directly.

There is a plethora of assets for which market values are not explicitly observable, simply because there is no market. For example, if I bought (not originated) a leveraged loan, or I hold a privately issued bond, there is nothing like market value. Where market values are not available, the accountants get into valuations as per models, which may be either completely subjective, or based on some objective quasi criteria. It is for this reason that the recent FASB standard FAS 157 requires fair value estimates to be classed into 3 levels, to depict the level of subjectivity in the valuation.

As the market values reflect current market sentiment, when the sentiment is high, we report a gain on books. When the sentiment is low, we report a loss.

Currently, fair valuation is applicable to several financial instruments – apart from all derivatives, sellable financial assets and trading assets, fair value rule is used for measuring securitization gains/losses, exposures on guarantees, etc. In short, fair valuations have become a pervasive part of the accountants' world.

Fair value rule has been implemented in phases, and it is nearly 8-10 years that fair valuation has been going on. Not that it is a settled rule – there have been voluminous interpretations, revisions and new standards to amplify, clarify or curtail the scope of earlier standards.

Questions have been raised in the wake of the subprime crisis on impact of the MTM rule. It must be clear that since the MTM rule was implemented, the world has not faced a colossal financial crisis of the magnitude of the current one. Hence, it is practically for the first time that the role of the MTM rule during a crisis situation has come to question. It has its benefits – in making the financial statements provide more relevant information. But the question quite often is – do the benefits outweigh the costs?

There are at least two huge costs of the MTM approach to which it is time to pay attention: (a) it is arguably pro cyclical and takes the market away from equilibrium, if the market is not in equilibrium already; (b) it leads to highly volatile accounting, such that almost every estimate of fair value is liable to be questioned by someone sitting in judgement.

First, on the pro-cyclicality. A business cycle arises when there are forces that move the market further away from equilibrium, when the market is already away from equilibrium. There are short-term self-cancelling spikes in markets but the central tendency of all markets is convergence. When losses exacerbate losses, or gains propel gains, the result is a business cycle. In normal circumstances, the beauty of the marketplace is that people hold different, and mutually opposite views on a certain thing. That is why they trade, and do so happily. In the MTM scenario, since every player in the market is an MTM player, everyone has losses to report on the P&L the moment the market takes an adverse turn and there is a broad-based fall in prices of financial assets. Though the loss is still a notional loss, the equity gets eroded. Equity is the basic premise on which all leverage is built in the world of finance – be it hedge funds, or CDOs or the banks. A dollar of equity being eroded might mean anywhere between 10 to 25 dollar of reduction of asset-holding capacity of the MTM player. This would mean, if the player was fully leveraged, it would have to shed assets or curtail exposures several times the notional loss. In a scenario where the market is already bad, the leveraged reduction in asset-holding ability would mean there are lots of sellers as compared to buyers. Obvious enough, this pushes the market further lower. This would mean more MTM losses, and more erosion of equity… Very quickly, we have the downside of the business cycle.

Imagine a scenario where we did not have the MTM rule. Since we are not reporting notional losses on the books, trades will be executed based on the different expectations that players in the market have. There will be buyers, as there are sellers. In the MTM scenario, we did not have buyers, as all the players were reporting losses resulting into curtailment of their leverage.

Tobias Adrian and Hyun Song Shin have argued that in market-driven financial system, price changes quickly lead to a contagion impact because of mark to market practices.

"However, in a modern market-based financial system, the channel of contagion is through price changes and the measured risks and marked-to-market capital of financial institutions. When balance sheets are marked to market, asset price changes show up immediately on balance sheets and elicit response from financial market participants". [Liquidity and Financial Contagion, at http://www.banque-france.fr/gb/publications/telechar/rsf/2008/etud1_0208.pdf] Recently, Paul Davies, writing for the **Financial Times** 29th Feb 2008 also drew attention to the impact of MTM accounting on the financial world.

The second major impact of MTM accounting is on the accountants. The moment there are estimates in accounting statements which are not statements of fact but reflections of opinion, almost every single opinion can be proved to be biased or wrong. This is exactly what is happening in every major bankruptcy or accounting investigation. Accounting issues were central to the bankruptcy of Enron and WorldCom both. In the wake of the subprime crisis, a major subprime originator New Century was among the first ones to file for bankruptcy. A 500 plus page examination report into bankruptcy of New Century spares more than 200 pages on accounting estimates. Securitization accounting has to do, among other things, on valuation of residual interests, which is to be present-valued at a risk-adjusted discounting rate. The choice of the discounting rate is always a matter of contention. In the recent crisis, most originators have revised upwards, sometimes to more than twice, their discounting rates for valuation of residuals. In case of New Century also, the examiner notes that the discounting rates should have been higher than what they were.

But then, that is a question of opinion, and every opinion can be questioned. The result is a lurking fear in the mind of every accountant while evaluating financial instruments which do not have explicit market values. Under apprehension, accountants tend to be unduly conservative, which leads to a valuation which is worse than the historical cost accounting approach.

The key question that we grapple with is: in the first place, we thought of MTM accounting to give to users a value which is more relevant. Here we have a case where there are values on which experts differ, and differ widely. They have differed every time the auditor changed, or the controller changed, or the model was replaced, or the entity went under some accounting investigation. So, does this subjective value have any relevance that we were trying to achieve by switching over to MTM accounting in the first place? There are reasons to believe that values put in financial statements have become far less relevant than they were under the historical cost convention. Sometimes, old is simply gold.

The author is a chartered accountant, and consultant on securitization, structured finance and related matters. The author may be contacted at vinod@vinodkothari.com