To: Technical Director, FASB
From: Professor Graeme Dean, The University of Sydney and Honorary Professor Frank Clarke, The University of Sydney (and Emeritus Professor, The University of Newcastle).
Topic: 17 March 2009 Invitation to submit responses to *Proposed FSP FA 157-e,* 'Determining Whether a Market Is Not Active and a Transaction Is Not Distressed'
Submission Date: 27 March 2009

This submission responds to an invitation for comment on FASB *Proposed FSP FA 157-e,* 'Determining Whether a Market Is Not Active and a Transaction Is Not Distressed'.

And, in particular, we wish to comment on Point 2, namely:

> *Will this proposed FSP meet the project's objective to improve financial reporting by addressing fair value measurement application issues identified by constituents related to determining whether a market is not active and a transaction is not distressed? Do you believe the amendments to Statement 157 in this proposed FSP are necessary, or do you believe the current requirements in Statement 157 should be retained?*

Our submission draws on our considerable work on the mark-to-market method of asset valuation over a considerable time. As members of the *Sydney School* we advocate that assets be stated at their 'current selling price in the ordinary course of business.' Accordingly, attached to this brief introduction is the argument we included in two of our recent books Corporate *Collapse: Accounting, regulatory and ethical failure*, Frank Clarke; Graeme Dean, and Kyle Oliver, Cambridge University Press, 1997; 2nd Edn, 2003; and *Indecent Disclosure: Gilding the corporate lily*, Frank Clarke and Graeme Dean, Cambridge University Press, 2007 (see book review in *The Accounting Review*, November 2008). Further, in an earlier (2004) submission to the FASB regarding its ED for Statement FAS 157 (Comment Letter #73, September 2004), with another *Sydney School* member, John Staunton we provided detailed comments on fair value measurement generally. You may wish to access that as well and we have provided it as a 'pdf' attachment to this submission. That submission provides several references to articles on measurement by Sydney School members.

To place our views in perspective consider the following excerpts from a June 28, 2008 *Credit Suisse Report*, 'Focussing on Fair Value: Mark–to--market accounting':

> There are few topics in the world of accounting today that generate as much passion, or get people more fired up, than "fair value" or "mark-to-market" accounting. (It seems as if the complaints about fair value accounting have picked up as asset values have fallen down; funny that we don't remember the same uproar when asset values were moving higher.) In particular, FAS 157, Fair Value Measurements, has been blamed for everything from the credit crisis to global warming, from multibillion dollar write-downs and forced capital-raising to Chien-Ming Wang hurting his foot running the bases.
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> As a reminder, FAS 157 is the much-maligned rule that defines "fair value" for accounting purposes:
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> > *Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.*
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> That definition of fair value is not all that different from the various definitions of fair value previously sprinkled throughout the accounting rules. However, FAS 157 does make some subtle but important clarifications. Under the new definition, fair value is clearly an exit price (what you would receive for selling an asset), not an entry price (what you would pay to buy an asset); and fair value is market based, not company specific (i.e., a company can't ignore what the market is telling it when it prices an asset or liability). For other changes to fair value accounting see Appendix C [not included in this submission].
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> FAS 157, which went into effect in the first quarter (effective for fiscal years beginning after November 15, 2008), does not change which assets and liabilities companies report at fair value. However, FAS 157 does introduce the concept of the "fair value hierarchy"—which groups assets and liabilities into three "levels" based on how reliable their measurements are. Level 1 is the most reliable; it's a true mark-to-market, based on observable market prices in active, liquid markets. Level 2 is less reliable; it can be a mark-to-market (e.g., market prices for similar assets, or market prices in markets that are not active), or a mark-to- model where the inputs are observable (e.g., yield curves, volatilities, prepayment speeds, credit risks, default rates, etc.). Level 3 is the least reliable (which is why it tends to get the most attention); it's a mark-to-model, based on unobservable inputs involving lots of management judgment (e.g., forecasted cash flows estimated by the company). In Level 3, the company is making assumptions about market participant assumptions.

We concur with this analysis. To indicate why, we now outline some ideas from our work referenced above which canvass the general theme that accounting data must be *serviceable*, that is *fit for the uses ordinarily made of them.* That necessitates that the data in published financial statements must be indicative of companies' current and past financial progress, indicative of its financial position – the nature composition and money's worth of its assets and the nature and amount of the liabilities enforceable against it, and serviceable for deriving indicators of its financial performance, rate of return, solvency, debt to equity and similar gearing indicators, asset backing, whether it satisfies its debt covenants, and the like. That is a rather tight specification. Where no market exists for an item and it therefore doesn't have a

market price, where it is highly specialised in a thin market, then that needs to be communicated. It is essential information. For the owners of the particular item no market price simply means that the options regarding its use are limited – it may well be that it can be used to produce a revenue stream, it can be retired, allowed to sit idle, given away, but no market price means simply what it says – the item cannot be exchanged for cash, cannot generally be pledged as collateral for borrowing, cannot contribute directly to the fund to extinguish debts.

Our position is to draw and rely upon the facts as they are at the date of the financials. It is preferable to be aware of 'what is', to use that as the base for speculating and acting on that data as well as providing the base of what 'might be' in the future. Clearly, that does not preclude expectations that the future will be different, that the item currently unsaleable may then be saleable, or those currently saleable may then be saleable at a higher than the current price, or that any obligation of an entity is more or less based on current prices and price levels. Nor does it preclude communication of that expectation and perhaps the basis for it. Indeed, everybody trading in the equities market holds such expectations. Consistent with the recent plea by James Chanos in the *WSJ,* 'We Need Honest Accounting: Relax regulatory capital rules if need be, but don't let banks hide the truth' (March 23, 2009), financial statements need to be factual, even when the facts offer 'cold comfort', as they do in the present case in respect of the so-called 'toxic assets' held by financial institutions. Those assets are simply 'poorly performing' in the jargon of earlier days – they represent a bad investment. Determining the best estimate of the market prices of those toxic assets will be of critical importance in determining the consideration that those participating in the public/private consortia in the current Geithner stimulus plan will pay for assets and the amounts for which the banks will be prepared to sell toxic assets. Indeed, those who argued against marking-to-market will now be doing so. Being dated, it follows that those prices hold only for that date. They are like every other measurement taken under controlled conditions, *dated* as at that specific time. Positions thereafter must be deviations from them. That is why we date positions – financial positions, have dated balance sheets, specify the dates between which income has been earned or losses incurred. Without recognising the dates of measurements we cannot evaluate performance, assess progress or regress. Specifying dates is inherent in notions of *improvement* and *decline*, *increase* and *decrease*,

expansion and *contraction*, *grow* and *diminish*, etc. Expectations regarding such matters must *follow* the current position. That is what *expectation* entails, departure from the present is the inherent nature of every anticipatory calculation. Indeed, without knowledge of the present state-of-play, the present market position, predictions of the future market prices are without a market foundation. Resort to a model – *marking-to-model* - when a market is thin or no market exists is to replace market truth with make-believe.

We draw the Committee's attention to the fact that the estimation problems currently facing accountants and directors seeking to report fair values for assets and liabilities is a longstanding problem – well recognised by the so-called 'golden age' theorists, like the earlier market selling price advocates, Chambers and Sterling. As if predicting the current debate regarding marking-to-market where no market exists Chambers made the following observations in a 1975 unpublished contribution to a proposed festschrift for DePaul University's Ernest Weinwurm, a fellow accounting academic. It draws on ideas in Chambers' published works (1970, 'Second Thoughts on Continuously Contemporary Accounting', *Abacus*, Vol.6 No.1 pp.39-55; and his 1974 'Third Thoughts', *Abacus*, Vol. 10, No. 4, pp. 129-137):

> [convention] led me to suggest some "practicable alternatives" as approximations where no market price was available. But ..., they appeared to compromise the principle of uniformity of valuation [which underpinned Chambers' 'General Theory']. Critics were quick to point this out. By that time, however, I was so convinced of the value of mathematical and metrological rectitude that I was able to countenance even zero values for assets which had no market price in their then state and condition . . . [Unpublished paper, 'Measurement in accounting'. Unpublished festschrift article in honour of Ernest Weinwurm; located in RJ Chambers Collection – http//:chamberslibrary.econ.usyd.edu.au – The University of Sydney Archives Unit (USA P202) or from the authors]

His reasoning for this was (and we argue it still applies) is noted in our summary above. Essentially, 'Where no market exists for an item and it therefore doesn't have a market price, is highly specialised in a thin market, then that needs to be communicated. It is essential information. For the owners of the particular item no market price simply means that the options regarding its use are limited – it may well be that it can be used to produce a revenue stream, it can be retired, allowed to sit idle, given away, but no market price means simply what it says – the item cannot be exchanged for cash, cannot generally be pledged as collateral for borrowing, cannot

contribute directly to the fund to extinguish debts.' Again, this will be the line of thinking that underpins the sales and purchases under the latest Geithner stimulus plan.

Returning to the 28 June 2008 Credit Suisse Report, clearly our view is also shared by some practitioners as well:

> So would changing the current rules, maybe providing a time-out from fair value accounting, save the market from its sins? We don't think so. Just ask yourself a simple question: Which information is more relevant today, what you paid for an asset in the past or what its worth right now? Ultimately, the job of the accounting should be to provide information to creditors, investors, and counterparties to help them in their decision making process. It should reflect economic reality, not a company's preferred view of what the economic reality should be. Whether a company is healthy, solvent, or has enough capital are questions for its investors, lenders, and regulators. (For example, regulators can choose to make regulatory capital rules less pro-cyclical.) To make good decisions, they need the best information. Hiding from the truth only prolongs this process, creating more uncertainty and forcing all the players in the system to charge a higher premium for risk.
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> Many investors wonder when the writedowns of assets that are reported on the balance sheet at fair value will stop? For marked to market assets the answer is simple, when asset values stop falling. Remember it's up to the markets it's not as if the company is setting up a reserve that it has complete control over. That's why estimating a future writedown or write-up of an investment in debt or equity securities is so difficult as the value of each security a company holds changes constantly. Where exactly will it stand ten minutes from now, how about by the end of the day, the end of the quarter? Where the markets take its value is anybody's best guess. That's why investors should be focused on the underlying economics of the company's portfolio (including the fair value of the investments, the reliability of the valuations, assumptions used, key exposures, concentrations of risk, how they are hedged, etc.) and how its value could change under various market conditions.
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> **The Real Problem with the Accounting**
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> If there is a problem with the accounting, in our view, it's that financial instruments are accounted for in so many different ways (trading, available for sale, held to maturity, cost, equity method and that's just investments in debt and equity securities; for a further discussion see our March 19, 2008 report, 'In Search Of...Other Than Temporary Impairments, More Write-Downs to Come?'). Some are on the balance sheet at fair value, some at amortized cost, and others at some never-never land in-between. (It's what the accountants call a mixed attribute model; we just think its all mixed up.) In some cases, changes in fair value run through earnings, and in others they go to shareholders' equity (in other comprehensive income). As a result, you can have companies with very similar economic exposures that have completely different accounting results. For example, contrast the investment banks that got hit by the first wave of "write-downs" as many of their assets are reported on balance sheet at fair value and marked-to-market through earnings, with many of the banks, insurance companies, and GSEs that have not yet taken other than temporary impairments of investments in debt and equity securities, or the banks where most of their loans are not reported at fair value and instead could get hit slowly and painfully by increasing loan losses over the next few years. We would prefer to see all financial instruments on the balance sheet at fair value with changes in fair

> value run through earnings. We can hear the complaints already: you're crazy, that would make earnings too volatile. Too bad, that volatility is real, even if the company has no control over it; we would prefer to see the financial statements reflect real economic volatility rather than a false sense of stability. Some would argue that makes earnings meaningless. No, it just means something different, instead of being a weak proxy for cash flows or something that you might put a multiple on as a valuation shortcut, it becomes more of a measure of the change in the economic value of the business. To make the information more useful to investors, we would also like to see the mark-to-market changes highlighted separately in earnings, which companies are only required to provide today for Level 3 assets.

In sum. Our position is that the proposed SFP will **not** lead to 'better financial reporting. This will, only occur when accountants draw and rely upon the facts as they are at the date of the financials. It is preferable to be aware of 'what is', and allow users to base their actions on that. In that regard the following excerpt from *Indecent Disclosure* (2007, p. 199 - a similar position was stated in *Corporate Collapse,*2003 p.278) is apt. There we made the case that market prices (whatever they may be) should be what is reported. We instanced our response to a previous 'special pleading' concern that had been raised by some in the press and elsewhere that block sales potentially distorted reporting on a market price basis:

> Markets are never perfect. Information is never complete. But the market prices of items are as objective an evaluation of their contemporary money's worth, of their current contribution to the wealth of their owners, as can be found. The better the information, the better the evaluation, the better the financial assessments, the better – should be – decisions to invest and disinvest. Properly informed securities markets require accurate information of the current wealth and past financial progress of companies. Share prices might reasonably be expected to capture not only their companies' current financial position and an understanding of how it arose, but also impound all the expectations and fears for the future that the information might evoke. A rational economic perspective would suggest that.

In sum, whether in respect of prices where block trades occur, or when an asset does not have an observable market price, such as for the current 'toxic' mortgage-based assets and liabilities, the role of a factual accounting is, and indeed can only be, to *tell it as it is*. Only if it does can it be described as an 'honest accounting'.