

Briefing notes on fair value accounting

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Internationally there are almost daily news reports criticizing or praising the role that mark-to-market accounting has played in the current financial crisis, as well as reporting on the standard setters' responses to calls for changes to those rules or extra guidance on applying them. Some of these articles are well-informed, others less so.

To put this debate in an informed context, this high-level briefing paper gives an overview of the following:

- Background to the financial reporting standards: Who sets them and what do they say about fair valuing financial instruments?
- What are the problems with fair value accounting – why has it attracted so much attention?
- How have the standards setters responded?
- How relevant is this debate to Hong Kong listed companies?

This information is current as of 17 November 2008.

Background to the financial reporting standards

Who sets the accounting standards?

Since 2005, Hong Kong Financial Reporting Standards have been virtually a word for word copy of their equivalent IFRSs. So, for example, the key international standards in

the fair value debate, being IAS 39 *Financial Instruments: Recognition and Measurement*, and IFRS 7 *Financial Instruments: Disclosure*, exist within HKFRSs as HKAS 39 and HKFRS 7 respectively. So far all amendments to IFRSs have been adopted without delay or deviation by the Hong Kong Institute of CPAs and therefore there is no further discussion in this paper of HKFRSs as a separate concept from IFRSs.

IFRSs are set by the International Accounting Standards Board. The IASB describes itself as an independent standard-setting body and consists of 14 members from a range of backgrounds and extensive experience in their fields. For example, the chairman, Sir David Tweedie, is the former head of the U.K. Accounting Standards Board and a recent addition to the board, Zhang Weiguo, is the former chief accountant at the China Securities Regulatory Commission.

Members of the IASB are appointed by IASC Foundation trustees. The trustees are professionally and geographically diverse and hold themselves accountable to the public interest. They are also responsible for raising funds for the IASB from a wide range of market participants across the world's capital markets, as well as from relevant regulatory authorities.

When setting new standards or amending existing standards, the IASB follows a transparent and lengthy due process, which includes extensive public consultation on draft proposals. The recent amendments to IAS 39 concerning reclassifications of financial assets, which are discussed further below, were an unprecedented exception to this due process.

Despite the above due processes and safeguards to provide transparency, the resulting IFRSs should not be considered to be "perfect." Some of the challenges facing the IASB, which hinder it from achieving its goal of "a single set of high-quality, understandable and international financial reporting standards," include the following:

a. The IASB began operations in 2001.

At that time it inherited the body of standards known as International Accounting Standards developed by its predecessor body, the International Accounting Standards Committee. The collective body of IFRSs today still includes 29 of those inherited IASs, while only eight entirely new individual IFRSs have been issued. As discussed further below, this legacy problem is one that directly impacts on the fair value accounting debate as the recognition and measurement requirements for financial instruments are contained within IAS 39.

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- b. As mentioned above, the IASB's funding is sourced by the trustees from various sources. Inevitably, the lack of a large staff base and other resources poses challenges for the IASB, both to the quality of their work and the speed at which their work plan progresses.
- c. Although the IASB considers itself an independent body, the standards it issues are used by more than 100 countries worldwide, most notably by all listed companies in the European Union, which inevitably result in these countries taking a close interest in the IASB's work and seeking to influence it. It is also inevitable that in working towards the goal of U.S. acceptance of IFRSs, some measure of political influence from the U.S. will affect the conclusions reached by the IASB.

What do the accounting standards say about fair value accounting?

Fair value measurement has been part of Generally Accepted Accounting Principles for many years. For example, even the 10th schedule to the Hong Kong Companies Ordinance dating back to 1974 contains presentation requirements for fixed assets stated at valuation and requires disclosure of the market value of listed investments where it differs from the amounts at which the investments are stated in the balance sheet.

In the current IFRSs, the fair value concept appears in many standards. For example, under IAS 18, revenue should be measured at the fair value of the consideration received or receivable and under IFRS 3, the various assets and liabilities acquired in a business combination (e.g. when a company acquires a subsidiary) are required to be stated initially at fair value. In all these

cases the same definition of fair value is used: "Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction."

In respect of financial instruments, the current recognition and measurement requirements are set out in IAS 39. As mentioned above, the IASB inherited IAS 39 from its predecessor body, the IASC. Despite making several amendments to IAS 39 since taking it over in 2001, the IASB remains dissatisfied¹ with its complexity. So far as measurement is concerned, this complexity includes a mixture of measurement models permitted within IAS 39 for the same financial instrument, depending on management's intention for holding it and, in some cases, the accounting policy choices it makes.

For example, if an entity buys a quoted bond, it needs to apply one of the following accounting policies for that financial asset, depending on management's intentions:

- Fair value at each reporting date, with all movements reported in profit or loss in the income statement (FVTPL) if held-for-trading (or, if not held-for-trading, if the entity chooses to measure the bond at FVTPL under the fair value option), or
- Amortized cost² if the entity has the intention and the ability to hold the bond until maturity, or
- If the bond does not fall into either of the above categories, then fair value at each reported date, with movements generally reported directly in equity until the bond is disposed of or is impaired (in this case the bond would be referred to as being "available-for-sale," or AFS).

In respect of equity financial

instruments (i.e. shares in another company), these can be classified as either FVTPL or AFS (depending on management's intent or policy choice), i.e. they are carried at fair value, unless the fair value cannot be reliably measured, with differences either being reflected immediately in profit or loss (if classified as FVTPL) or on disposal or impairment (if classified as AFS).

The IASB has stated on many occasions, most notably in a discussion paper issued in March 2008 on *Reducing Complexity in Reporting Financial Instruments*,³ that its long-term goal is to replace IAS 39 with a more principles-based standard. The current thinking is that this new standard should adopt a single measurement model of measuring and recognizing all financial instruments at fair value with all movements reported in the income statement (FVTPL)⁴.

This preference for FVTPL for financial instruments was already evident in the requirement in IAS 39.50 introduced in 2003 that once a financial asset has been measured and reported at FVTPL, an entity may not change that asset's classification to any other form of measurement even if its intention towards that asset changes. It was this prohibition on reclassification that was the subject of amendment in the unprecedented move by the IASB in October 2008 to suspend due process and amend an IFRS without public consultation. This is discussed further below.

What are the problems with fair value accounting – why has it attracted so much attention?

As mentioned above, fair value accounting rules have been part of GAAP for many years. Why has it suddenly drawn so much attention and

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so many calls for change?

No doubt one factor is simply that there have been dramatic falls in the market value of certain financial instruments as a result of the adverse changes to the fundamentals underlying those assets, and the entities holding those assets are adverse to booking these losses. As Lynn Turner, the former U.S. Securities and Exchange Commission chief accountant, has been quoted as saying in response to banks’ assertions that fair value accounting is the cause of the problem, “the only thing fair value accounting did is force you to tell investors you made a bunch of very bad loans.”⁵⁵

Nevertheless, there is general acknowledgement that the answer is not as simple as this. In particular, the following areas associated with fair value accounting have been highlighted as being problematic:

(a) Pro-cyclicality

Critics of fair value accounting have accused it of “pouring fuel on the fire” rather than simply “measuring the flame.”⁵⁶ That is, simply reporting mark-to-market losses can cause further declines in market values, which in turn affect losses reported by investors and so on in a tailspin. The decline in market values may come, for example, from sell orders flooding the market when banks and others (such as fund managers) are forced to liquidate assets. The pro-cyclical nature of fair value accounting

may be exacerbated by capital adequacy ratios set by regulators, which rely directly on IFRS-based information, rather than other non-GAAP measures.

(b) Finding fair values for non-listed products and/or in inactive markets

As discussed above, a single definition of fair value is used throughout IFRSs. This definition focuses on the hypothetical price at which an exchange of the asset between willing buyers and willing sellers would occur. However, there is a strong emphasis in IAS 39 for assuming that market data is the best evidence of fair value. This has left preparers and auditors with two difficult calls to make:

i. What is the fair value of a financial asset that is not readily traded because of its nature, i.e. how to fair value, for example, a highly structured product, which is the result of a repackaging many times removed from the original underlying assets (such as subprime mortgage loans); and/or

ii. How to distinguish between market data, which is indicative of fair value, and market data which relates to “fire sale” values achieved in a distressed or inactive market? That is, when is the preparer justified in ignoring market data or adjusting it in subjective valuation models, to arrive at higher fair values than are indicated by current market transactions?

Both these issues allow those who are intent on overstating assets to manipulate the financial statements. However, even the most well-intentioned

entity will struggle to establish a fair value in such circumstances (particularly when both i and ii are present) and may, in their wish to avoid attracting criticism for overstating assets, in fact tend more towards understatement by placing undue reliance on market data from distressed markets and/or react perhaps over sensitively to negative news concerning the financial health of counterparties and others associated with the product.

How have the standards setters responded?

Recent developments in this connection include the following:

- *Valuing financial assets in markets that are no longer active*

The regulators have issued guidance, which has sought to reduce the risk that fair values are understated as a result of inappropriately marking to an inactive or distressed market. Details are as follows:

- On 30 September 2008, the U.S. SEC and FASB staff issued a joint statement in the form of questions and answers about fair value measurement issues in the current market environment. This guidance gave comfort that when a market is not active or transactions are disorderly, market prices are not determinative of fair value. This was followed on 10 October by more extensive guidance in the form of FASB Staff Position No. FAS 157-3 *Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active*. Following each of the U.S. releases, the IASB issued press releases, which reaffirmed its belief that fair value measurement guidance under IFRSs and U.S. GAAP are consistent.
- On 31 October an expert panel set

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up by the IASB in May 2008 issued some educational guidance in the form of an 82 page report entitled “Measuring and disclosing the fair value of financial instruments in markets that are no longer active,” accompanied by an IASB staff summary. As announced in the IASB’s press release, this guidance takes into consideration and is consistent with the guidance issued by the FASB and U.S. SEC on 30 September and 10 October.

- *Amendments to the fair value accounting rules in IAS 39 to allow reclassifications*

On 13 October 2008, the IASB took the unprecedented step of amending IAS 39 without first issuing the changes in the form of an exposure draft for public comment. This move was in direct response to pressure from the European Union, which had threatened to go ahead with its own “carve-out” if necessary.

The amendments were described by the IASB as “addressing the desire to reduce differences between IFRSs and U.S. GAAP.”⁷ In this regard, the amendments relaxed the prohibition in IAS 39 on reclassifying financial assets that were carried at FVTPL to allow reclassification of non-derivative financial assets in certain limited circumstances. The amendments took immediate effect, with back dating of reclassifications to 1 July 2008 being permitted.

Specifically, the amendments allow loans and receivables (i.e. non-quoted debt instruments with fixed or determinable payments) to be reclassified out of FVTPL if previously the debt was held-for-trading purposes but now

the entity has the ability and intention to hold the assets for at least the foreseeable future. The reclassification would be made at fair value at the date of reclassification and from then on this amount would be regarded as cost for the purposes of applying an amortized cost policy.

A similar treatment is permitted for quoted debt securities, but only in “rare circumstances” and only if the entity now had the ability and intention to hold until maturity. “Rare circumstances” are not defined in the amendments. However, the press release, which accompanies the amendments, said: “The deterioration of the world’s financial markets that has occurred during the third quarter of this year is a possible example of rare circumstances cited in these IFRS amendments.”⁸

In addition, in “rare circumstances” an entity can reclassify equity or quoted debt securities out of the FVTPL category and into the AFS category, thus continuing to measure at fair value but potentially reducing the volatility in the income statement (depending on whether the assets continue to decline in value and are regarded as impaired).

As a result of this amendment, serious questions have been raised concerning the IASB’s independence and robustness. For example, on 12 November, Sir David Tweedie was asked by the chair of a U.K. parliamentary hearing whether the IASB was “spineless.”⁹ As mentioned below, the debate over the political threat to IASB’s independence and credibility is continuing to grow. Meanwhile, headlines such as “Banks’ accounting gets murkier” are appearing as the banks publish their third quarter results. For example, The Royal Bank of Scotland

is said to have avoided booking £1.4 billion of losses as a result of the rule change, and Deutsche Bank, Lloyds TSB and HSBC collectively are said to have avoided booking losses of €1.5 billion.¹⁰

Next steps on the question of fair value accounting rules include the following:

- The U.S. Economic Emergency Stabilization Act, approved on 3 October 2008, includes a provision requiring the U.S. SEC to report within 90 days (i.e. by 2 January 2009) on the effects of mark-to-market accounting on financial institutions, including the impact of such accounting on bank failures in 2008, and to make recommendations on the advisability and feasibility of modifications to such standards. In this connection, the IASB and FASB have organized a series of roundtables to discuss the future of fair value accounting.
- European Union ministers have continued to apply pressure on the IASB to make further changes to IAS 39. On 27 October, the EU wrote to the IASB setting out further amendments, which they consider should be made in time for the publication of the year-end results. In particular, they are seeking to expand the reclassification concession to those assets, which were voluntarily classified at FVTPL even though not held-for-trading at the time, and to amend the impairment rules on AFS debt securities, to reduce the extent to which deficits on those assets are reported in profit or loss. Unlike the October 2008 amendments, these further changes would not result in greater convergence with U.S. GAAP.

1. For example, see quote attributed to Sir David Tweedie in the IASB’s press release on 19 March 2008, which announced the release of the IASB’s discussion paper *Reducing Complexity in Reporting Financial Instruments*.

2. “Amortized cost” in this regard refers to the measurement policy by which the bond is carried at initial cost, with interest accreted under the effective interest rate method, less provision for any impairment losses. This effectively results in any premium or discount, compared to the redemption amount, being amortized over the period until maturity, hence the name “amortized cost.”

3. Published in March 2008, with comments due by 19 September 2008.

4. See paragraphs IN5 and IN8-IN10 of the introductory part of the discussion paper *Reducing Complexity in Reporting Financial Instruments*, and also section 3, Part A “Why fair value is the only measure appropriate for all types of instrument.”

It is understood that the IASB has not yet responded and reported remarks made by Sir David Tweedie on 12 November at the U.K. parliamentary hearing mentioned above indicate that their response, when they do, will not be favourable.¹¹ Of greater concern than the particular amendments that are requested by the EU is the damage to the IASB's reputation and standing if it did bend to such requests for a second time.

- On 15 November, the G20 summit on the financial markets and the world economy was held in Washington. Ahead of the meeting, on 7 November, the EU published "Global financial crisis: European Council conclusions of the informal meeting of heads of state or government," which include the EU's views of "common principles on which to build a new international financial system," which should be discussed at the G20 summit. These include the following:

"Both prudential and accounting standards applicable to financial institutions will have to be revised to ensure that they do not contribute to creating speculative bubbles in periods of growth and make the crisis worse at times of economic downturn."

In application of this principle, the EU considers that the following approach could be adopted:

"Adopt the principle of convergence of accounting standards and review the application in the financial sector of the fair value rule in order to improve its consistency with prudential rules."

On 11 November 2008, the trustees of the IASC Foundation wrote to U.S. President George W. Bush and requested that a copy of their letter be circulated to participants ahead of

the G20 meeting. The letter expresses support for both fair value accounting and the independent standard-setting process and expresses the view that efforts to improve the financial reporting should be led by the IASB in accordance with the established standard setting process.

Based on the communiqué issued after the summit, there is general support for the role of global standard setting. In particular, fair value accounting was not identified as being a cause of the financial crisis and instead financial institutions were told they "must also bear their responsibility for the turmoil and should do their part to overcome it including by recognizing losses, improving disclosure...."¹² Action steps identified in the communiqué in respect of financial reporting focused on increasing the transparency of financial reporting, including in respect of off-balance sheet vehicles. The global accounting standard setting bodies were also asked to enhance guidance on how to value complex, illiquid products, especially during times of stress. However, there was an indication that some steps may be taken in the near term to address the governance of the IASB in order to ensure its transparency, accountability and "an appropriate relationship between this independent body and the relevant authorities." It is not yet clear what action will be taken in this regard and therefore the extent to which this will increase or decrease the political pressures on the IASB.

How relevant is this debate to Hong Kong listed companies?

- Any changes to IFRSs have a direct impact on HKFRSs. In particular, the amendments to IAS 39 were endorsed

by the council of the Institute on the day after the IASB issued them. However, so far there is little indication that the amendments in respect of reclassifications will have a significant effect on reported profit or loss by Hong Kong financial institutions or other Hong Kong listed entities for this year-end.

- Both financial institutions and corporations hold structured products, which may have underlying assets linked to the U.S. subprime market and therefore valuations of these assets will be problematic for these entities. However, so far there is little indication that any losses will result in Hong Kong financial institutions having inadequate capital.
- Hong Kong listed entities may also have acquired other investment or derivative products, whose fair values have fluctuated significantly as a result of the financial crisis. For example, listed companies have issued profit warnings concerning losses arising from foreign currency instruments, equity investments and derivatives over equities.

In respect of all of the above, a cautious view should be that we may not have yet seen the worst of it, and further impacts of the financial crisis and contagion from the U.S. may still emerge from Hong Kong listed companies with direct- or indirectly-linked exposures.

These briefing notes are reprinted with the permission of **Marvin Cheung**, trustee of the IASC Foundation, who recently sent these notes to the Hong Kong government. The notes were prepared with the assistance of **Catherine Morley**, principal in KPMG China's professional practice department, and have been updated to 17 November 2008.

5. *The Washington Post*, 23 September 2008

6. *The Washington Post*, 23 September 2008, comment attributed to Ed Yingling, president of the American Bankers' Association

7. IASB press release dated 13 October 2008

8. IASB Press release dated 13 October 2008

9. As reported in *CFO.com*, 12 November 2008

10. *The Wall Street Journal*, 12 November 2008

11. As reported in *CFO.com*, 12 November 2008

12. Paragraph 8 of the G20 declaration: full text