

Fair Valuation in times of Financial Crisis

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The Financial Crisis - Evolution

- The sub-prime crisis
- The credit crunch
- The liquidity crisis
- The great asset sell-off
- New definition of ROI?

The Financial Crisis – Main Causes

- Lending defied norms
- De-regulation of banking sector – Banking went beyond lending
- Complex financial instruments – *The Emperor's New Clothes*
- Regulation lagged behind

Financial Reporting – Taking Stock

“Net income is a virtually useless number”

- *J. Michael Cook, former Chairman of AICPA, & former Chairman and CEO emeritus, Deloitte and Touche LLP.*

Indignant? Why?

- What is the company's worth, and by extension, what is its share worth?
- What is the company's earning potential?
- What are the risks faced by the business?

Financial reporting – Fixing it

- We need an accounting model that captures economic reality
- Fair Value accounting – an attempt to overcome shortcomings of historical cost, to:
 - give users a clearer picture of the economic state of the company
 - put an end to “earnings management”
 - earnings depend more on what happens on the balance sheet than in the income statement

Fair Value - Essentials

- 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 (IAS 39)
- Fair value is distinct from:
 - Value in use (IAS 36)
 - Investment value (Worth)
 - Marriage value (Synergy)
 - Special value (Special purchaser)
- But similar to Market value (*IVS 2007*)

Valuation Techniques

**Market
Approach**

**Income
Approach**

**Cost
Approach**

Selection of a valuation technique depends upon:

1. The nature of the asset or liability being valued, and
2. The availability of relevant data

Fair Value – the Accounting Framework

- IFRS discusses Financial Instruments under three different standards:
 - IFRS 7: Disclosure
 - IAS 32: Presentation
 - IAS 39: Recognition and measurement
- US GAAP is similar, especially with the convergence between FASB and IASB
 - FAS 115: Accounting for Certain Investments in Debt & Equity Securities
 - FAS 133: Accounting for Derivative Instruments and Hedging Activities
 - FAS 157: FV Measurements
 - FAS 159: FV Option for Financial Assets & Liabilities

The Fair Value Debate

The Critics

- Preparers of financial statements (especially banks)

The Backers

- Investors
- Regulators (including SEC)
- Standard setters, notably IASB, FASB
- Auditors
- Rating agencies
- The G20 Finance Ministers – mid-Nov meeting

The Dissenters say...

- FV cannot ensure precision, unlike the transaction-driven historical cost system
- Active markets a pre-requisite for FV; in inactive markets FV is subjective & inconsistent
- In downturns, FV can cause non-compliance with capital adequacy requirements
- FV is 'pro-cyclical' and can accelerate downturns by prompting asset sell-off to meet capital requirements
- Capital adequacy considerations may drive Banks to hoard capital

The Backers say...

- Better an imprecise but transparent FV system than a precise but irrelevant historical cost-based system
- Inactive markets call for a greater level of guidance in applying valuation methodologies, NOT for suspending FV; e.g. mark-to-model (Level 3 of FAS 157)
- Shift the debate away from Fair Value onto banks' capital requirements; re-think formulae for computing capital adequacy; talk to Basel Committee
- FV accounting did not cause the financial crisis; abandoning it will not solve the problem

Backers of FV.....cont'd

- Suspending FV accounting, especially when prices are falling, would be biased and would:
 - Cast aside investors' need for meaningful information
 - Strike a blow against independent standard-setting
 - Destroy the very neutrality of accounting
- Accept the message, rather than shooting the messenger!

IASB's Response to the Crisis

- The IASB Expert Advisory Panel has issued guidance on FV measurement and disclosure in inactive markets
- IASB has issued an amendment to IAS 39 and IFRS 7, after holding 7 meetings between June and October
- The IAS 39 amendment relaxes certain restrictions on reclassification of financial instruments (other than derivatives) to bring it on par with FAS 115 (“rare circumstances”)
- IFRS 7 disclosure requirements enhanced

IAS 39 Amendment – the flip side

The amendment has not been spared criticism

- According to financial analysts it reduces comparability of banks' financial statements
- It allows preparers to “look back” until 1st July 2008 for reclassification and cherry pick the date/price that suits them best – objectivity?
- Due process was not carried out before issuing the amendment; no ED issued; public comment?

- Critic or Backer?

- Q & A

- Future seminar topic:

The future of financial reporting

Thank you