



How Fair is Fair Value Accounting?

By now we are all somewhat weary of the global credit crunch which continues to plague financial markets, but let us take some time to look at it from a different angle. In financial circles, some are saying that the adoption of fair value accounting in recent years has contributed to the global credit crisis and the banking write downs that came with it.

The notion of fair value accounting, also known as marked-to-market accounting, consists of valuing the assets and liabilities of companies by their current worth in the marketplace instead of their purchase price or historical cost. While the concept has always been the subject of much discussion, it is the growing liquidity problems and massive write downs that are causing many financial institutions that were in favour of it in 'good times' to now question whether it is such a good idea after all. Is the tide of opinion turning against fair value and marked-to-market accounting?

Financial instruments are usually traded in active markets with adequate pricing, in which case fair value makes sense. However, when a market is not very active, price mechanisms fail and markets dry up. Banks and other financial institutions are then forced to report even lower values for their assets and take write downs to their income statements. In short, the argument goes that using asset values based on highly volatile markets paint a misleading picture.

Two of the world's largest insurers, AXA and AIG, claim that International Financial Reporting Standards (IFRS) have been a key factor in the global financial crisis because their use of fair value accounting has increased market volatility. According to Henri de Castries, chief executive of AXA, it is a conceptual mistake to value assets that are being held for the long term at marked-to-market levels. He illustrated this by saying that if your next door neighbour was selling his house at a distressed price your house should not be worth less as well if you had no intention of selling. Martin Sullivan, chief executive of AIG, claims that a reduced valuation is not a loss if there is no intention of crystallizing it. He argued that the current rules created a vicious circle in which companies incurred paper losses, lost the confidence of investors and then had to raise funds in unfavourable market conditions.

The arguments against fair value come from many different sources. Barney Frank, chairman of the Financial Services Committee in the U.S. House of Representatives, has asked for fair value rules to be reconsidered. The former governor of the Bank of England, Lord Edward George, has warned that fair value was adversely affecting market confidence. The Financial Services Authority (FSA) in the U.K. has been looking at the issue of market-induced downward valuations since last year and has criticized the fair value concept. They have noted that accounting standards for financial statement reporting do not generally permit banks to make prudent valuation adjustments.

The other major argument against fair value concerns the use of fair values when these are not based on market prices. When there is no market to mark against, pricing for assets becomes very theoretical. Obtaining a price from a third party to get a sense of where the market is, also known as a market read, can be very subjective. Complex modeling of asset values may also be no closer to the true value than historic cost.

Notwithstanding all of this, fair value continues to enjoy a lot of support. Besides, it is not entirely clear what exactly did cause all the massive write downs. Was it marked-to-market accounting? Impairment charges? Off-balance sheet items that came back on the balance sheet?

Bank of America CFO, Joe Price, has noted that the financial industry's current woes are probably more attributable to poor risk assessment than accounting changes. He goes even further to say that marked-to market accounting is an important component of risk control and is more likely to make that risk more transparent. Goldman Sachs weathered the credit crisis particularly well, something that many observers attribute to the firm's long-standing practice of marking its books to market and its conservative stance as the credit markets began unraveling.

A panel of experts assembled by the Securities and Exchange Commission to review the topic found that fair value remains the type of financial information investors find most useful. Any talk of abandoning fair value accounting, most panelists agreed, risked ignoring real economic problems. Fair value can provide valuable information, particularly in tough markets, because it tells investors what is under stress. If the volatility is real then the financial statements should reflect that real economic volatility. A research report by Credit Suisse studied 380 companies in the S&P 500 that have adopted fair value measurement and the verdict was that marking assets and liabilities to market value clarifies economic reality for all stakeholders. Regulators and investors want the fuller picture that fair value gives them. No one likes to report bad news but you have to manage the risks associated with the investments you make.

Sir David Tweedie, chairman of the International Accounting Standards Board, was quoted recently as saying that "the credit crunch isn't an accounting problem. It's a banking problem". Nevertheless, the chairman has been an outspoken critic of the very complex IAS 39, the main accounting standard behind fair value accounting for financial instruments. The IASB is working on a revision of IAS 39 which should make the rules simpler. However, much of the complexity of the standard is derived from the complexity of the financial instruments it is addressing and no solution will be perfect. What may be required are further improvements to measurement of fair value in illiquid markets, further disclosures and more regulations for accounting of off-balance sheet investments. A return to cost accounting is highly improbable.

A combination of overexposure to certain assets, poor risk management and lots of leverage are all contributors to the turmoil in financial markets. But could accounting have helped to prevent or lessen the fall out of the credit crisis? If the illiquidity behind the credit crunch arose because of a misunderstanding of the risks, and that misunderstanding is related to the complexity of financial instruments, then perhaps financial reporting should help to unravel those complexities, not make them worse.

Fair value accounting does have its weaknesses and in light of the stiff test that the credit crisis has imposed it should now be reviewed and improved upon. To what extent it will change is anyone's guess but it is here to stay.

FINANCIAL & ECONOMIC INDICATORS

As at 24 July, 2008

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	107.33	106.27
Euro	1.57	1.59
Jamaica	72.30	72.20
Guyana	204.90	204.40

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	125.49	129.29
Natural Gas (US\$/mmbtu)	9.69	11.41
Gold (US\$/Troy Ounce)	928.05	957.43

Eurobond Indices (Return % YTD, as of 24-July-08)

Lehman Brothers Global Aggregate Index	3.31
JP Morgan EMBI+ (percentage change)	13.60
CMMB Eurobond Index	n/d

<u>Policy Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
United States	2.06	2.00
Euro Zone	4.25	4.25
Japan	0.51	0.51
Brazil	13.00	12.25
Trinidad	8.25	8.25
Jamaica	13.50	13.50
Barbados	4.50	4.50

<u>Market Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
US 90-day T-Bill	1.62	1.38
US 10-Yr Treasury	4.00	3.99
3-month UK Libor	5.80	5.81
Japan 90-day T-Bill	0.53	0.53
Brazil 90-day T-Bill	13.48	12.85
TT 90-day T-Bill	7.17	7.17
Jamaica 90-day T-Bill	14.46	14.19
Barbados 90-day T-Bill	4.02	4.16

Sources: Bloomberg, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, www.lehman.com

DISCLAIMER

The information contained in this documentation is for your information only. All information contained in this documentation has been obtained from and is based on sources, including but not limited to, newspaper and magazine articles that CMMB believes to be accurate and reliable. However such information, facts, calculations, methodology, assumptions and estimates contained in this documentation have not been verified by us. All opinions and estimates constitute the Author's judgment as of the date of the documentation which are subject to change; however neither its accuracy and completeness nor the opinions based thereon are guaranteed. As such, no warranty, express or implied, as to the accuracy, timeliness or completeness of this documentation is given or made by CMMB in any form whatsoever. Consequently, CMMB assumes no liability for the accompanying information, which is being provided to you solely for general information.