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Disclosures About Market Value of Financial Instruments

Statement of
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Mr. Chairman and Members of the Financial Accounting Standards Board: (Introduction of Dan Murrin, Accounting Fellows)

We appreciate the opportunity to comment on the Exposure Draft on Disclosures About Market Value of Financial Instruments and welcome the opportunity to give you our views. My oral testimony today supplements our written comments submitted under date of May 20, 1991. Those comments expressed full support of the Exposure Draft and mentioned a few refinements. Our letter also alluded to the accounting difficulties we see in the banking community. My oral comments today will attempt to elaborate on the bank issues as these may play out in market value disclosures.

GAO is often called the "Congressional Watchdog". GAO's staff assist Congress in analyzing issues and providing information that result in improvements in governmental activities. GAO's Accounting and Financial Management Division (AFMD) works to improve the quality of financial management throughout the federal government through audits, evaluations of accounting and budgeting systems and active involvement in promulgating federal accounting and auditing standards.

But GAO's interest in accounting and auditing transcends the federal sector when the vital interests of the government are at stake. Accordingly, GAO is also concerned with private sector financial management and reporting--directly through impacts on federal guaranty funds or other government exposures to loss, or indirectly through congressional interest in the execution of regulatory responsibilities to protect taxpayers and investors.

Our work over the last several years in the financial institutions area is a case in point and provides the principal basis for my remarks today. Our work highlights how important accounting standards are to the successful operation of financial institutions and to the regulation function of government. We believe that market value disclosures can be of particular value to regulators. Accordingly, we support the exposure draft and urge its adoption as an accounting standard.

In a series of reports, including a recent report on 39 banks which failed in 1988 and 1989[1], we identified accounting, auditing and internal control weaknesses which continue to be a significant cause of bank failures. These breakdowns in corporate governance led to bank failures and illustrated a seriously flawed early warning system to identify troubled banks. However, we are not here today to discuss the specifics of our reservations with respect to the historical cost accounting model presently used as a basis for the early warning system. We have previously transmitted our findings on the weaknesses of FAS 5 and 15 to the Financial Accounting Standards Board and applaud its decision to consider the problems we have now with these financial accounting standards.

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[1]Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, April 22, 1991)

Two of our observations with respect to the historical cost accounting model merit particular attention in developing requirements for disclosures about the market value of financial instruments. These two determine market value, particularly for troubled assets, and the recognition of loan loss reserves in developing market value estimates, may require additional guidance in this Exposure Draft. Additionally, to aid comparability among institutions and the understanding of the significance of disclosures, we believe that any standard adopted should be more prescriptive with respect to presentation of market value disclosures. We will discuss each of these issues in turn.

First the matter of definition of market value

Paragraph 5 of the exposure draft provides a definition of "market value" which we believe merits some clarification. Our experience has indicated that preparers of historical cost financial statements often place emphasis on the portion of the definition which stipulates quote "a willing buyer and a willing seller, other than in a forced or liquidation sale" to the detriment of the quote "current transaction" element of the definition. We are concerned that this emphasis may carry over into the development of disclosures about market value.

We believe that this emphasis may result in preparers inferring that quoted market prices are unrepresentative based on projections of market value in a "normal" market. We are afraid that they will decide that recessionary conditions and thin market trading are not "normal" market indicators, when in fact they are representative of "current transaction" prices. We do recognize that temporary market inefficiencies can occur, and result in isolated market aberrations in the demand for and resulting prices of financial instruments and underlying collateral values. That is not what we are talking about. Also, we do not advocate the use of "liquidation" basis accounting, and you should not infer from my comments that we believe that "fire-sale" pricing is appropriate in dealing with such market aberrations. However, we believe that the emphasis in practice we have mentioned often results in the complete rejection of existing market based pricing, leading to the use of valuation techniques similar to those described in paragraphs 11 and 28 in inappropriate circumstances. In summary, we believe that there should be a strong presumption that quoted market prices are representative of market value. Thus, we encourage the FASB to make explicit that the use of the alternative valuation methods described in paragraph 28 are discouraged if a quote is available, or other indication of market value in a trading market exists as described in paragraph 27. In the event that the alternative valuation methods described in paragraph 28 are utilized, we encourage the FASB to clarify that it is expected that the discount rates and cash flows used in such valuation methods are intended to arrive at a result which is comparable to currently existing - albeit potentially depressed - market values in exchange transactions.

If alternative valuation techniques are utilized, there is a need for realistic cash flow projections. We believe this point is critical. We have found that future projections of cash flows which are not realistic are frequently utilized in making fair market value determinations required in the historical cost accounting model. Again, I want to emphasize that we do not advocate liquidation basis valuations in aberrant market conditions. But, we do advocate the use of realistic assumptions. In this regard, we commend to your reading paragraph number 3 of the qualifying criteria for the Treasury's proposed loan-splitting guidance. While we had real problems with the loan-splitting proposal, as did a number of others including the FASB staff, we liked the passage that reads in part that quote "cash flows.....should be based on long term lease contracts, third party commitments or similar arrangements." We believe that this reliance on demonstrated cash flows and not predictions of future events which may or may not occur is critical in arriving at market values, particularly for problem assets.

Now the matter of loan loss reserves

We are concerned that in implementing the requirements to provide market value disclosures, a mechanical approach to valuing loans may lead to inappropriate recognition of the market values of these assets. We have previously noted our concerns with respect to the application of FAS 5 and 15 for loan loss reserves, and have expressed our view that additional guidance is needed to ensure that loan loss reserves developed pursuant to FAS 5 are adequate. Until this is done we have special concern with how existing "FAS 5" basis loss reserves will be utilized in determining market values disclosures.

We are not concerned with instruments with quoted market values, as with a pool of mortgage loans for which a quote can be inferred from a secondary market. However, we are concerned with loans valued pursuant to the guidelines in paragraphs 11, 24 and 28, where, in practice, the adjustments made to reflect market value may only reflect changes in interest rates. We are afraid that in the absence of clear direction from the FASB, existing loss reserves will not be reevaluated to determine whether they reflect a true settlement rate available for the risk of default inherent in the loan. To the extent that loss reserves developed pursuant to FAS 5 are not representative of the loss reserves which third parties would require when purchasing the related loans, they are not appropriate benchmarks for use as market value disclosures.

However, our reading of the exposure draft, and a survey of comment letters on the exposure draft, lead us to conclude that this sort of implementation shortcut, just accepting loss reserves, is likely to occur.

To this end, while we continue to advocate additional guidance and modifications of the methodologies used to calculate loan loss reserves under historical cost accounting pursuant to FAS 5, we also hope that the FASB will explicitly recognize that the concepts presently used in the historical cost model to calculate loss reserves are inappropriate measures of credit risk for purposes of preparing market value disclosures.

Finally the presentation of market value information

We believe the Board should consider requiring disclosure of all market value information required by this and other pronouncements in a single footnote, with this presentation in the form of a supporting schedule. The main captions of the balance sheet and off-balance sheet items should be displayed along with the related unrealized appreciation and depreciation so that readers can understand the impact of market values and comparison can be more easily made with other institutions. Some precedent exists for issuers covered by the Investment Company Act of 1940, who prepare their statements on a cost basis, disclose market values as well as the cost basis for individual assets, and compute net unrealized appreciation or depreciation. We note that pulling these disclosures together in one place would help to prevent preparers from variously emphasizing or deemphasizing market value information in response to desires to tell only the story they want to tell to financial statement users.

Concluding remarks

That concludes my remarks today. Auditors are frequently criticized for focusing on negative aspects of proposals. Occasionally, GAO has also been subject to this criticism. I want to emphasize that our view that additional implementation guidance is needed in the proposed standard should in no way be viewed as detracting from our strong support for the concept of market value disclosures. We view such disclosures as vital, applaud FASB's efforts to require such disclosures, and urge adoption of a Standard in this regard.

I would be pleased to address any questions you may have.