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Effective Valuation Method of Toxic Assets and Their Influence on Banks' Financial Statements

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Effective Valuation Method of Toxic Assets and Their Influence on Banks' Financial Statements

Morgan Logue

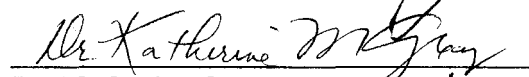
Senior Honors Project

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of the Westover Honors Program**

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Abstract

The crash of the housing market caused risky home loans and mortgage backed securities to be worth almost nothing; this not only drastically decreased national banks' net income but also devastated the United States' economy. The United States Treasury Department believes that they have found a \$700 billion solution to the United States' financial crisis. The Public-Private Investment Program (P-PIP), which is a part of the Troubled Asset Relief Program (TARP), plans on clearing toxic assets from national banks' balance sheets through auctions. Two main concerns that affect the end results of this auction is how to motivate banks and investors to participate, and how to value assets and liabilities. With current valuation accounting standards, bad assets' value would be significantly lowered, causing banks to report large losses and may even force banks into bankruptcy. The goal of this paper is to evaluate valuation mechanisms that distribute the risk and returns fairly to the banks and taxpayers.

Introduction/Literature Review

Since 1993 developed countries have been taking advantage of borrowing money; savings have been decreasing and debt-to-income ratio has been rising steadily. Credit and the housing market are intertwined with one another; people would borrow funds to obtain housing property and were encouraged to do so because of the belief that property prices would continue to rise. Because the housing market was believed to be a safe investment, banks and other lenders were willing to lend to individuals with poor credit history and/or an insufficient income. These low-quality mortgages are known as subprime mortgages. Mortgage brokers lowered their standards and qualifications for United States citizens to receive mortgages. Banks were willing to lower

their requirements and lending policies to cash in on this high demand for asset-backed securities, specifically collateralized debt obligations (Poole, 2009).

The federal government was a supporter of subprime loans because of the government's goal and desire to have more American families owning homes (Poole, 2009). This would help make the American Dream a reality. The Bush Administration promoted the idea of owning homes by supporting two of the largest mortgage companies in the United States, Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac specialized in prime mortgages. To be able to compete with new competitors, Fannie Mae and Freddie Mac began to offer subprime mortgages (Poole, 2009). The support from the government gave a falsified belief that the securities were backed by the United States government; this caused investors to undervalue subprime-assets' risk. When the market crashed, so did Fannie Mae and Freddie Mac; but the government bailed them out.

When resources became easily attainable, the housing market flourished which led to a drastic increase in economic growth. Housing prices almost doubled between 1997 and 2006, and in 2006 the housing prices were more than 50 percent above the highest housing price reached in the 20th century (Council of Economic Advisors, 2010). The government continued to encourage the purchase of homes with lowered interest rates and relaxed lending policies. Though lenders were willing to supply subprime mortgages and made them sound appealing with low beginning interest, subprime mortgages were more costly than most mortgages. The interest on subprime mortgages began to rise after the first few years; subprime mortgages had higher insurance costs, and higher fees making these mortgages extremely expensive for individuals who were borrowing beyond their means. By 2006 there was \$600 billion of subprime mortgages, which represented more than 20% of total mortgages (Mizen, 2008).

A market for collateralized debt obligations (CDOs) emerged because of the growing popularity and high demand for securitized products in the subprime mortgage market (Mizen, 2008). This investment option was open to the global economy, and the low risk with high return was extremely attractive to international investors. This investment seemed too good to be true, and it was. Investors very quickly filled their portfolios with collateralized debt obligations and by doing so they were breaking the main rule of investing, diversification. The risks of these investments were not correctly valued. The risk was based on the assumption that the housing market would continue to be strong and increase, and interest rates would remain low. The correlation between default risk and housing prices was not considered. By 2006 housing prices across the United States became stagnant. The adjustable-interest rates that started out low began to rise and with this, defaults on loans started to increase drastically (Davis, 2009). In 2007, the demand for housing disappeared and collateralized debt obligations were worth close to nothing in the current market. With the growing number of subprime-mortgage defaults, the uncertainty for these investments rose. As a result, large investment companies tried to receive money from banks to cover losses incurred by the subprime-related assets. Banks were unwilling to lend their money because they believed the borrowers would be unable to repay the funds, and the banks wanted to keep liquid assets available to be able to cover any future losses from asset-backed securities that they may encounter. Because of the realized risk of subprime-backed assets, the necessary insurance to cover default risk became very expensive, making asset-backed securities extremely difficult to sell. When the investors were unable to sell the assets or borrow money to cover investment losses, the market for asset-backed securities disappeared, making it difficult for banks and investment companies to identify their losses. Because asset-backed securities are currently measured by fair market value, their worth is based on the market. Since the demand

for asset-backed securities disappeared, there is no existing market to value these assets by.

Based on Financial Accounting Standard Board's fair value accounting method, the financial institutions were required to write-down these assets to their current market value. Financial institutions were all effected by these write-downs differently, depending on their investments in mortgaged-back securities, loans, and collateralized debt obligations. Lowering the value of these assets lowered the total assets of the institutions; because of this they are known as toxic assets, meaning they have a negative affect on the companies' financial statements. Toxic assets have little to no market, which in return lowers the assets' value. The assets have to be adjusted downward on the balance sheet to their current value; this lowers total assets recorded on the balance sheet. No one expected that the crash of the subprime mortgage market would spread to the entire financial sector (Council of Economic Advisors, 2009).

The increase in asset worth was in part fueled by the drastic increase in construction and consumer spending. This spending was encouraged by low interest rates and easy credit (Council of Economic Advisors, 2010). When the housing prices and wealth began to fall, and credit availability began to freeze, household and business confidence declined, which resulted in decreased spending and investments. The United States of America's wealth fell drastically. "Real GDP declined at an annual rate of 2.7 percent in the third quarter of 2008, 5.4 percent in the fourth quarter, and 6.4 percent in the first quarter of 2009. Industrial production, which had been falling steadily over the first eight months of 2008, plummeted in the final four months- dropping at an annual rate of 18 percent" (Council of Economic Advisors, 2010, p.44). The housing market crash had spread to the rest of the economy and this was extremely visible in the American automobile industry. GM and Chrysler both declared bankruptcy after sales of motor vehicles dropped by an average of 40 percent (Council of Economic Advisors, 2010). The

economy was crashing; American businesses were all largely affected. Businesses began reducing costs by cutting back on labor. In 2008, job loss increased from 100,000 per month to 740,000 per month; by the end of 2009 the unemployment rate increased 3.3 percent totaling to 10 percent (Council of Economic Advisors, 2010).

There are three major parties that have been accused of causing the financial crisis: the federal government, the private sector, and the Financial Accounting Standards Board (FASB) (Davis, 2009). FASB is a private sector entity that has the responsibility of setting and controlling accounting standards. Currently the fair value accounting method has been taking most of the blame from the general public and businesses. Fair value is defined by SFAS No. 157 as the price that would be received to sell assets or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This means that the value is adjusted based on the market price at the date being considered, the entrance price (2006).

On November 15, 2007, FASB required institutions to record specific assets, at mark-to-market, also known as fair value. Mark-to-Market is not a new asset valuation method; it is used to measure many assets. Stocks are a common example of assets being measured in mark-to-market. The most notable impact of this accounting regulation was seen in the mortgage-backed securities, which forced banks and other institutions to revalue these assets and adjust their financial statements. Most of the institutions carrying mortgaged-backed securities had to mark down these assets, which led to large losses.

The pressure from the government and companies forced the Financial Accounting Standards Board (FASB) to make adjustments, which included additions and explanations to fair value accounting (Cheng, 2009). One of the main reasons for the changes in fair value accounting was to make the rules apply to the current economic standing, which includes

different valuation methods for specific types of assets. Under FASB 157 three classes of assets were created: level 1, level 2, level 3. "Level 1 assets are traded in organized exchanges with observable prices. Level 2 assets are those which do not have a quoted price but whose price can be observed either directly or indirectly. Level 3 assets have unobservable inputs due to their illiquid nature," (Harris & Kutasovic, 2010, p.121). The most criticism of fair value accounting is found in level 3 assets. Because level 3 assets have no organized or observable market, fair market value has to be achieved by unbiased assumptions and computations. Intuitions must disclose how they achieved the value recorded, but because the value is based on judgment there lacks consistency between different companies' financial statements. The values of these assets are based on the current selling price, and because these assets have no market, companies had large write-downs and large losses on financial statements.

With this unexpected downturn of the economy, businesses and investors turned to the federal government for a solution. The United States Treasury first produced the Troubled Assets Relief Program (TARP), which was designed to purchase over \$700 billion dollars of mortgaged-backed securities and loans, which are now considered toxic assets. Banks and corporations took the money that was made available by TARP. But, when these institutions accepted the money they also had to accept strict regulations created and enforced by the government. The main goals of TARP are to be able to stabilize the declining economy and to have strong government oversight on companies that were strongly affected by the crash (Casabona & Shoaf, 2009). The problem that the government ran into was how to determine the value and worth of these troubled assets.

The United States Treasury then created the Public-Private Investment Program (P-PIP), which is under the authority of TARP, to try to determine how to value toxic assets found on

companies' balance sheets. The program's main objective is to determine how to qualify and price toxic assets that are currently un-marketable and are present on companies' balance sheets (Fournier & Sisky, 2009). The government decided on using the idea of an auction to determine the value of toxic assets. The government is trying to split the risk between the private and public sector. The Public-Private Investment Program is divided into two programs, the Legacy Loan Program (LLP) and the Legacy Securities Program (LSP). The Legacy Loan Program is designed to purchase troubled loans, and the Legacy Securities Program purchases trouble securities, which are backed by mortgages (Alston & Bird, 2009). Under LLP and LSP, toxic assets will be auctioned off to a set of bidders. The winning bidder does not pay the entire cost of the toxic asset upfront; the government provides both loans and equity to the winning bidder. The government provides a fraction of the price as a loan and pays half of the remaining cost as equity (Zheng, 2009). This gives values to the toxic assets. The winner has the option of either paying back the loan or defaulting. If the winning bidder pays back the loan, they receive the remaining share of the toxic asset. But, if the bidder defaults, the government retains the toxic asset and pays for it entirety with taxpayers' money. The goal of the auction is to split the risk of toxic assets between private investors and taxpayers, but unfortunately the taxpayers take the majority of the risk. One of the biggest problems with the proposed solution is lack of participation. Companies fear the possibility of increased regulation from government intervention, which they saw in the Troubled Assets Relief Program.

Though both the government relief programs appeared promising on paper, most banks have proven to be resistant to accepting the help. Banks are unwilling to sell their toxic assets for their fair market value. There is a difference between the value of current toxic assets and the price desired by the owners. Toxic asset owners are not willing to compromise and lower their

desired prices for their toxic assets; the only buyer that will overpay is the government. TARP and P-PIP give banks the option to sell their toxic assets, but very few banks are willing to sell these assets at a loss; because of this TARP and P-PIP are ineffective. Wilson and Wu (2009) have promoted the idea of regulators forcing banks and institutions to sell their toxic assets. This would be the most cost efficient way of getting rid of toxic assets. They believe investors must suffer the consequences of bad investment decisions.

A growing concern of my generation and generations to come is the current economic crisis and the drastic increase in government spending. Graduating this year, most seniors are concerned about getting a job when the job market is not improving. Not only is the poor economy affecting us currently but also in the long run; the United States' government will eventually have to pay off the additional debt caused by the extremely large stimulus plan, the Troubled Asset Relief Program, and possibly the Public-Private Investment Program. Though these projects were deemed necessary to improve the economy there has been limited positive outcomes from them. Capital is at a stand still; no one is willing to spend or invest large amounts of money, because no one is confident in investing in the current market. The American society is becoming very cautious and conservative with money. Even banks are making it difficult to borrow money, which discourages businesses and investors from funding new projects. One way to restore confidence in our economy and government is to be able to solve one of the main problems keeping us in this recession, how to value toxic assets. This is a present issue that has yet to be solved. No one has been able to discover a way of recording toxic assets that pleases the Financial Accounting Standards Board (FASB), the government, and the companies, or a way to purchase toxic assets without the taxpayers taking the majority of the risk.

Methodology

Two methods of research were performed to collect data and valuable information, reviewing professional journals and survey and analyses. Reviewing both academic journals and accounting textbooks provided a strong background about the current economic crisis, government solutions, and also accounting standards. These journals were discovered by using the Knight-Capron Library's online resources, specifically LC OneSearch. Here is where I was able to distinguish the articles that were reliable and professional from the public and general articles. Each article had theories and ideas of how and why the economic crash came and what caused it. Some authors have even proposed solutions to improve the current economy, though they are all theoretical. The most important and useful articles related to the relationship between fair value accounting and the financial crisis. There are two types of articles relating to this topic: those that support fair value accounting and those that believe it is one of the main contributors to the financial crash. Either way the government and Financial Accounting Standards Board (FASB) are working together to find a solution, even if that includes adjusting or re-wording accounting standards.

Banks and Certified Public Accounting Firms (CPA) are only two of many industries that have been affected by the financial crisis. They have been able to see the impact of the changing and updated accounting standards and regulations on their financial statements throughout the years. Because of this, I took a random sample of Certified Public Accounting firms and small regional banks from both Illinois and Virginia to interview. I created an individual questionnaire designed specifically for the banks (Appendix A) and Certified Public Accounting firms (Appendix B). These questionnaires were reviewed and tested by Dr. David Murphy, and then revised multiple times. After the questionnaire was completed and deemed acceptable, I

contacted Chief Executive Officers and Chief Financial Officers of banks, and the partners of Certified Public Accounting firms for interviews. Depending on the CEOs, CFOs, and CPA partners' schedules they either received a questionnaire through email or a phone interview.

Data

Because the interview questions were directly related to my thesis, they have given me the most useful information. Everyone interviewed was entitled to his or her own opinion, and their answers were all extremely biased based on their professional background. All the entities were affected by the current economic crisis, some more than others.

CPA firms and banks have different responsibilities and functions as a business and thus, they have different opinions about the financial crash and how to record toxic assets. CPA firms are in the business of protecting external financial statement users. Their job is to make sure external users are not taken advantage of by public and private institutions. They achieve this by making sure their customers, who are other businesses, follow all of GAAP's requirements. They always have the best interest of financial statement users in mind; this is how they make money. The success of the CPA's firm relies more on reputation than on financial statements. This concept is shown in the interviews; the CPA firms are more concerned with external users and believe that fair market value is the most appropriate way to record toxic assets.

Banks do not agree with CPAs because fair market value negatively affects their current net worth. The banks interviewed and most other corporations attempt to represent their company in the most positive economic position possible, but fair market value shows entities at their current worth whether it is positive or negative. Because the success of banks and other corporations relies on their current net worth and future cash flows, banks were extremely

negative when asked their opinion on fair market value.

The banks interviewed were unwilling to accept any blame for the current financial crisis. The Bank of the James and the American National Bank and Trust both blamed the government and accounting methods, specifically fair value accounting, as one of the main components for the economic crash. "Fair value accounting is one of those things that sounds better in theory than it turns out to be in practice. Especially when the accounting principle is inconsistent with the basic business model of the entity" (W. Tarynham, personal communication, October 2010). They believe that fair value accounting is useful when valuing more liquid assets. However, when it comes to less liquid assets, like loans and land, it does not accurately portray the assets worth, because there is not a secondary market for these types of assets. Secondary market is where previously issued securities and assets are bought and sold among individuals and institutions (Spiceland, 2009). "It depends on the business model and whether there is a real market from which to derive 'fair value' pricing. For us, our loans are typically held for long-term investment and as such should be accounted for at amortized cost. Our bonds are technically available for sale and there is a market for them, therefore, fair value accounting is somewhat doable" (W. Tarynham, personal communication, October 2010). American National Bank even came up with a new accounting principle: Guesstimated. This theory would allow banks to record assets at the greater of fair value or estimated net realizable value. This would allow banks to avoid losses on the balance sheet and the comparability between different banks financial statements would be non-existent because every bank would chose the most beneficial way to record the assets. This valuation method looks out for the best interest of the banks and corporations and fails to consider external users of financial statements. The banks viewed government spending and current national debt as a bigger influence on the economic crisis than

the poor banking decisions and managerial judgment.

American National Bank is strongly opposed of FASB's fair value accounting, so the CFO of American National Bank wrote a letter to FASB (Appendix C) expressing their concern and an alternative accounting method, amortized cost. American National Bank believes that fair market value does not correlate with the purpose of banking. "The proposed default measurement basis for loans is fair value and is fundamentally inconsistent with the basic model for most banks, which is to originate and hold loans until payoff, renewal, or charge off" (W. Tarynham, personal communication, October 2010). American National Bank sees no benefit in using fair value accounting instead the bank sees consequences. American National Bank believes if fair value accounting is continued to be used to value loans, banks will become more restrictive and make it more difficult for borrowers to receive loans. American National Bank also claims that both investors and bank management will make decisions based on inconsistent and unreliable data. "If we as a bank provide basic GAAP financial statements, which purpose is to represent financial position and results of operations, with such ambiguous data as starting point, not only will investors be misled (those few that remain in our sector), but bank management will likely be making decisions and taking actions based on poor quality, subjective data. Our strategic concern is that the proverbial tail (the accounting system) will wag the dog" (W. Tarynham, personal communication, October 2010).

Price Waterhouse, Cherry Beckett & Holland , and Silver Leiner Schwartz & Fertel were the three Certified Public Accounting Firms that were interviewed. Unlike the banks, the accountants do not believe that the fair value accounting method had any influence on the economic crash; rather they see it as the messenger of companies' current financial position based on their financial and investment decisions. The CPA firms believe fair market value is the

most appropriate valuation method for assets because it is the clearest indication of what the company will eventually receive in the time frame of the expected sale. Instead they blame the banks' issuance of loans and securities to unqualified recipients as the main cause of the crash. Banks and management replaced mechanical rules and regulations with judgment, which was influenced by greed, and now the United States of America and the world are suffering the consequences. Because accountants' and auditors' main duty is to protect financial users, such as, investors, by making sure that financial statements are in accordance with generally accepted accounting principles, they believe that recording at fair value is the most accurate and reliable way of recording assets and protecting the best interest of financial statement users.

The banks and Certified Public Accounting firms have different views on what caused the economic crash, and who is at fault and should take the blame. They both agree that the government is unable to come up with a solution to improve the current economy. Both industries believe that the Troubled Asset Relief Program and the Public-Private Investment Program have been ineffective in producing a positive boost to the economy; instead the government has inefficiently used taxpayers' resources. TARP and P-PIP were created for short-term relief, which postpones the problem instead of fixing it.

The main areas the government is trying to focus on are the employment rate, housing market, and national deficit. Unfortunately the government can only have a direct affect on one of these objectives, the national deficit. Based on simple economics, the government can decrease the deficit by controlling state and federal spending. This can be achieved through better budgeting or by cutting back on spending in specific areas; there have been recent cut backs in national defense and educational spending. The government can indirectly affect the employment rate and housing market by encouraging the flow of cash by reducing taxes for both citizens and

businesses. Having more pro-business policies will provide businesses with more available cash for investing and spending. As businesses' spending increases, consumers' confidence will rise and so will their spending. An increase in spending from both businesses and consumers will increase the demand for items and provide more jobs. As the unemployment rate lowers, the standard of living will increase and so will the demand for housing.

Statement of Financial Accounting Concepts (SFAC) 1 and 2

The main purpose of financial statements and financial regulations is to provide financial statement users with information useful for decision making, information that is helpful in predicting cash flows, and information about economic resources, claims to resources, and changes in resources and claims (SFAC 1). The objectives of financial reporting stated by FASB's SFAC 1 are:

Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have reasonable understanding of business and economic activities and are willing to study then information with reasonable diligence

Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities of loans. Since investors' and creditors cash flows are related to enterprise cash flows, financial reporting should provide information to help investors, creditors, and others assess the cash inflows to the related enterprise.

Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources) to other entities and events, and circumstances that change its resources and claims to those resources (p. 1).

External users of financial statements include investors, creditors, employees, customers and suppliers, government regulatory agencies, and financial intermediaries. To make sure the

best interests of financial statement users are protected the Securities and Exchange Commission (SEC) was created. "The SEC has the authority to set accounting standards for companies, but has delegated the task to the private sector" (Spiceland, 2009, p.9). Though the SEC have passed their responsibility they still control the power to change and remove standards they do not agree with. Financial Accounting Standards Board (FASB) is under direct control of SEC. FASB has taken the responsibility of setting accounting standards in the United States.

The main objective of financial statements is to provide valuable information for decision makers; SFAC 2 helps achieve this by providing an outline of necessary qualitative characteristics of accounting information (Appendix D). The main focus is on understandability and decision usefulness. Understandability refers to the information being provided must be comprehensible to users, "who have a reasonable understanding of business and economic activities and are willing to study the information." Decision usefulness means the information must be useful for making decisions that require investors' resources. To be useful, accounting information has to be relevant and reliable, which are the primary qualitative characteristics of accounting information. Reliable information is useless if it is not relevant to the decision being made. Relevant information is meaningless if it cannot be relied on (Spiceland, 2009).

Relevance is made of three major components: predictive value, feedback value, and timeliness. Predictive and feedback value provides confirmation of "Investors expectations about future cash-generating ability," (Spiceland, 2009, p.22). The SEC requirement of financial statement information being available quarterly and annually allows information to be timely, meaning the information is available before decisions are made. Reliability consists of information that is verifiable, representationally faithful, and neutral. Verifiability refers to the "consensus" among different measurers; the costs can be traced to any transaction.

“Representational faithfulness exists when there is an agreement between a measure or description and the phenomenon it purports to represent,” (Spiceland, 2009, p.24). Information being reported and relied on by external users must be neutral; no particular group is being favored. Companies must refrain from attempting to represent their company in the most positive position, they must show the company's current financial status, whether is good or bad.

Secondary qualitative characteristics that influence decision usefulness are comparability and consistency. Comparability allows financial statement users to have the ability to see stability or changes in assets' and liabilities' values throughout different companies and over different periods of time. Consistency helps users evaluate information of companies overtime, using the same accounting principles helps satisfy this objective. If a company changes to a different accounting principle this supplement information must be disclosed. Based on the full disclosure principle, this information must be included. The full disclosure principle means that financial statements must include any information that could influence decisions made by external users (Spiceland, 2009). “Supplement information is disclosed in a variety of ways including: 1) parenthetical comments or modifying comments 2) disclosure notes 3) supplemental financial statement” (Spiceland, 2009, p.31).

Two major constraints that can prevent these qualitative characteristics from being effective are cost effectiveness and conservatism (Spiceland, 2009). Costs of providing financial information are gathering, processing, and distributing the data. “Information is cost effective only if the perceived benefit of increased decision usefulness exceeds the anticipated costs of providing that information,” (Spiceland, 2009, p.25). Conservatism attempts to consider all risks and uncertainties in business situations. “Conservatism is not an desirable characteristic nor is it an accounting principle,” (Spiceland, 2009, p.26). An example of conservatism demonstrated in

accounting is the concept of recording perceived losses but not recording gains until they are realized or virtually certain to exist.

Historical Costs and Fair Market Value

With the current financial condition the dispute about which financial valuation method is the most relevant and reliable has come down to historical cost, one of the oldest and most used accounting methods, and fair market value, the newer and believed future of accounting.

Historical cost is one of the most used accounting valuation methods. Historical cost measures assets and liabilities based on their original transaction value, meaning the assets and liabilities are based on the amounts given or received in the exchange transaction (Spiceland, 2009). International Accounting Standards Board (IASB) defines historical cost as: "In case of assets, the historical cost delimits the amount in cash equivalents of cash paid at while buying them the moment of their buying or the proper (correct) value of the paid amount while buying. In case of the debits, the historical cost represents the value of equivalents gotten by the exchange of obligations or in certain circumstance, the value that is expected to be paid in cash or equivalents of cash in order to put eliminate the debits, while doing business accordingly. The historical cost is the consequences of this fundamental principle: the principle of the nominal monetary and the principle of prudence" (Jianu & Jianu, 2009, p.188).

One of the alternatives to recording toxic assets is fair market value. Recently FASB has attempted to redefine and explain fair market in an attempt to make it easier to apply. Fair market value used to be defined, as "the price for which property would exchange between willing buyer and a willing seller, each having reasonable knowledge of all relevant facts, neither under compulsion to buy or sell and with equity to both" (King, 2009, p.22). In 2006 SFAS 157 was

issued and redefined fair market value as “the price that would be received to sell an asset or paid to transfer a liability, in a orderly transaction between market participants at the measurement date” (p.8301). This definition focuses on four major components: the exit price, the market-based measurement, the hypothetical and orderly transactions, and the measurement date.

Exit price refers to the money paid or received at the time of sale, not the carrying value or amount originally paid for the asset, which is the entry price. Fair market value is a market-based measurement, the existing demand for an asset in the current market economy determines the value of the asset; the entity and management do not get to decide the worth of an asset or liability. Hypothetical and orderly transaction refers to the fair value measurement as how much the asset or liability “would be” if it was sold in the current market. This is not the same as force-liquidation (companies' claiming bankruptcy and selling their assets quickly to receive cash). Finally the most controversial aspect of fair market value is the measurement date. Fair market value is recorded as of the measurement date, regardless of the condition of the market. The entry price of an asset has no influence on the assets' current worth. Fair market value recognizes that the economy will never be completely stable (Jianu & Jianu, 2009). Depending on the market, the assets' values can fluctuate. “FASB's SFAS 157 also provides a hierarchy of valuation techniques to be used to measure fair value” (Cheng, 2009, p. 2): Level 1, Level 2, Level 3. In 2008, in response to the financial crisis, FASB came out with FSP FAS 157-3 “Determining the Fair Value of Financial Asset When the Market of that Asset is Not Active.” FSP FAS 157-3 provides how and when to measure assets in an inactive market. “In an inactive market, a reporting entity may determine that observable market inputs (Level 2) require significant adjustment, and, thus, it would be more appropriate to use unobservable inputs (Level 3) in estimating fair value” (FASB, 2006, p.8318). Measuring Level 3 assets and liabilities allows

entities more discretion when determining fair market value. In 2009 FASB finished adjusting fair value with one last additional piece of information, FSP FAS 157-4. "FSP FAS 157-4 was created to help accountants determine if a market is inactive, if transactions are not orderly, and how to measure fair value in inactive and transitions are not orderly" (Cheng, 2009, p.2).

Historical Cost vs. Fair Market Value: The Superior Method

There is no obvious or superior way to evaluate toxic assets. Both historical cost and fair market value have advantages and disadvantages. The accounting method that protects the best interest of external users and satisfies the majority of the qualitative characteristics of accounting information should be used not only to record toxic assets but should be continually used as the primary accounting valuation method.

Historical cost became popular in the nineteenth century, but has origins in the fifteenth century (Jianu & Jianu, 2009). The reason this valuation method has remained popular over the years is because of its understandable, verifiable, and reliable information. Historical cost is regarded as a simplicit valuation method. It is recorded at the purchasing price of the asset or liability, known as day of entry. Historical cost records the real value of an item at the date of entry (the day it is purchased); there are no estimations or unknowns. Financial statement users easily understand this concept. There are few to none necessary calculations, just basic numbers. Historical cost is past oriented; this allows the information provided to be fixed and also verifiable (Jianu & Jianu, 2009). Once an asset or liability is recorded at historical cost it remains fixed as long as it stays in the possession of the current owner. Historical cost's fixed value emphasis the simplicity of historical cost because the values of the assets and liabilities do not change until they are sold. Because historical cost is recorded at the entry price, the transaction

already occurred and there are recorded documents that exist and prove property rights; these documents support the recorded costs. Historical cost is highly verifiable because it is a past oriented valuation method, which the recorded costs can be traced to supporting documents, such as invoices or purchasing orders. Historical costs' verifiability allows it to be objective because it offers certified documents as support, which serves as evidence for financial statement users (Jianu & Jianu, 2009).

Historical cost is neutral because it is based on official documents that cannot be adjusted to benefit the entity. There is no judgment necessary when determining historical cost, allowing it to be unbiased. An important external factor for valuation accounting is cost. The cost of valuating assets and/or liabilities is based on how much time and effort was necessary to determine the value. Because the values used for historical cost has already been recorded in documents, there are no necessary computations to determine the value; so, the cost is almost non-existent. These advantages satisfy the components of reliability. Because historical cost is verifiable, representational, and neutral external users can rely on the information being provided.

The historical cost seems to have desirable advantages but it also has multiple weaknesses pertaining to the concept of relevance. The simplicity of historical cost has its drawbacks. Comparability is a key concept of qualitative factors of financial accounting. Comparability is the ability to compare similar assets and liabilities over time and also between entities. Historical cost hinders financial statement users the ability to do this because historical cost is recorded at entry price and is not adjusted; the values recognized are on different days so, similar assets and liabilities will have different values depending on when they were purchased.

Because historical cost is past-oriented, recorded at entry price, it provides financial statement users little valuable information when making investment decisions based on a company's current net worth. Information provided by financial statements is supposed to represent past, current, and future cash flows based on decisions made by management. Historical cost only provides information based on the past; it provides no predictive value or feedback value. Another consequence of past-oriented valuation methods is that assets and liabilities recorded under historical cost show no relation with the current market and economy, which makes the values provided unrealistic.

The monetary unit assumption is one of four assumptions underlying GAAP. The monetary unit assumption assumes that the United States dollar will be stable over time. "That is, the value of the dollar, in terms of its ability to purchase certain goods and services, is constant over time" (Spiceland, 2009, p.29). Based on this assumption historical cost would be appropriate in valuing toxic assets because the value of specific assets would not change from the entry price. However, this assumption is not reliable because it ignores value fluctuations, inflation. If the value of the United States dollar decreases, the information recorded in historical cost is not realistic.

A major misconception about fair value is the belief that it is a new accounting valuation. There have been new guidelines for measuring, recording, and disclosing fair value, specifically in illiquid markets, but fair market value is not a new or experimental valuation method. It appears in all financial statements along with historical cost, there are mixtures of both. There are over 40 instances in GAAP where fair market value is required when recording assets and liabilities (Spiceland, 2009). Fair market value is required when trading securities and securities available for sale; investment in stocks and bonds and also note receivables and note payables are

all recorded in fair market value. Though some assets and liabilities are required to be recorded in fair market value, SFAS No. 159 gives companies the option of reporting some or all of its financial assets and liabilities at fair value. Many accountants refer to fair market value as “the accounting valuation of the future.” They are confident in all of the advantages that fair market value has to offer, and accountants want to see it replace historical cost. Supporters of fair market value argument that “knowing the ‘truth’ is better than disguising things simply to look better” is hard to oppose (Diana, 2009).

Fair market value is not fixed; the values of assets and liabilities adjust depending on the market, the information provided is comparable. Fair market value promotes comparisons of assets and their values in both time and between entities. All similar assets and liabilities will be represented by the market value rather than the purchase prices. Values of assets and liabilities change overtime depending on demand, whether the values increase or decrease; they are depicted through fair market value. Because the values are adjusted over time the similar assets are comparable throughout time and between companies because the worth depends on market value, not purchase price. Fair market value also considers the changing value of the United States dollar. Because fair market value is based on market values, inflation is considered when recording assets and liabilities. Fair market value’s adjusting values and comparability provides investors with more visibility of financial statements, meaning it provides more detailed information of the current nature of the economy and how it affects specific investments and industries; it shows the relationship between the two.

Fair market value is considered to be relevant based on its main qualitative characteristics. “Relevance reflects the usefulness of accounting information, and assist users in assessing the events past, present, and future” (Jianu & Jianu, 2009, p.189). Fair market value

reflects the current value of transactions made by entities allowing users to decipher whether the entity has been making quality and smart decisions and investments, which will make both the entity and the investors more money. Fair market value shows the present value of past transactions that will help predict the future value and performance of the entity. Fair market value provides financial statement users relevant information for decision-making.

Fair market value recognizes that the economy is not always stable, it recognizes this and provides options when recording assets and liabilities: level 1, level 2, level 3. This makes fair market value more flexible because it takes into account the nature of the economy. Unlike historical cost, fair market value does not have the constraint of conservatism. Whether the market is strong or weak, the current status of the economy is represented in the values of the assets and liabilities, this provides more valuable information and numbers for decision making, because it shows the value of the entity at that specific moment. Fair market value is considered to be unbiased, though not as neutral as historical cost, fair market value is still objective. It does require some estimates but fair value relies mostly on the changes in the economy. Any estimates required to form current assets' and liabilities' values must be described and recorded in the financial statement disclosures.

Fair market value seems very appealing to both accountants and financial statement users, but like all accounting valuation methods, it has some drawbacks. Because fair market value is not based off a fixed or documented value, it lacks verifiability. Appraisers may all have similar assessments but the values can still vary. When determining the value of assets and liabilities occasionally estimates are required, because fair value does not have a precise or exact figure amount. Because fair value requires professional judgment the credibility and neutrality of the information provided can be questioned. Since fair market value requires some estimates and

judgment and has no fixed or designated values, it lacks simplicity and understandability. Some necessary computations must be considered when recording at fair market value, which requires a lot of disclosures. Computations and disclosures may be confusing to financial statement users. One of the major constraints of fair market value is the cost of constantly re-evaluating and assessing the changing values of assets and liabilities. Fair market value takes more time and energy to reach values than historical cost.

IASB

Today companies are competing in a global economy. While this allows the potential market of consumers for their products to be larger it also brings in more competitors. Because more international transactions and investors are now involved, there has been a push for international financial reporting standards; that will be in charge of setting accounting standards making all international companies' financial statements to be the same. This allows financial statement users to be able to compare financial statements more accurately. The international Accounting Standard Committee (IASC) was formed in 1973 to establish global accounting standards. In 2001 IASC formed the International Accounting Standards Board (IASB). IASB has two main objectives “(1) to develop a single set of high quality, understandable, and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements, and (2) to cooperate with national accounting standard-setters to achieve convergence in accounting standards around the world” (Spiceland, 2009, p.14). In 2007, over 100 jurisdictions require or permit the use of IFRS (Spiceland, 2009). Most developed European nations have already adjusted and changed to International Financial Reporting Standards (IFRS), while the United States has still yet to make the conversion.

Developed countries that have already converted to IFRS are pushing for the United States to accept IFRS, and there is a prediction by 2013 the United States will. In 2002 FASB and IASB signed the Norwalk Agreement, establishing FASB's commitment to converge GAAP and IFRS. Under the Norwalk Agreement, the boards agreed to remove existing differences between the two standards and to coordinate future standard-setting agendas so major issues are solved by working together (Spiceland, 2009). FASB's Generally Accepted Accounting Principles and the International Accounting Standards Board's IFRS have multiple differences. The most noticeable is IFRS' large emphasis on fair market value and other forms of current value methods when assessing the financial position and performance of entities (Jianu, 2009).

Conclusion

Academic articles and interviews with banks and Certified Public Accounting (CPA) firms have shown that there is not one superior method in valuing either assets or toxic assets. Arguments will continue on which method is more accurate, and the accounting firms and banking industries will always be in disagreement over the best way of recording assets. Accounting firms believe that it is more representative for assets to be recorded at their current market price; they believe this more accurately reflects companies' current financial status and is more relevant and fair for financial users, such as investors. On the other hand banks do not agree; they do not believe that all assets should be recorded at fair value, because the difference between liquidity and the date of planned sale. If a bank does not plan to sell an asset in the current market the banks do not believe they should have to record it at market value, rather the assets should be recorded at historical cost.

When taking into consideration different entities' opinions on valuation methods, we

must recognize any underlying motive or benefit they may receive with different methods, making them biased. Banks' future earnings and investors are based on current net worth, and with fair market value their financial statements show a lower worth than with historical cost. Because historical cost represents the banks in a more positive economic position, this may explain why banks are so supportive of historical cost over fair market value. CPA firms main objective is to make sure customers are following all the requirements of GAAP, and this includes protecting the best interest of external users by providing them with relevant and reliable information.

The purpose of having financial statements is to provide external users with reliable and relevant information useful for decision making, as stated in SFAC 1. SFAC 1 also states that financial statements must provide information that is predictive of cash flow and information pertaining to economic claims to resources and changes in those claims. External users consist of investors, creditors, employees, customers, supplies, labor unions, and government regulatory agencies. These users all rely on financial information provided by entities to make decisions using their own resources. SFAC 2 provides a descriptive outline of qualitative characteristics that financial statements must have to be effective and useful for external users. The SEC and FASB must work together to determine the superior valuation method that protects the best interest of the external users. The accounting method that contains the most of these qualities and satisfies all the necessities of SFAC 1, is the preferred accounting method for valuating toxic assets. Historical cost and fair market value are the two valuation methods that are being considered. Both historical cost and fair market value have advantages and disadvantages when recording toxic assets.

Historical cost is past-oriented; this characteristic allows the information provided to be

understandable, verifiable, and reliable. Historical cost is recorded at the entry price and remains fixed until the ownership of the assets and liabilities is transferred. Because of this, no estimates or formulas are required to value the assets, the values are recorded on supportive documents, which also makes the values verifiable. Because the worth of the assets and liabilities are recorded on supportive documentations, the managers cannot make adjustments to the worth to show bias earnings, meaning the information is neutral.

Fair market value's adjusting values provides external users with comparable, visible, and relevant information. Under fair market value assets and liabilities are represented by market value, which is determined by demand. Similar assets and liabilities owned by different institutions will all be recorded at the same value. This allows users to compare financial statements between institutions and make well-informed evaluations and decisions. Since the value of assets and liabilities adjust overtime, investors can see correlations between specific assets and liabilities and the current economy, providing visibility of financial statements.

Both accounting valuation methods have advantages, but it is their disadvantages that set them apart. Though historical cost's past orientation is a benefit it is also a major downfall. Historical cost is too conservative and does not provide users with feedback or predictive values, based on managerial decisions and investments. Investors are interested in the current and future performance of a company, and historical cost only provides the past.

Fair market value's adjusting worth lacks verifiability, simplicity, and complete neutrality. But even with these disadvantages, fair market value is more supportive of financial statement users than historical cost because it satisfies both SFAC 1 and more of FASB's qualitative financial accounting characteristics. By providing adjusting values of assets and liabilities throughout the year, fair market value represents the current value of entities based on

the nature of the economy. Recording assets and liabilities at current market price makes the information more comparable; users can evaluate assets and liabilities over time or between companies. The values recorded are transparent, allowing investors and other financial statement users to recognize the relationship between the economy's current condition and certain assets. Financial statement users are not concerned about the cost of assets or liabilities; they are more interested in the current and future value, and fair market value does this. Fair market value is the best option of recording toxic assets because it provides financial statement users with both relevant and reliable information.

“Appendix A”

Bank Interview Questions

1. How has your business been affected by the market crash?
2. What valuation method did you use for mortgaged backed securities and loans, before the crash?
 - A. What valuation method are you using now? (are you still using the same method?)
3. Do you think that valuation methods had an influence on the economic crash?
 - A. Did it make the financial crisis worst?
4. Do you think that assets should be recorded at net realizable value, fair value, or at cost? Why?
5. How are you currently recording toxic assets?
6. What effect does toxic assets have on your balance sheet?
7. What do you think is the best and fairest way in recording toxic assets?
8. Do you have any level 3 assets?
 - A. What do you have?
 - B. Have you had a large increase in level 3 assets, since the crash?
9. How have you decided to value level 3 assets when using marking to model?
10. Do you believe Tarp and P-Pip has had a positive affect on the economy? (Do you think it will work?)
 - A. What part do you find most attractive?
 - B. What part would you change?
11. Have FASB's additional rules and procedures on valuation (FSP FAS 157-e, FSP FAS 115-a and FAS 124-a, FSP FAS 157-4) had an affect on your balance sheet and toxic assets?
 - A. What did it do?

12. Do you believe that nationalization of banks would be a better solution?
13. What do you think is necessary to improve the United States economy?

“Appendix B”

Accounting Firm Questions

1. How has your business been affected by the market crash?
2. What is the most common valuation method for mortgage backed securities and loans, in the firms you audit?
3. Have you noticed a drastic change in valuation methods since the economic downturn?
4. Do you think valuation methods had an influence on the economic crash?
 - A. Did it make it worst?
5. What do you think is the best way to record toxic assets?
6. Do you think that assets should be recorded at net realizable value, fair value, or at cost? Why?
7. What do you think is the best and fairest way in recording toxic assets?
8. Do you think it was necessary for FASB to adjust valuation rules?
 - A. Do you think this made it easier to implement and understand fair value?
9. Have you noticed a large increase in level 3 assets, since the crash?
 - A. How are they valuated?
10. Do you believe Tarp and P-Pip has had a positive effect on the economy? (Do you think it will work?)
 - A. What part do you find most attractive?
 - B. What part would you change?
11. What do you think is necessary to improve the United States economy?

“Appendix C”



AMERICAN NATIONAL

Your Relationship Bank

June 10, 2010

Director
Financial Accounting Standards Board
401 Merrit 7
PO Box 5116
Norwalk, CT 06856-5116

Re: Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities, issued May 26, 2010

To the Director and Board Members:

We are a financially healthy, 100 year old, publicly traded community bank located in Virginia, with over \$800 million in assets, 18 branches, and over 200 employees. We believe that the purpose of external financial reporting is to provide the public and investors an accurate, timely and understandable report on the actual financial position and operations and cash flows of our business enterprise, in conformity with all relevant GAAP and regulatory requirements, from which well informed investment decision may be made.

We commend the Board on its desire “to provide financial statement users a more timely and representative depiction of an entity’s involvement in financial instruments, while reducing the complexity in accounting for these instruments.”

However, we respectfully wish to register strong disagreement with much of the recent exposure draft on *Accounting for Financial Instruments*, issued May 26, 2010.

We believe that the measurement basis for financial instruments should be determined by, first, the operative strategy of the business entity and, second, by the presence or absence of *robust and viable market for the financial instruments*. This is basically consistent with the current FAS 115 guidance applied to held –to-maturity, available-for-sale, and trading bond portfolios.

The proposed default measurement basis for loans is fair value and is fundamentally inconsistent with the basic business model for most banks, which is to originate and hold loans until payoff, renewal or charge off. There is no material benefit that we can see to fair value accounting for what is, in effect, our finished inventory, loans held for investment. A bank “manufactures” and sell loans to its customers, not unlike any other manufacturer. We recognize the fact that our “manufacturing” creates a financial instrument, but the most likely, albeit unintended, consequence of implementation of fair value accounting for loans is that banks will become more restrictive in their lending and offer fewer options to their customers, in order to minimize the fair value volatility of their loan portfolios. That volatility will be directly impacting net income or comprehensive net income under these new requirements.

For most plain vanilla loans, there is not a viable marketplace from which to derive benchmark prices for generic categories of loans. We cannot price our loans as quickly, efficiently or as reliably as we do our bonds. Consequently, loan fair value amounts will be at best ambiguous and at worst misleading. The auditors will probably want to term this Level 3- pricing.

If we as a bank provide basic GAAP financial statements, which purport to represent financial position and results of operations, with such ambiguous data as a starting point, not only will investors be misled (those few that remain in our sector), but bank management will likely be making decisions and taking actions based on poor quality, subjective data. *Our strategic concern is that the proverbial tail (the accounting system) will wag the dog (the bank).*

Amortized cost is not perfect, but it does provide an objectively verifiable and, importantly, understandable basis from which to account for loans. The exposure draft acknowledges, indirectly, exactly that in paragraph 34 in the discussion on *Investments That Can Be Redeemed Only for a Specific Amount*. That section is discussing FHLB and Federal Reserve stock, but the key points are – there is no readily determinable market value and they are not held for capital appreciation. **Those two factors are the same for plain vanilla loans as for investments without readily determinable market value.**

A good argument can be made that bank core deposits have a value, a core deposit intangible, beyond the nominal dollars reflected in our customers' accounts. However, this discussion is more relevant in the context of accounting for intangible assets than fair value of financial instruments. Further, the exposure draft creates a present value formula for this intangible based on a new concept, an “all-in-cost-to-service rate”, which netted against an alternative 3 funding rate, and combined with an estimated implied maturity for non-maturity core deposits determines the amount. This approach contributes mightily to further obfuscation, subjectivity and complexity of our financial reporting.

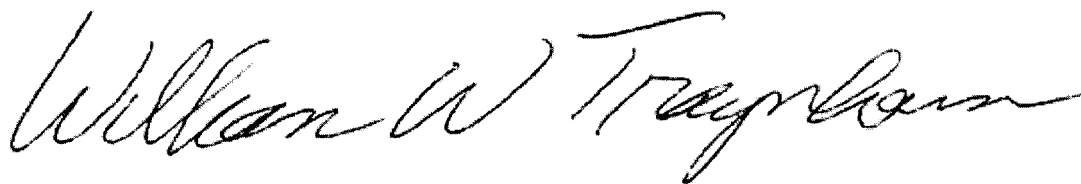
We object to interest income being computed based on historical cost less allowance for credit losses. This will make it very difficult for us to evaluate yields on different generic categories of loans.

Having any dollar excess of the contractual interest on loans over the GAAP based interest become, effectively, part of the loan loss allowance is imaginative, but further adds to the complexity of our financial reporting.

The proposed requirements for the Allowance for Credit Losses, accounting by class and by pool versus individually assessed loans, represent a quantum increase in complexity with little to no discernible benefit. This level of granularity will be extremely difficult for most community banks to provide and will require significant resources to accomplish.

Banking is already a very transparent industry. Our financial information is readily available from the SEC and FDIC and from our own web sites. To the extent we can keep subjectivity to a minimum in our financial reporting, investors and the industry will be well served.

The operational complexities inherent in these proposals are implicitly recognized in the four year deferral for "small" non-public companies. However, much of the deferral "benefit" from being "small" is rendered moot by the "non-public" modifier. In truth, this exposure draft, if approved, will require massive changes in bank core information operational systems throughout the country. The tremendous resources needed to accomplish this will dwarf the nominal, and arguable, value of the new information derived, thereby flunking the cost / benefit criteria of most sound decision making and failing one of the Exposure Draft's primary goals: reducing the complexity of accounting for financial instruments.

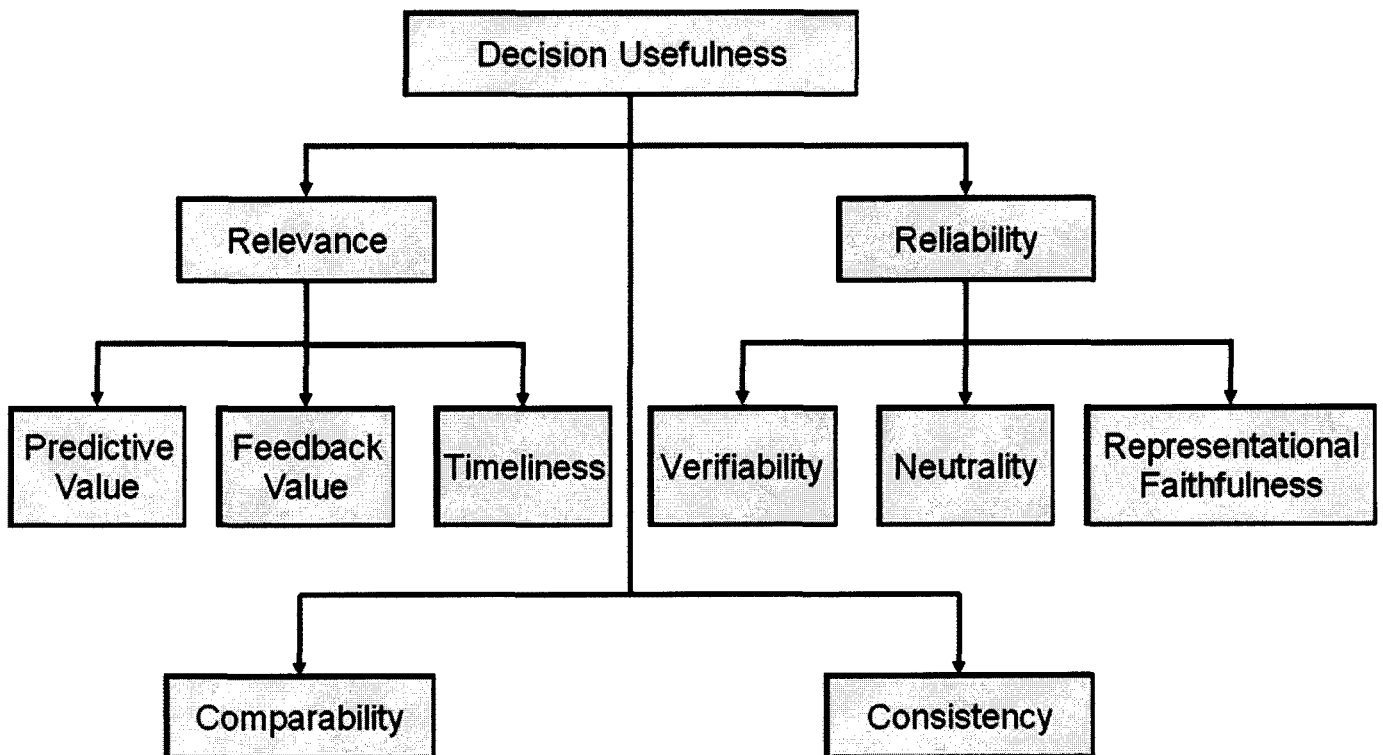
A handwritten signature in black ink, reading "William W. Traynham". The signature is fluid and cursive, with the first name "William" and last name "Traynham" clearly legible.

William W. Traynham, CPA
Chief Financial Officer
American National Bankshares, Inc. and American National Bank & Trust Company

“Appendix D”

Chart 1:

Qualitative Characteristics of Accounting Information



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