Transparency and Liability Valuation

by Philip E. Heckman

The most notable thing about the current crisis in the financial markets is the nature of the instruments that caused the trouble. The subprime mortgage debacle would have been bad enough by itself, but it has been aggravated out of all proportion by marketing of mortgage obligations as CDOs, sliced and diced in backroom chop shops, blessed by the laying on of hands by the rating agencies and sold over the counter to the unsuspecting. In fact the regulation of these instruments was strictly hands-off. Similar things can be said of the rogue portfolio of credit default swaps that brought about the near-collapse of AIG. The common thread here is that all these factors conspire to confound scrutiny and to frustrate attempts to trace obligations back to the originators, in a word, to undermine *transparency*.

Supposedly the regulatory vacuum surrounding these instruments, imposed by law in the case of CDSs, was intended to permit the "free" market to work its magic without interference. Here we are led to draw a distinction between "wild" markets and "free" markets. A wild market is unregulated and unscrutinized. Information flows are purposely impeded for competitive reasons and reduced to trickles from rumor and espionage. No one knows what anyone else is doing, and pricing is blind and haphazard. In such a market, there are no safeguards against anticompetitive behavior and no guarantees that the market will clear. The only guarantee is that there *will* be liquidity crises.

When economists claim almost mystical advantages for "free" markets, are they talking about the wild markets described above? Hardly. All the *empirical* evidence for the virtues of free markets, market efficiency foremost, comes from exchanges. Only exchanges produce the quantitative data needed to support such conclusions. Only markets where transactions and valuations are disclosed timely and accurately can enjoy the advantages claimed for the free market. *There is no efficiency without transparency.*

So what does all this have to do with accounting standards for liability valuation? Although many think of them only as a source of operating costs, financial accounting standards are intended as a means of conveying timely, accurate and relevant information to the investment markets. The fair value initiative was put forward by FASB and IASB in order to advance this goal. Does it have a prospect of succeeding? The current outcry against fair value mark-to-market accounting in the banking community concerns mainly the valuing of assets with impaired liquidity, for which market values are unknown or erratic. (As an aside, before we talk about liabilities, I suggest that this outcry, arising from the subprime crisis, would have been nipped in the bud and confined to a narrow sector if only CDOs were traded on exchanges.) Apart from problems with asset volatility, liabilities add a whole new layer of confusion to the fair value puzzle, which so far has attracted little notice.

The central concept of fair value is to record values for assets and liabilities which are as close as possible to the values these instruments would have in an open market, supposing one existed. IASB and FASB (abetted by some in the financial economic community) recognize no difference in the valuation bases for assets and liabilities: liabilities are recorded at the current market price payable by the beneficiary of the contract. This has perverse consequences. For instance, a company can reap profits from a credit downgrade, which leaves it free to write down its liabilities because it is now less likely that it will be able to honor them. A dramatic instance is provided by Radian Group in first quarter 2008, where a $215 million loss was turned into a $195 million profit. (David Reilly, The *Wall Street Journal*, May 19, 2008, p. C12.) Radian made full disclosure of this oddity, but it was under no legal or regulatory obligation to do so. Other companies enjoying similar windfalls might be less forthcoming.

This opacity in the accounting for liabilities did not begin with fair value but is as old as the discipline of accounting itself. In accounting for debt, it has always been the custom to record the proceeds of the loan as the initial liability and to amortize on a fixed schedule using the implied interest rate. The change introduced by fair value is to take

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account of changes in market interest rates by revaluing the liability and running the changes through income. This is precisely what produced the Radian anomaly and drew attention to the defects of the entire scheme of accounting for liabilities.

In point of fact, the accounting discipline has produced an alternative. Professors Chasteen and Ransom of Oklahoma State University propose a revolutionary schema (*Accounting Horizons*, July 2007) for rationalizing the accounting for liabilities. Their approach rests on the realization that the insolvency put (the value of the corporate owners' immunity from recourse in the event of default), is a benefit directly to the owners and not to the enterprise itself. In the case of obligations certain as to amount and timing, they propose recording the liability at the appropriate risk-free rate. The difference between this value and the actual proceeds (the share of the insolvency put pertaining to the liability) would then be recorded as a direct charge against equity. Future changes in valuation due to changes in the risk-free rate would be taken through income, while the effect of changes in credit standing would be charged directly against equity. This approach would lead to a balance sheet transparent as to the enterprise's actual financial obligations and would provide directly useful information to the capital markets. Further, it would conform to the going concern assumption of financial accounting, since it assumes that the enterprise will, in fact, honor its obligations.

Does the going concern assumption cut both ways? There has been considerable anguish over the fair value requirement to record assets at current market value regardless of whether the market is functioning properly or not. It seems that an enterprise accounted for as a going concern should be able to record assets with reasonably well known future cash flows discounted at rates which exclude illiquidity penalties. I do not know of a widely accepted analytical approach for filtering out the effects of illiquidity on market prices. If one exists, now is the time to dust it off; else, now is the time to invent one.

As I noted above, the financial accounting system is intended to enhance transparency in the financial markets. The fair value reform was intended to further this goal. In its present state, it does not. "Mark to market" assumes that, if liabilities were traded, assets and liabilities would trade in the same market. They would not. Liabilities would trade in a market where the price is determined by adding the cost of surety (the insolvency put again) to the asset price. The current formulation of fair value is too simplistic by half, and the result is not transparency but opacity. It will not serve its purpose until accounting for liabilities is rationalized and means are provided for dealing with market pathologies.

When someone extols the virtues of "free markets," listen carefully to discern whether he is advocating disciplined, efficient, transparent and orderly markets or whether he is making a sly appeal for laissez-faire where opacity rules, anything goes, ample scope is provided for deeds done in darkness, and epic train wrecks are inevitable. We should heed the lesson of *Blazing Saddles*: when there's no marshal in town, the bad guys take over.

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