GAO

United States
General Accounting Office
Washington, D.C. 20548

Accounting and Financial
Management Division

May 20, 1991

Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Dear Sir:

SUBJECT: File Reference No. 098-E

The United States General Accounting Office (GAO) has reviewed the exposure draft on Disclosures About Market Value of Financial Instruments. We are pleased to have this opportunity to provide comments on the draft.

The GAO supports the adoption of this exposure draft as a Statement of Financial Accounting Standards. We believe it is essential that financial statement users be adequately informed of the current market value of all of an entity's financial instruments. Market value information is needed in order to (1) assess the overall financial condition of the entity, (2) assess management's performance with regard to those financial instruments, and (3) arrive at conclusions necessary for decision-making.

We have a particular interest in market value information with regard to financial institutions. The GAO has been studying the issues surrounding the need for market value information from financial institutions. The continuing crisis in the savings and loan industry and the growing problem of insolvency within the banking industry would have been more readily apparent had market values been disclosed for all financial instruments. We have also been reviewing a related issue regarding the application by financial institutions of the requirements of FAS 5 and FAS 15 in the valuation of non-performing loans and repossessed collateral. The use of historical cost to value debt securities and loans, especially non-performing loans, held by banks and thrifts has been one of the leading factors in masking the need for earlier intervention to save failing financial institutions.

In September 1990, the Comptroller General testified before the Senate Committee on Banking, Housing, and Urban Affairs on the reforms that are needed to strengthen the Federal Deposit Insurance Corporation's Bank Insurance Fund. He stated that current financial reports, prepared in accordance with generally accepted accounting principles, do not always reflect a financial institution's true condition. He said that GAO is concerned that accounting principles allow bank management too much discretion in recognizing and determining loss amounts reported in financial statements.

In that same testimony, the Comptroller General stated that there is a problem with the definition of fair market value used in determining the amount of loss to be recognized by financial institutions on an asset writedown. The current definition assumes that the asset can be held until market conditions are good and that the seller has a good bargaining position. This frequently results in higher fair market values than are justifiable in the circumstances.

These concerns were further highlighted in a GAO report entitled Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26) issued in March 1991. In that report, we stated that the accounting profession and the appropriate regulatory agencies should promptly consider amending accounting rules to require banks to record losses when occurrence of loss is likely (more than 50-percent chance) rather than probable, which is currently being defined as virtually certain. They should also require banks to value underlying collateral on the basis of existing market conditions.

In April of this year, GAO issued another report entitled Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43). We analyzed the financial reports and bank examination reports for 39 banks that failed in 1988 and 1989 to identify the impact of accounting and internal control weaknesses on those failures, and to identify the need for reform to minimize future losses. In this report, we provided the evidence that current accounting principles did not provide advance warning of the true magnitude of deterioration in the financial condition of these banks. As a result, we have recommended that accounting principles be changed so that losses for problem loans be taken if considered to be more likely than not, rather than probable. We have also recommended that the definition and determination of fair market value be changed to reflect the effect of existing market conditions. The report also expresses our support for this exposure draft as a method to enable financial statement users to make better judgments about the true financial condition of banks.

We believe the adoption of this exposure draft is a step in the right direction. We encourage the Board to move quickly to address the difficult issues associated with recognition, measurement, and valuation of all financial instruments. In the meantime, we are encouraged that the Board has added an agenda project addressing loan loss recognition. We believe the rapid resolution of these issues is vitally important for the users of financial statements.

We believe the final statement could be clarified and improved by making some changes to the exposure draft. These changes may help avoid misunderstandings and provide additional guidance to preparers. Our specific comments and suggestions are provided in the enclosure.

We hope that our comments will be helpful. If there are any questions relating to our response, you may contact Ms. JoEllen McCormack at (202) 275-9525.

Sincerely yours,

Donald H. Chapin

Donald H. Chapin
Assistant Comptroller General

Enclosure

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ENCLOSURE

COMMENTS ON DISCLOSURES ABOUT MARKET VALUE OF FINANCIAL INSTRUMENTS

DEFINITION OF MARKET VALUE

We believe the definition of "market value" as given in paragraph 5 of the exposure draft should be clarified. We are concerned that preparers and users often place the emphasis in this definition on the later part, i.e. willing buyer/seller in other than a forced or liquidation sale. Not enough emphasis has been placed on the first part - current transaction. This incorrect emphasis often allows use of future projections that are unrealistic.

We propose expanding paragraph 5 to explain that the emphasis is on "current transaction" based on existing market conditions and that the later part of the definition is included to avoid the use of isolated market aberrations from the determination of market value. Thinness of market trading and economic recessions should not be considered as isolated market aberrations.

OPTIONS ALLOWED FOR ESTIMATION OF MARKET VALUE

Paragraph 9 of the exposure draft allows for the use of several methods of estimation of market value that have been developed in other GAAP literature as listed in Appendix A of the draft. The amounts computed for market value under those requirements are to be acceptable for the purposes of the proposed statement.

We realize that the guidance provided for the determination of market value in this draft is much more specific than that given in the previous exposure draft on this issue. Nevertheless, the proposed standard is still very broad in this regard. While we do not recommend a change in the draft at this time, we encourage the Board to monitor comparability of disclosures after this statement takes effect. Experience may prove that more specific guidance is needed. If a problem is indicated, then the Board could consider adding an agenda project to provide more specific guidance for estimating market value in all those situations for which such values must be determined.

TREATMENT OF QUOTED PRICE AS A MARKET ESTIMATE

Throughout the exposure draft, the Board states that quoted market prices should be used if available. This is followed by statements that if quoted market prices are not available, then management must make an estimate of market price.

The draft implies, but does not specifically state, that the use of a quoted market price is also a method of estimating market value. Many financial instruments are traded in several markets simultaneously and, at any given time, different prices may be quoted for the same instrument on these different markets. The draft implies this in paragraph 6 when it states that the quoted price in the most active market should be used. Yet, the exposure draft does not explicitly state that this is a method of estimating market value.

While this is a minor point, it may become important with regard to paragraph 13. This paragraph states that an entity shall disclose the method(s) and significant assumptions used to estimate market value. Does this mean that an entity should disclose which financial instruments had their market values determined by use of quoted market prices?

We suggest the Board make it perfectly clear that use of quoted prices is a method of estimating market value and that the use of quoted prices is one of the methods that must be disclosed under the requirements of paragraph 13.

REFERENCE TO APPENDIX B

There is no reference within the standard portion of the draft (paragraphs 3-16) to Appendix B. We believe that paragraph 11 should include a reference to this appendix in the discussion of methods used to estimate market value. This would help alert the reader to the examples much the same way as paragraph 9 alerts the reader to the existence of the listing in Appendix A.

USE OF PRICING MODELS TO BE DEVELOPED IN THE FUTURE

Paragraph 26 states that a variety of option pricing models have been developed in recent years and are regularly used to value options. Examples are the Black-Scholes model and the binomial models. The paragraph states these are appropriate to use.

The question then arises as to whether pricing models yet to be developed will also be appropriate. Such new models could gain widespread acceptance for valuing current types of financial instruments. In addition, new financial instruments may be developed and this could lead to the development of new pricing models.

How will a preparer or auditor know if and when such new pricing models are appropriate for use in meeting the requirements of this statement? The Board should consider how this paragraph should be changed to clearly state its position with regard to the use of new pricing models that may be developed in the future.

METHOD OF DISCLOSURE

We believe the Board should consider requiring disclosure of all market value information required by this and other pronouncements in a single footnote. This footnote should include a schedule displaying the main captions of the balance sheet and off-balance-sheet items and should show all unrealized appreciation and depreciation due to changes in fair market values. Some precedent for this type of disclosure exists in the Investment Company Act of 1940. The Act requires investment companies to provide statements of the aggregate value of investments as of the balance sheet date and a list showing the amounts and values of securities owned on the balance sheet date.