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Recent FASB reporting changes may require expert advice

February 09, 2010 - Financial Digest

Changes in the Financial Accounting Standards Board (FASB) reporting requirements have placed added responsibilities on borrowers while providing opportunities for improved reporting on loans and swaps.

What is FAS 157 'Fair Market Value'? FASB's interpretation of fair market value is the seller's maximum exit price, in its principal market, adjusted for credit risk. While market and cost values can be used when applicable, the most common methodology is discounted cash flow stream. Because loans are priced to assignment or secondary market value, it allows some loan fees to be recaptured.

It is important to note that bank provided swap market values are not FAS 157 compliant. Not only are they a biased source with a conflict of interest, but they include a bank profit margin and don't take into account the credit market adjustment.

Why Adopt FAS 157 for Loans and Swaps? Private companies choose to reflect their liabilities at market value for multiple reasons. The most common reasons are competitive advantage, investor demand, and management assessment. For borrowers who have the ability to raise funds at loan spreads more competitive than their peers, it allows them to capture the value of that competitive advantage on their balance sheet. Because FAS 159 allows borrowers to "cherry pick" which loans to value, borrowers can reflect only their winners. For borrowers who have swaps, valuing the offsetting unrealized gains on loans reduces their comprehensive income volatility.

In these uncertain times investors are looking for fuller disclosure and are more frequently requesting that all assets and liabilities be marked to market. GAAP accounting is also moving in that direction and is expected to eventually require all liabilities be listed at market value. Borrowers may be interested in tracking the impact of adopting the standard in order to make an informed decision and be fully prepared.

Finally, as management reviews its property investments the market value of the loan directly impacts its gain on sale. Particularly as credit spreads are at historic highs and interest rates rise as expected over the next year, management may have cause to consider property sales to capture gains on its loans irrespective of any appraisal value change.

Why use an independent valuation provider? The most critical requirements of a valuation specialist are the company's independence, relationship with auditors, transaction capability, ease of use, and of course cost. An independent advisor offers the benefit of being unaffiliated with any audit firm, mortgage broker, or lender. A SAS70 compliant system that has been accepted by the 'Big Four' and other accounting firms is a major factor in selecting the right advisor. Providers should be able to value non-investment grade commercial real estate loans, both secured and unsecured, and covering as many as six property types.

Borrowers and investors should source an independent unbiased mark to market valuation for loans and derivative instruments. To make it easier to manage the balance sheet, borrowers should look for the following services: Daily mark-to-market valuations; FAS 157 valuation services (including loans adopting FAS 159); FAS 133/161 hedge accounting services; cash flow analysis; sensitivity analysis;monthly or quarterly journal entries; and valuation attestation letters

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