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## assurance

# Controlling the real-world risks of mark-to-market valuation

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**A** biopharmaceutical firm thought it had a healthy balance sheet — until September 2008. Then it suddenly found itself in a perfect storm. The plunge in global markets pushed its market capitalization and share price below the threshold needed to maintain its listing on the Nasdaq Global Market. It was under threat of being delisted.

But there was an even more immediate concern: The company's balance sheet included a \$24 million position in auction-rate securities. The position had been established by the company's broker, Lehman Brothers, without management's knowledge. It seemed safe enough. The securities were based on bonds — largely corporate and municipal bonds with a 30-year time horizon, as well as government securities, primarily in the student loan market. The securities were a money-market-like investment, with the only apparent difference being that funds were available not daily, but once a week when the securities went to auction and the rates reset.

Then — almost literally overnight — the position came apart. The market in auction-rate securities collapsed and

the auction process came to a halt. It was the weekly auction that was the source of cash — without it, the holdings were 30-year bonds that couldn't be redeemed. And due to mark-to-market rules, the value of the securities disappeared from the company's balance sheet. While the bonds had inherent value, the securities couldn't be traded and had severely diminished value. The situation was critical.

An intensive negotiation process with Lehman Brothers led to a Friday-night agreement — Lehman would cover the position and put \$24 million back in the company's account. The following Sunday, Lehman went bankrupt, taking the agreement with it. In desperate straits, the company arranged to sell the securities to an Icelandic bank that was also one of its investors. The purchase price? \$11 million, or 40 cents on the dollar. Still pressed for cash, the company took the only action it could — it sold its key patent, the foundation for its business plan and the basis for its long-term prospects. The company was able to cover its cash needs — at the cost of its future

### THE REAL WORLD

This is a true story and one that points up a dangerous fact: Mark-to-market accounting isn't just an abstraction or a matter for policy debate — or a concern only for banks. It's a real accounting practice that can lead to real consequences for businesses right here, right now.

Mark-to-market accounting, a component of the fair value accounting hierarchy, has been associated in the public's mind mainly with the financial crisis. The process — which is, of course, common — requires that certain balance sheet assets be priced at their current market value, even if they don't have to be sold and even if the market isn't liquid. The practice had a significant impact on the banks that hold so-called "toxic assets" — affecting their capital, liquidity and credit-worthiness.

There are many arguments for and against the application of mark-to-market in the banking industry and suggestions for changes in how the rules are applied. The Financial Accounting Standards Board's recent guidance to ease mark-to-market rules and give companies more leeway in reporting the value of their assets is the farthest-reaching

example to date of mark-to-market reform.

### **ANTICIPATE SURPRISES**

But there are problems associated with mark-to-market — and not just the problem of compulsory low valuations that the banks have complained about, and that the FASB interpretations were designed to address. In fact, many problems related to fair value originate before a valuation crisis occurs — when companies accept too-optimistic valuations and use them as the basis for strategic plans, or fail to anticipate that markets might become disorderly and force changes in the way certain assets perform.

The biopharmaceutical firm found itself in trouble because, like the banks in boom times, it relied on mark-to-market when conditions were good, and believed that the upside mark-to-market valuation of its auction-rate securities was real. In an upward-moving market (either a long-term recovery or a brief rally), mark-to-market can make balance-sheet assets seem healthier and safer than they actually are. Then, a sudden downturn and disorder in the markets can wipe out those valuations — and force the company into a series of bad choices.

The trap here — a less-recognized risk of fair value accounting — is best-case forecasting. The biopharmaceutical firm carried its auction-rate securities on the books at \$24 million — the price it could expect to realize if it was able to hold the securities to the maturity of the underlying bonds. Under the influence of the mark-to-market model that Lehman applied at purchase, the company thought that the book value was real — that the securities had \$24 million in cash value. But the instant the market for the

securities failed, the valuation model forced the biopharmaceutical to acknowledge the failure. The securities were still performing and had a long-term value of \$24 million. But their immediate cash-generating potential was significantly lower.

The application of mark-to-market rules to the company's auction-rate securities reflected the plunge in the securities' trading value. But earlier, the same rules masked the underlying weakness of the auction process. Because the securities had been tradable, the fair value failed to anticipate that they could become un-tradable — and wipe out a majority of their value. The company relied on the "good news" valuation, and then was whipsawed when the valuation turned bad.

### **PRE-EMPTIVE RESTRUCTURING**

What should a company or an individual do to mitigate these risks? The answer is to be aware — before a crisis hits — that the application of fair value rules may be painting too rosy a picture of the assets. And the logical next step is to take a hard and skeptical look at the balance sheet — at the first signs of trouble, and well before the trouble becomes a crisis.

The question to ask, with the help of skilled professionals, is this: Where are the balance-sheet time bombs that look safe now, but that could explode in the event of a sudden downturn in the financial markets or the company's fortunes?

The professional to have at your side during this process is a restructuring expert. This is not because your company needs restructuring, as the point is to avoid it. The restructuring specialist can help you do just that by taking a forensic approach to balance-sheet analysis, and

developing contingency plans that can prepare you for the worst case, where restructuring is in fact required.

A restructuring specialist might apply alternative asset-valuation models — using historical accounting, for example — alongside mark-to-market, to create a more rounded picture. By valuing hard assets such as real estate at historical levels — that is, according to the purchase price — the specialist can illustrate that mark-to-market valuations, even in a down market, might still be too optimistic.

Even more fundamentally, a restructuring expert is more likely to spot the potential weaknesses in certain assets, such as a long-term security for which the short-term market is at risk of failure.

Finally, the restructuring specialist can help develop and "stress test" multiple financial and tax scenarios based on different possible outcomes, and work with the company to create cash and working capital management plans, as well as business segment cash flow and profitability analyses and recommendations.

The key is to take action sooner, rather than later. The time to call on a restructuring expert is now, before you need one — while you still have options and can make decisions about a company's future. The longer you wait, the more likely that a market event beyond your control will plunge you into crisis, and force you into desperation moves because you failed to recognize the potential worst case. A hard look now is the best way to avoid pain later on.

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