

# Hot Topic

Update on major accounting  
and auditing activities

## SEC completes study on mark-to-market accounting

### Contents

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### Summary

On 30 December 2008, the Securities and Exchange Commission (SEC) delivered to Congress its statutorily mandated study of "mark-to-market" accounting (the Report).

As required by the Emergency Economic Stabilization Act of 2008 (EESA or the Act) the Report addresses the following six key issues:

- ▶ The effect of mark-to-market accounting standards on financial institutions' balance sheets
- ▶ The relationship of such accounting standards to bank failures in 2008
- ▶ The effect of such accounting standards on the quality of financial information available to investors
- ▶ The advisability and feasibility of modifications to such accounting standards
- ▶ Alternative accounting standards to those provided in FASB Statement No. 157, *Fair Value Measurements* (Statement 157)
- ▶ The Financial Accounting Standards Board's (FASB) process for developing accounting standards

The Report recommends that the use of fair value accounting standards not be suspended; however, it also recommends improvements to existing practice, including reconsidering the accounting for impairments and the development of additional guidance for determining fair value of investments in inactive markets, including situations in which market prices are not readily available.

The following provides an overview of the key issues addressed in the Report, as well as the recommendations set forth therein. However, this summary does not address every aspect of each recommendation included in the Report, which is available from the SEC's website at <http://www.sec.gov/news/studies/2008/marktomarket123008.pdf>.

### Background

On 3 October 2008, EESA was signed into law by President Bush. Section 133 of the Act mandates that the SEC conduct, in consultation with the Board of Governors of the Federal Reserve System and the Secretary of the Treasury, a study on mark-to-market accounting standards. The Report was to be delivered to Congress by 2 January 2009.

The Act's requirement for this study resulted in part from concerns expressed by some that fair value accounting contributed to instability in the US capital markets. However others, particularly investors, stated that fair value accounting serves to enhance the transparency of financial information provided to the public.

In preparing the Report, the SEC staff indicated that it obtained and analyzed data from a broad-based population that included a cross-section of financial institutions. In addition to empirical analysis, the SEC staff obtained input from market participants through a public comment letter process and by hosting a series of three public roundtables to obtain a wide range of views and perspectives from all parties.

### **Key issues addressed in the Report**

#### ***Effects of fair value accounting standards on financial institutions' balance sheets***

The Report addresses the issue of whether accounting standards that require fair value accounting inappropriately affect the balance sheets of financial institutions. To consider this issue the SEC staff analyzed a sample of fifty financial institutions from a broad-based population of financial institutions.

The SEC staff observed that fair value measurements were used to measure a minority of the assets and liabilities included in financial institutions' balance sheets. The percentage of assets for which changes in fair value affected income was significantly less, and resulted primarily from fair value accounting for derivatives and investments held for trading purposes. However, for those same financial institutions, the SEC staff observed that fair value measurements did significantly affect reported income.

#### ***Effects of fair value accounting on bank failures in 2008***

The SEC staff observed that fair value accounting did not appear to play a meaningful role in bank failures occurring during 2008. Rather, bank failures in the US

appeared to result from growing probable credit losses, concerns about asset quality, and, in certain cases, eroding lender and investor confidence. For those failed banks that did recognize sizable losses from fair value accounting, the SEC staff concluded that those losses were not the reason for their failure.

#### ***Effects of fair value accounting on the quality of financial information available to investors***

The SEC staff observed that, based on its research, investors generally support measurement of investments at fair value and believe that those measurements provide the most transparent financial reporting of an investment, thereby facilitating better investment decision-making and more efficient capital allocation among companies. However, many investors also indicated the need for improvements in the application of existing standards, including those dealing with impairment of investments, application of Statement 157 (particularly in times of financial stress), fair value measurement of liabilities, and presentation and disclosure requirements for assets and liabilities measured at fair value.

#### ***Process Used by the FASB in Developing Accounting Standards***

The SEC staff observed that while the FASB's process works well for developing neutral and unbiased accounting guidance, there are several steps that could be taken to enhance the FASB's process. These recommendations include steps that could enhance the timeliness and transparency of the process. For example, to timely identify and address challenges encountered in the application of standards in practice, key participants in the capital markets need to communicate and understand these challenges as they arise. To facilitate the more timely identification and resolution of issues, the SEC staff believes that it is advisable to move quickly to implement the recommendation of the SEC Advisory

Committee on Improvements to Financial Reporting (CIFiR) related to the creation of a financial reporting forum (FRF).<sup>1</sup> CIFiR's final report can be found on the SEC's website at [www.sec.gov](http://www.sec.gov).

#### ***Alternatives to Fair Value Accounting Standards***

The Report addresses the specific consequences of suspending the guidance in Statement 157. Any such suspension would not change current fair value accounting requirements, but instead would merely remove the current measurement guidance. The Report also discusses whether it would be prudent to modify or suspend current accounting standards that require fair value measurements.

The SEC staff observed that Statement 157 does not specify what assets or liabilities are measured at fair value, but instead provides guidance on measuring fair value when required by other accounting standards. The SEC staff stated that suspending Statement 157 would result in inconsistent and sometimes conflicting guidance on fair value measurements. As to alternatives to fair value accounting, the SEC staff stated that while such alternative measurement objectives exist, each alternative exhibits strengths and weaknesses, as well as implementation issues.

#### ***Advisability and feasibility of modifications to fair value accounting standards***

The Report summarizes steps taken by standards setters and those underway to improve current accounting requirements. The Report also provides recommendations on the advisability and feasibility of modifications to existing accounting standards and related financial reporting requirements, which are discussed below.

<sup>1</sup> Under CIFiR's proposal, the FRF would include key constituents from the preparer, auditor, and investor and other user communities, to meet with representatives from the SEC, the FASB, and the PCAOB to discuss immediate and long-term pressures on the financial reporting system.

## Recommendations

### *Statement 157 should be improved, but not suspended*

The SEC staff believes that without Statement 157, issuers would return to practices that existed prior to the issuance of the standard. These practices were based on varying definitions of fair value throughout US GAAP and relied upon the limited or conflicting guidance available for applying those definitions. Further, the SEC staff believes that suspending Statement 157 would reduce the comparability and consistency of fair value measurements and therefore hinder investors' ability to obtain decision-useful information from financial statements.

As discussed in several other recommendations below, the SEC staff believes that further improvements to the existing application of fair value measurement requirements are necessary.

### **Existing fair value measurement requirements should not be suspended**

The SEC staff does not believe that either a suspension or elimination of existing standards that require measurement at fair value (i.e., mark-to-market accounting) is advisable.

The SEC staff believes that the abrupt elimination of fair value measurement requirements would erode investor confidence in financial reporting. The Report observes that accounting standards generally require mark-to-market accounting through the income statement only for certain derivatives and investments that financial institutions hold for "trading" purposes. Further, the SEC staff observed that over 90% of those mark-to-market measurements are based on observable inputs, such as quoted market prices.

### *Additional steps should be taken to improve the application of existing fair value requirements*

The SEC staff believes that a number of steps should be taken to improve the application and practice related to existing fair value measurement requirements (particularly as they relate to both Level 2 and Level 3 estimates) including:<sup>2</sup>

- ▶ Considering the need for additional application guidance or best practices for determining fair value in illiquid or inactive markets
- ▶ Enhancing existing disclosure and presentation requirements related to the effects of fair value in the financial statements
- ▶ Educational efforts, including efforts to improve the application, where appropriate, of reasonable judgment and analysis in the determination of fair value estimates
- ▶ Examination by the FASB of the effects of liquidity in the measurement of fair value, including whether additional application or disclosure guidance is warranted
- ▶ Assessment by the FASB of whether the incorporation of a company's own credit risk in the measurement of liabilities provides decision-useful information to investors, including whether sufficient transparency is provided currently in practice

<sup>2</sup> Statement 157 provides a hierarchy for inputs used in fair value measurement based on the degree to which the inputs are observable in the market. Level 1 in the hierarchy includes inputs that are based on quoted prices in active markets for the identical asset or liability. Level 2 includes quoted prices of similar instruments in active markets, quoted prices for identical or similar instruments in inactive markets, and observable market information on valuation parameters or market-corroborated information. Level 3 represents measurements that incorporate significant unobservable inputs that reflect the reporting entity's own assumptions regarding valuation parameters that market participants would use. Valuation techniques used to measure fair values should maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

In addition, the SEC staff believes additional assistance in the form of guidance, education, and training is warranted in several areas. Examples include further tools to make judgments regarding:

- ▶ How to determine when markets become inactive
- ▶ How to determine if a transaction or group of transactions is forced or distressed
- ▶ How and when illiquidity should be considered in the valuation of an asset or liability
- ▶ How the effect of a change in credit risk on the value of an asset or liability should be estimated
- ▶ When observable market information should be supplemented with or supplanted by unobservable information in the form of management estimates
- ▶ How to confirm that assumptions utilized are those that would be used by market participants and not just by a specific entity

The SEC staff recommended that the FASB consider which of the above issues could be resolved through a review of the objectives of Statement 157 and which issues would be best addressed by the valuation community. The SEC staff also recommended that the FASB consider working with valuation and appraisal associations and organizations to develop additional valuation guidance and best practice documents to assist preparers and valuation specialists in performing valuations for financial reporting purposes.

Further, the SEC staff recommended that the FASB reconsider how the FASB uses the Valuation Resource Group (VRG), including whether the VRG should function more like the FASB's Emerging Issues Task Force, whether subcommittees of the VRG should be used for specific issues, and whether VRG meetings should be open to the public.

The SEC staff also recommended that the FASB continue efforts to address fair value measurement issues related to the valuation of liabilities.

***The accounting for financial asset impairments should be readdressed***

The SEC staff recommended that the FASB reassess current models for the recognition of impairment of financial instruments.

The SEC staff suggested that the evaluation should consider narrowing the number of models that currently exist in US GAAP. In that regard, the SEC staff stated:

“While there are a number of alternative models that the FASB should consider, several commenters have suggested the development of a model that would require recognizing impairments through income related only to credit losses (calculated on an incurred loss basis consistent with impairments on loans), while the remaining decline in fair value of an investment (the portion that is not related to incurred losses) would be recognized in [Other Comprehensive Income (OCI)]. The Staff believes that this model has the potential to provide investors with both fair value information as well as transparent information regarding the cash flows management expects to receive by holding investments, rather than through accessing the market currently. That is, such a model would appear to help bridge the gap between the current fair value and the value expected from holding investment positions until markets return to normal liquidity levels. Other models, including the elimination of OTTI in favor of more prominent reporting of impairments in OCI, should also be evaluated. Further, in reassessing impairment the FASB should consider whether the “ability and intent to hold to recovery” test under SFAS No. 115 is sufficiently operational, including whether the operation of the model in practice is consistent with the notion of an AFS security.”

In conjunction with evaluating current impairment guidance, the SEC staff recommended that consideration be given to increasing the prominence of OCI by requiring a separate statement or presentation on the face of the income statement.<sup>3</sup>

The SEC staff also recommended that the FASB reconsider the existing preclusion in US GAAP from reversing an impairment charge when the fair value of an investment security recovers in value. International Financial Reporting Standards permit the recognition of such recoveries in certain circumstances.

Finally, the SEC staff recommended that the consistency of information provided to investors be improved, including the implementation of measures to provide investors with insight into management’s expectations of probable cash flow declines.

***Implement further guidance to foster the use of sound judgment***

The SEC staff observed that the use of judgment in accounting, auditing and regulation has increased due to the focus on more objectives-based standards (such as Statement 157) and increased use of fair value estimates. The SEC staff recommended that guidance regarding the application of judgment in connection with fair value measurements should keep pace with this increased use.

In its final report, CIFIIR recommended that the SEC issue a statement of policy articulating how it evaluates the reasonableness of accounting judgments, including the factors that it considers when making this evaluation. CIFIIR also suggested that the Public Company Accounting Oversight Board (PCAOB) issue a similar statement with respect to auditing judgments

<sup>3</sup> Note that the FASB and the International Accounting Standards Board (IASB) recently issued a Discussion paper, *Preliminary Views on Financial Statement Presentation*, which proposed a single statement of comprehensive income, which would include items included in other comprehensive income, to replace the current income statement.

The SEC staff believes that it is advisable that the SEC and PCAOB consider whether statements of policy related to the application of judgment in making fair value measurements would be appropriate.

***Accounting standards should continue to be established to meet the needs of investors***

The SEC staff recommended that US GAAP continue to be developed to satisfy the needs of investors.

The SEC staff observed that while financial reports prepared using US GAAP are valuable tools considered by other users of information, US GAAP should not be established or modified to serve the needs of others at the expense of investors. This is particularly true in situations in which the other users of financial information have the ability to dictate the form and content of such information.

To the extent that the interaction of fair value accounting and regulatory capital requirements has resulted in concerns about “pro-cyclicality” (including whether accounting standards are resulting in the sale of assets or the need to raise capital in down markets), the SEC staff recommended that such concerns not be addressed through changes in accounting standards that would reduce investor confidence.

***Additional formal measures should be established to address the operation of existing accounting standards in practice***

The SEC staff recommended that additional formal measures be adopted to facilitate the identification and resolution of practice issues encountered in the application of existing accounting standards, including:

- ▶ Implementing CIFIIR’s recommendation for an FRF
- ▶ The implementation by the FASB of a post-adoption review process
- ▶ The establishment of a formal policy for standard-setting in circumstances that necessitate an almost immediate response

***Address the need to simplify the accounting for investments in financial assets***

The SEC staff believes that it is advisable for the FASB and IASB to work to simplify the accounting for investments in financial instruments, including the continued exploration of the feasibility of reporting all financial instruments at fair value. The SEC staff noted that significant obstacles continue to exist for such a move, including concerns about the degree of relevance and reliability of fair value measurements, and concerns about how changes in fair value should be recognized in the income statement. That is, many continue to believe that holding gains and losses (unrealized items) have a different character than realized gains and losses. The SEC staff observed that this appears to be particularly true during times when the value of securities is affected significantly by declines in liquidity.

The SEC staff believes that it is advisable to address these and other obstacles prior to any significant expansion of the use of mark-to-market accounting through the income statement for assets other than trading assets and derivatives.

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