SEC Delivers Report to Congress Regarding Results of Study on Fair Value Accounting Standards

On December 30, 2008, the Securities and Exchange Commission ("SEC") delivered a report to Congress regarding the results of its study of the "mark-to-market" accounting framework provided by Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ("SFAS 157").[1] This study was mandated by Section 133 of the Emergency Economic Stabilization Act.[2] The 211-page report by the SEC's Office of the Chief Accountant and Division of Corporation Finance addressed the following six key issues:

- the effects of such accounting standards on a financial institution's balance sheet;
- the impacts of such accounting on bank failures in 2008;
- the impact of such standards on the quality of financial information available to investors;
- the process used by the FASB in developing accounting standards;
- alternative accounting standards to those provided in SFAS 157; and
- the advisability and feasibility of modifications to such standards.

Based on its findings presented in the report, the SEC staff (the "Staff") recommended against suspending fair value accounting standards. Instead, the Staff advocated improving 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 where market prices are not readily ascertainable.

I. Background

The FASB promulgated SFAS 157 in September 2006, and it became effective for financial statements issued for fiscal years that began after November 15, 2007. SFAS 157 provides a framework for measuring and evaluating the fair value of assets and liabilities for purposes of complying with generally accepted accounting principles in the United States ("U.S. GAAP"). SFAS 157 does not itself require mark-to-market or fair value accounting. Rather, other accounting standards in various ways require "fair value" accounting, of which mark-to-market accounting is a subset. A central concept of SFAS 157 is the "fair value hierarchy," which categorizes the inputs used to determine fair value. Level 1 inputs are those with readily verifiable prices, such as stock quotes. Level 2 inputs are those for which there is a market, albeit one with imperfect pricing. Examples of

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1 *See* U.S. Securities and Exchange Commission, Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting, *available at* http://www.sec.gov/news/studies/2008/marktomarket123008.pdf (last visited Jan. 6, 2009). *See also* Congressionally-Mandated Study Says Improve, Do Not Suspend, Fair Value Accounting Standards (Dec. 30, 2008), *available at* http://www.sec.gov/news/press/2008/2008-307.htm. In addition, *see* FASB Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, *available at* http://www.fasb.org/pdf/fas157.pdf.

2 *See* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, Division A, *available at* http://thomas.loc.gov/cgi-bin/query/z?c110:H.R.1424.enr:. *See also* SEC Commences Work on Congressionally-Mandated Study on Accounting Standards (Oct. 7, 2008), *available at* http://www.sec.gov/news/press/2008/2008-242.htm. For further discussion, see our recent firm memorandum, The Emergency Economic Stabilization Act of 2008: an Overview (Oct. 13, 2008) (discussing selected provisions of the Emergency Economic Stabilization Act, including Section 133), *available at* http://www.cahill.com/news/memoranda/000116.

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Level 2 inputs include inventory prices and real estate. Level 3 inputs, in contrast, are those that reflect the company's "own assumptions about the assumptions market participants would use in pricing the asset or liability...developed based on the best information available in the circumstances."

Although SFAS 157 states that assets and liabilities should be valued using Level 1 and 2 inputs where possible, it acknowledges that if current market prices are determined as a result of "a forced liquidation or distress sale," unobservable inputs may be appropriate. Under circumstances in which compelled sales taking place in the market predominate, SFAS 157 permits issuers to value their assets and liabilities using Level 3 inputs. Indeed, this was the subject of a joint press release by the SEC and FASB staffs. On September 30, 2008, the SEC and FASB staffs issued guidance to clarify the application of SFAS 157-required fair value measurements and mark-to-market accounting principles as they relate to inactive markets.[3] On October 10, 2008, the FASB issued FASB Staff Position 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*, which further clarified the application of fair value measurements.[4]

A number of parties blamed fair value accounting for the instability in the financial markets experienced in the United States and much of the world in 2008. Critics asserted that the write-downs in the value of investments held by financial institutions did not accurately reflect the underlying economics of the securities. In part to ascertain whether this perspective had merit, as well as to address the other key issues set forth above, Section 133 of the Emergency Economic Stabilization Act of 2008 mandated that the SEC, in consultation with the Board of Governors of the Federal Reserve System and the Secretary of the Treasury, conduct a study of SFAS 157 mark-to-market accounting standards as they are applicable to financial institutions, including depository institutions.[5] The study was spearheaded by then SEC Deputy Chief Accountant James Kroeker.[6] The study commenced on October 7, 2008, and the SEC was required to submit a report of the study to Congress by January 2, 2009. The study included the results of SEC analysis of data obtained from a broad-based population that included a cross-section of financial institutions. In addition to empirical analysis, the SEC also gathered input from researching public records, from investor groups, accounting and auditing firms, valuation specialists, banks, insurance companies, think tanks, and academics through a public comment letter process, and through hosting a series of three public roundtables.

II. Key Findings and Recommendations of the Report

Among its key findings, the report observed that:

- with regard to the effects of fair value accounting standards on financial institutions' balance sheets, fair value measurements were used to measure a minority of assets and liabilities. The

[3] *See* SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting (Sept. 30, 2008), *available at* http://www.sec.gov/news/press/2008/2008-234.htm. In addition, see our recent firm memorandum, SEC Office of the Chief Accountant and FASB Staff Issue Press Release Clarifying the Application of SFAS 157 (Oct. 2, 2008), *available at* http://www.cahill.com/news/memoranda/000113.

[4] *See* FASB Staff Position No. FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* (Oct. 10, 2008), *available at* http://www.fasb.org/pdf/fsp_fas157-3.pdf. For further discussion, see our recent firm memorandum, Recent Developments Relating to SFAS 157 (Oct. 20, 2008), *available at* http://www.cahill.com/news/memoranda/000117.

[5] For further discussion, see our recent firm memorandum, Recent Developments Relating to SFAS 157 (Oct. 20, 2008), *available at* http://www.cahill.com/news/memoranda/000117.

[6] In January 2009, Mr. Kroeker was promoted to acting Chief Accountant to replace the retiring incumbent.

percentage of assets for which changes in fair value affected income was significantly less, reflecting the mark-to-market requirements for trading and derivative investments. However, fair value measurements did significantly affect financial institutions' reported income.

- with regard to the impact that fair value accounting may have had on bank failures in 2008, mark-to-market accounting did not play a meaningful role in those bank failures. Rather, U.S. bank failures in 2008 likely occurred as a result of growing credit losses, concerns about asset quality, and in some cases, eroding confidence among lenders and investors.

- with regard to the impact of fair value accounting on the quality of financial information available to investors, investors generally believe that fair value accounting facilitates better investment decision-making and increases transparency with regard to financial reporting. However, investors indicated the need for improvements to the application of existing standards. Improvements to the impairment requirements, application of SFAS 157 (particularly in times of financial stress), fair value measurement of liabilities, and improvements to the related presentation and disclosure requirements of fair value measures were cited as areas requiring improvement.

- with regard to the process used by the FASB in developing accounting standards, in general, the FASB's process works well to develop neutral and unbiased accounting guidance. However, there are steps the FASB could take to enhance existing procedures, including steps to enhance the timeliness and transparency of the process.

- with regard to alternatives to fair value accounting standards, each alternative exhibits strengths and weaknesses, as well as implementation issues. The suspension of fair value accounting to return to historical cost-based measures would lead to a reversion of practice. It would likely result in inconsistent and sometimes conflicting guidance on fair value measurements and would reduce the comparability and consistency of fair value measurements. In addition, it would tend to increase investor uncertainty and adversely impact investor confidence by removing access to information at a time when that information is particularly useful. However, given the significant challenges which have been encountered with respect to implementing existing standards, additional measures to improve the application and understanding of fair value requirements are advisable.

- with regard to the advisability and feasibility of modifications to fair value accounting standards, the report outlines eight key recommendations by the SEC regarding the use and application of SFAS 157:

    1. SFAS 157 should be improved, but not suspended.

    2. Existing fair value and mark-to-market requirements should not be suspended.

    3. Additional measures should be taken to improve the application of existing fair value requirements. These include:

        a) considering the need for additional application guidance, best practices, and other tools for determining fair value in illiquid or inactive markets, including the need for guidance to assist companies and auditors in addressing:

- how to determine when markets become inactive and whether a transaction or group of transactions are forced or distressed;
- how the impact 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 and/or reliance placed on unobservable information in the form of management estimates; and
- how to confirm that assumptions utilized are those that would be used by market participants and not just a specific entity;

b) enhancing existing disclosure and presentation requirements related to the effect of fair value in the financial statements. As one hopeful means to this end, on December 24, 2008, the FASB proposed a new Staff Position, FSP FAS 107-a.[7] This proposed Staff Position would amend the disclosure requirements in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*,[8] to increase the comparability of information about certain financial assets that have related economic characteristics but different reporting measurement attributes. If adopted, FAS 107-a would require companies to provide additional disclosures about specified financial assets that are not measured at fair value through earnings. Comments on the proposal are due January 15, 2009. If adopted, the new disclosures would be effective for periods ending after December 15, 2008. The International Accounting Standards Board ("IASB") is concurrently proposing a similar set of disclosures for reporting entities that prepare financial statements in accordance with International Financial Reporting Standards;

c) increasing educational efforts, including those to improve the application of reasonable judgment and analysis in the determination of fair value estimates;

d) examination by the FASB of the impact of liquidity in the measurement of fair value, including whether additional application and/or disclosure guidance is warranted; and

e) assessment by the FASB of whether incorporating a company's own credit risk in the measurement of liabilities provides useful information to investors, including whether sufficient transparency is currently provided.

4. The accounting for financial asset impairments should be addressed.

- The Staff recommended that the FASB reassess current impairment accounting models for financial instruments and consider implementing SEC-recommended improvements, including: reducing or narrowing the number of models used for determining and reporting impairments, considering whether the utility of information available to investors would be improved by providing additional information about whether current declines in value are consistent with management expectations of the underlying credit

[7] *Available at* http://www.fasb.org/fasb_staff_positions/prop_fsp_fas107-a.pdf.

[8] *Available at* http://www.fasb.org/pdf/fas107.pdf.

quality, and reconsidering current restrictions on the ability to record increases in value (when market prices recover).

5. Implement further guidance to foster the use of sound judgment.

    - The Staff recommended that the SEC and PCAOB consider whether statements of policy related to the application of judgment in making fair value measurements would be appropriate. That is, the SEC and PCAOB should issue statements of policy articulating how they evaluate the reasonableness of accounting and auditing judgments, respectively, including the factors that the SEC and PCAOB consider when making this evaluation.

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

    - The Staff recommended that U.S. GAAP should continue to be developed to satisfy the needs of investors rather than other users of information. That is, U.S. GAAP should not be further developed or modified to serve the needs of others at the expense of investors.

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

    - The Staff recommended that additional formal measures should be adopted to facilitate the identification and resolution of issues encountered when applying existing accounting standards in practice, including:
        - Implementing the SEC Advisory Committee on Improvements to Financial Reporting's recommendation for a financial reporting forum;
        - Implementation by the FASB of a post-adoption review process; and
        - Establishment of a formal policy for standard-setting when a near-immediate response is needed.

8. Address the need to simplify the accounting for investments in financial assets.

    - The Staff recommended the continued joint work by the FASB and IASB to simplify the accounting for investments in financial instruments, and the Staff encouraged the Boards to explore the feasibility of reporting all financial instruments at fair value. The Boards should seek to inform not only present but future decisions about the appropriate measurement attributes in accounting standards.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com.