- SEC keeps fair value but lays out plan for improvements
- Coordination of FASB and international standard setters called for
- Asset impairment assumptions clarified
- Specific guidance will be improved and released more regularly
- A significant reversal of FAS 157 would damage investor confidence

By Brendan Sheehan

Keeping things fair

Those on Wall Street looking for an easy accounting fix to some of the bad debts pummeling financial company balance sheets, or those that have not been bought as part of the federal government bailout and therefore pummeling taxpayer's balance sheets, will be disappointed that the SEC stands firm on the use of fair value accounting.

Many people – mostly at Wall Street firms – accuse Financial Accounting Standard 157, requiring companies account for assets at 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date,' of heightening the financial crisis by forcing companies to write down the value of many financial instruments. As such, they called for the repeal of FAS 157.

The discussion resulted in Congress commissioning a study of mark-to-market accounting practices as part of the Emergency Economic Stabilization Act of 2008. The SEC led the probe, and after three months of investigation, determined that FAS 157 should remain. Conducted by the SEC, Federal Reserve and US Treasury, the study was released to the public December 30, finding FAS 157 'did not appear to play a meaningful role in the bank failures that occurred in 2008.' The SEC adds that the standard increases transparency and promotes better decision-making.

Ongoing support for the accounting standard was widely expected as regulators need to appear firm on financial companies taking excessive risks or hiding behind new accounting mechanisms to conceal the true value of balance sheets. The decision was greeted with support from the investor and accounting community.

Barry Melancon, president and CEO of the American Institute of Certified Public Accountants (AICPA), supported the decision, saying in a press release, 'AICPA is pleased the SEC staff recommended against the suspension of fair value accounting rules. … The role of accounting standards is to provide investors and management with the best possible information about the financial condition of publicly traded companies.' AICPA supported the assertion that fair value accounting improves transparency and decision-making.

The report comes as no surprise, as there were indications of the direction the SEC would take. John Rogers III, partner at Foley & Lardner says, 'The SEC's conclusions are not surprising given the support for fair value accounting expressed during the Commission's roundtable discussions in October and November.'

Room for improvement

Although the report does not countenance the idea of scrapping FAS 157, it identifies areas for improvement: the SEC will readdress accounting for financial impairment; increase the amount of guidance offered; and simplify requirements for level two and three estimates.

Despite these changes, the rule retains most of its teeth and, according to Rogers, 'will not satisfy those who blame fair value accounting for our current financial crisis and believe FAS 157 requires write-downs to fire sale values far below losses that will actually be realized.' The conclusions, he continues, 'debunk one of the principal arguments raised by fair value opponents, demonstrating that credit losses, not fair value write-downs, were primarily responsible for bank failures in 2008.'

TYPES OF GUIDANCE TO EXPECT IN 2009

- How to determine when markets become inactive
- How to determine if a transaction or group of transactions is forced or distressed
- How and when should illiquidity be considered in the valuation of an asset or liability
- How should the impact of a change in credit risk on the value of an asset or liability be estimated
- When should observable market information be supplemented with and/or reliance placed on 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

Mark Schonfeld and Jennifer Halter, from the New York office of Gibson, Dunn and Crutcher, explain in a report issued mid-January: 'The most significant conclusion of the SEC's study on mark-to-market accounting is that the report does not recommend suspension of FAS 157. Indeed, the report states at the outset that the economic crisis was not caused by fair value accounting requirements, but rather resulted from market participants' efforts to clear significant amounts of debt from their balance sheets coupled with a reduced appetite for risk and eroding confidence of lending counterparties.'

Though withdrawing FAS 157 was always unlikely, there is growing support for a 'middle ground' that regulators may move toward. As Rogers explains, 'The SEC acknowledged, but did not adopt a 'middle ground' proposal that received favorable comment from ... staff at the roundtables [in October and November] to separate the fair value write-downs into two components – incurred credit losses and the liquidity discount resulting from current market dislocations. Under that proposal, the credit loss component would reduce income, but the liquidity discount would be reflected in 'other comprehensive income'. Despite the potential appeal of this solution, the complexities of implementing it probably rendered it impractical.'

Many experts in the accounting and legal professions support the SEC and the authors of the report in their aim to improve the application of FAS 157, but the issue of complexity may make real change difficult.

One of the eight principal recommendations states: 'Additional measures should be taken to improve the application and practice related to existing fair value requirements (particularly as they relate to both level two and level three estimates).' To assist market participants in determining 'the price that would be received' or fair value of an asset or liability, say Schonfeld and Halter, FAS 157 established a three-level hierarchy called inputs. Generally, level one inputs are current quoted market prices in an active market for the identical asset or liability; level two inputs are quoted current market prices for similar assets or liabilities in an active market; and level three inputs are unobservable, and are used where observable inputs are not available, such as where there is little or no market activity for the asset or liability being valued.

Rogers explains, 'The SEC continues to stress the judgments that may properly be made under FAS 157 to use level three models to arrive at fair value when relevant observable inputs are unavailable. However, the sophisticated work this approach requires, while well within the capability of some major financial institu-

CONGRESS-MANDATED TOPICS FOR REVIEW UNDER EESA

- The effects of such accounting standards on a financial institution's balance sheet
- The impact 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 Financial Accounting Standards Board in developing accounting standards
- The advisability and feasibility of modifications to such standards
- Alternative accounting standards to those provided in FAS 157

tions, may be of little use to smaller institutions and community banks with lesser resources.'

Keep it legal

Beyond computational complexities, legal concerns may deter companies from disclosing this type of information. 'Although some holders of securities believe fair value write-downs can best be estimated using broad ranges, the commission was advised that concerns over potential liability have discouraged disclosures of that type because they invite litigation over the value chosen for financial statement purposes,' says Rogers.

The simplification theme runs throughout the report and the SEC is heeding calls to clarify inconsistencies about the valuation for impairment of specific assets. The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have been asked to work in unison to simplify the reporting of complex financial instruments. Reporting all financial instruments at fair value was examined but not recommended until current implementation obstacles can be overcome

The study focused on inconsistencies between accounting rules for impairment of asset types. 'Fair value opponents argue that using the present value of expected future cash flows to determine impairment of a loan, while basing other-than-temporary impairment of available-for-sale securities on fair value exit prices, makes no sense,' says Rogers. 'But the SEC report makes the case for having these issues ironed out by accounting standard setters, not by hasty regulatory fiat.'

The report recommends improving impairment accounting models by: reducing the number of models utilized 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 underlying credit quality or probable cash flow declines; and reconsidering current restrictions on the ability to record increases in value when market prices recover, as is currently permitted under international financial reporting standards. The report noted that impairment guidelines are not consistent with reporting guidelines for impairment charges for other non-securitized investments, resulting in investors receiving information not recognized, calculated or reported on a comparable basis.

While FAS 157's future is somewhat unclear, expanded guidance, improved cooperation between FASB and the IASB and clarity of impairment criteria will greatly improve the transparency of financial company reports. This in turn will enable both investors and regulators to determine capital of financial institutions.

The SEC did not suggest fixing the problem facing insured banks by adopting lenient regulatory accounting principles, thus allowing banks to avoid the impact of fair value write-downs on the bottom line. Rogers concludes: 'Establishing vastly different measures of capital for regulatory purposes than are used for investor disclosures seems unwise and likely to lead to more confusion and loss of confidence in our financial institutions.'

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EIGHT RECOMMENDATIONS OF THE SEC'S REPORT ON MARK-TO-MARKET ACCOUNTING

- FAS 157 should be improved, but not suspended;
- Existing fair value and mark-to market requirements should not be suspended;
- While the SEC does not recommend a suspension of existing fair value standards, additional measures should be taken to improve the application and practice related to existing fair value requirements (particularly as they relate to both level two and level three estimates);
- The accounting for financial asset impairments should be readdressed;
- Further guidance to foster the use of sound judgment should be implemented;
- Accounting standards should continue to be established to meet the needs of investors;
- Additional formal measures to address the operation of existing accounting standards in practice should be established; and
- The need to simplify the accounting for investments in financial assets should be addressed