The SEC's December 30, 2008 Report — Not the Last Word on Fair Value Accounting

The U.S. Securities and Exchange Commission's (SEC) December 30, 2008 report on mark-to-market accounting undoubtedly disappointed fair value opponents and reassured its defenders. The SEC declined to suspend the application of Financial Accounting Standard (FAS) 157, concluding that most investors believe fair value accounting increases financial reporting transparency. To those who blame fair value accounting for the current financial crisis, this decision probably dashes the hope for a quick solution. However, the report is far from the last word on the many fair value accounting issues our economic difficulties have brought to light. The SEC identified several areas in which improvements are needed, making recommendations about changes that could be considered. Additionally, it described the proper role that accounting standard setters play in assessing modifications to U.S. generally accepted accounting principles (GAAP) and international accounting standards.

This week, two developments at the *Financial Accounting Standards Board* (*FASB*) show that there is more to come on the fair value issue. On January 12, 2009, the FASB staff issued FASB Staff Position (FSP) EITF 99-20-1, which eliminated the reference to the "market participant" view of expected cash flows when making impairment determinations for certain beneficial interests in securitized financial instruments. On January 15, 2009, the comment period on FSP FAS 107-a expired. Despite some significant opposition, an issuance on revised disclosures about alternative valuation approaches for various debt securities and loans may be forthcoming in the near future. Both actions have proceeded on an expedited schedule and are to be effective for reporting periods ending after December 15, 2008. It is possible that implementation difficulties will result in a delay in application of FAS 107-a's requirements, if it is approved.

The FASB's current activity and projects underway recognize that, despite the underlying soundness of the fair value principle, all is not well with GAAP treatment of asset values in a time of severe economic dislocation. One of the fundamental disagreements over fair value determinations under FAS 157 is the belief that the declines in values it identifies are attributable to multiple components, some of which may reflect real economic losses and others of which may not. A basic illustration focuses on debt securities with contractual cash flows. Declining credit-worthiness of obligors may reduce expected future cash flows, making a security less valuable to its holder. That incurred credit loss is one component of the security's fair value decline. However, the current liquidity crisis and frozen markets may make the security saleable only at a deep discount. The liquidity discount and other market factors can result in an equal or much larger decline in the security's fair value.

Fair value opponents argue that FAS 157's approach distorts economic reality by forcing write-downs, not only for the amount of incurred credit losses, but also for liquidity discounts that may never be realized. The SEC roundtables and comments on fair value accounting developed the competing views on this subject and produced a proposal to separate these two components of an asset's fair value decline for accounting purposes. Under the proposal, for debt securities that are required to be reported at fair value, the incurred credit loss portion of the fair value decline would be recognized in the income statement. The remaining decline attributable to liquidity discounts or other factors would be reported in other comprehensive income, which reduces equity, but not income. To draw attention to this decline, the other comprehensive income "loss" would be shown "below the line" on the face of the income statement. While this compromise proposal was not endorsed, it may form the basis for future recommendations and study by accounting standard setters.

This week's FASB activity addresses issues that are related to the incurred loss/liquidity discount distinction. While not changing accounting rules governing carrying values of assets, FSP 107-a would require disclosure of both the incurred loss amount and the fair value of certain assets, enabling investors to see the difference between the two. It would apply only to assets such as loans and is available for sale securities that are not currently carried at fair value under existing GAAP. In an environment in which such controversy surrounds these two components of fair value declines, new disclosure requirements that familiarize investors with the factors affecting potential asset values and declines may pave the way for more informative and useful disclosures for assets required to be reported at fair value. However, making detailed information of this type available is a costly enterprise, and the FASB will have to determine whether the benefits justify the resultant burdens. Because a similar proposal to amend International Financial Reporting Standard (IFRS) 7 is pending before the International Accounting Standards Board (IASB), it too will have to consider these issues.

FSP EITF-99-20-1 is an effort to address an inconsistency in the accounting treatment of impairments for two categories of assets. For certain beneficial interests in securitized assets, FSP EITF-99-20-1 would determine whether an other-than-temporary impairment exists by assessing the cash flows from an asset that a market participant would use in determining fair value. Impairment of debt securities subject to FAS 115, on the other hand, is not subject to a market participant's view of cash flows, instead requiring the holder to exercise judgment about the probability that it will be unable to collect all amounts under the security when due. Retreat from a market-participant test for a particular impairment purpose does not constitute abandonment of the exit price perspective mandated under FAS 157. But it does reflect the need to consider alternative treatments in contexts in which the market participant view may not produce consistent or intended results. FSP EITF-99-20-1 is not without controversy, having been adopted over the strong dissenting votes of two FASB members. Nor does it settle the most contentious impairment issue presented by current economic conditions — the different standards applicable for measuring impairment of loans under FAS 114 and debt securities under FAS 115.

The debate about fair value exit prices and longer-term economic values will continue. The SEC's report makes the case for resolving these issues before accounting standard setters, not through emergency regulatory studies. That the SEC decided against suspending fair value accounting does not mean that important changes are unlikely to be made as events unfold. There are obstacles to any change. For example, separating incurred loss information from other components of fair value declines is not easy. The incurred loss could be defined as the present value of future expected cash flows discounted at the security's stated interest rate, which provides a frame of reference. However, as some of the comments to FSP 107-a explain, information of this type is not ordinarily maintained in accounting records, and developing systems to make it available could take time. In addition, there is resistance to reporting the components of declines in the fair value of assets that are required to be carried at fair value under FAS 157. FSP 107-a would not apply to such assets.

Whether the desire to improve investors' understanding of fair value declines will cause standard setters to require additional information about the components of such declines remains to be seen. For those who believe that the liquidity discounts experienced under current market conditions are temporary, having those discounts separately identified may be a partial solution. While the alternative of carrying assets at amortized cost may be more to their liking, the SEC report suggests that investor preference for fair value information is a powerful argument for staying the FAS 157 course. The events of the past two weeks tell us that there will be no quick resolution of these issues and, given their complexity, that outcome seems appropriate. One thing is certain. The SEC's thoughtful analysis of the issue will not be the end of the fair value matter. This week's activity at the FASB alone shows that the SEC's report is not the last word on these important issues.

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John L. Rogers III
Chicago, Illinois
312.832.4915
jrogers@foley.com

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