



SEC Hosts First of Two Mark-to-Market Accounting Roundtables

This is a summary of a forum discussion. No rules have been proposed or finalized.

BACKGROUND

October 29, 2008 — The U.S. Securities and Exchange Commission (SEC) hosted the first of two roundtable discussions to provide input to the Congressionally mandated study on mark-to-market accounting required by the Emergency Economic Stabilization Act of 2008. The second roundtable is scheduled for Friday, November 21, 2008. The SEC expects to submit its final report to Congress on January 2, 2009.

KEY POINTS

Most panelists believe Financial Accounting Standard 157 (FAS 157), *Fair Value Measurements* should be retained, but that the recent market turmoil has highlighted areas where the standard could be improved, additional guidance offered, disclosures increased and accounting practice clarified. Preparers are completing their first full fiscal year applying FAS 157, and it appears the standard's newness and the existence of unusual market conditions have created challenges in its application.

Panelists arguing against fair value accounting and the continued use of FAS 157 viewed the debate from a historical perspective. Former Federal Deposit Insurance Corporation (FDIC) Chairman William Isaac noted that the financial crisis in the 1980s would have been much worse had mark-to-market accounting been applied. He indicated that the FDIC did not require banks to write down loans to current transaction prices, but rather conducted an impairment style test that allowed institutions to rely more on cash-flow-based valuations. In addition, Richard Murray of SwissRe reminded the audience that mark-to-market accounting was U.S. generally accepted accounting principles prior to the Great Depression. In response, other panelists noted that FAS 157 allows companies to use factors other than the last transaction price when valuing assets, potentially resulting in a reclassification of assets from level two to level three, but that preparers were reluctant to use that option.

Ray Ball of the University of Chicago noted that FAS 157 "brings more judgment than any other standard written" and asked, "Why was judgment not used?" Later, SEC Chairman Cox asked, "How is it that institutions have passion about mark-to-market and yet are not discussing it with investors?" He implied that if entities felt the valuations they booked did not reflect economic reality then those preparers should have a larger number of assets falling under level three in the FAS 157 model and greater disclosure of their analyses. There was general agreement that FAS 157 provides the tools needed to address differing views on fair value, but preparers are reluctant to reclassify assets from level two to level three under the model.

Roundtable panelists felt that the general interpretation of how to apply FAS 157 is different from FASB's original intention, limiting the use of level three valuation models. Chuck

Maimbourg, Key Bank, noted, “[FAS] 157 is behind us. We have swept down this interpretive path where you go out in the market and find the lowest price you can find and mark your asset to it.” On several occasions, panelists mentioned that the fear of litigation and a negative external auditor response was behind this emerging interpretation of FAS 157. Mr. Ball summed it up, saying, “Sarbanes-Oxley certainly makes you act conservatively.” In short, panelists felt FAS 157 was fine in principle, but additional guidance was needed to put those principles into practice.

Numerous panelists suggested changes to return FAS 157 to its original purpose or improve the standard, including:

- Align FASB’s fair value disclosure requirements with recommendations recently made by the International Accounting Standards Board’s (IASB’s) Expert Advisory Panel. (FASB representative Thomas Linsmeier noted that FASB will decide whether to add such a project to its agenda shortly).
- Separate fair value changes due to credit losses from changes resulting from “other causes,” reporting incurred credit losses in the Income Statement with other causes flowing through Other Comprehensive Income. Panelists thought this distinction should be disclosed, if not made in the financial statements.
- Provide guidance on when a market is sufficiently illiquid and require a company to move from level two to three under FAS 157.
- Provide guidance on how to address differing levels of liquidity for different asset classes.
- Provide guidance addressing the inclusion or exclusion of specific components in valuation models.
- Loosen some of the tainting rules associated with the classification of assets as held-to-maturity.
- Examine propriety of guidance provided on Other-Than-Temporary-Impairments. Financial institutions may be required to write down certain debt securities classified as Held-to-Maturity and Available-for-Sale categories even if no credit loss has occurred.
- SEC/PCAOB should provide a framework for preparers and auditors for making judgments under FAS 157, including the creation of a “Safe Harbor.”

The list of suggestions illustrates that the debate regarding the application of FAS 157 and related standards is far from over. It’s also evident that preparers need to carefully apply this standard and be diligent about working through issues with their external audit firms.

Other FAS 157-related issues included:

- Understanding and separating regulator views on fair value for safety and soundness purposes from investor’s information requirements. Panelists suggested regulators might want to reconsider how reserves are established during more favorable market conditions to better prepare for market downturns.
- Raising awareness that the application of FAS 157 and related judgments foreshadow the challenges that U.S. entities will have making other accounting judgments during a transition to International Financial Reporting Standards (IFRS).
- Highlighting the effect of fair value in the application of FAS 141R, *Business Combinations*, which is effective December 15, 2008. Mr. Maimbourg noted that Key Bank walked away from specific acquisitions to avoid the requirement to revalue acquired loans to fair value.
- In the view of panelists, recent SEC and FASB guidance on fair value did little to change current practice.

IMPACT TO BUSINESSES

While specific SEC rules or accounting changes were not made, preparers should consider how issues raised in the forum will affect their application of FAS 157, including:

- The adequacy of their current fair value disclosures. The SEC's recent "Dear CEO" letters, FASB's potential expansion and clarification of disclosure requirements and investors' desire for clearer disclosures are all incentives for preparers to take a fresh and critical look at this important area. Ultimately, preparers will want to review their disclosures to make sure they are clearly and completely "telling their story" to regulators and investors. In addition, organizations should assess whether they have the supporting data to provide additional disclosures to the market if required.
- The adequacy of the documentation and controls supporting fair value judgments. Specifically, preparers will need to provide detailed disclosure and appropriate support to auditors for decisions made to reclassify specific assets from level two to level three under FAS 157. Organizations valuing assets at level three may be able to justify higher valuations, but they need to be prepared to support those conclusions.
- For calendar year-end filers, December 31, 2008, represents the first fiscal year-end containing the application of FAS 157. Given the application issues identified during this forum, preparers should consider a full review of their fair value documentation and controls to avoid significant financial statement or internal controls audit issues, deficiencies or weaknesses.
- Organizations considering acquisitions that close after December 15, 2008, should incorporate the fair value effects of FAS 141R into any analysis of the transactions.
- Companies considering how a transition to IFRS will affect their organizations should review issues that arose in conjunction with making fair value judgments. This experience is a good indicator of the kinds of accounting and control issues that a preparer will need to address as they transition to IFRS.

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