

# Hot Topic

Update on major accounting  
and auditing activities



## SEC hosts roundtable on fair value accounting

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### Summary

On 29 October 2008, the Securities and Exchange Commission (SEC) hosted the first of two roundtables to discuss fair value accounting and the recent period of market turmoil. The second roundtable is scheduled to be held on 21 November 2008. These roundtables serve as public hearings intended to provide the SEC with valuable insights from investors, companies, and other market participants affected by the current market conditions. The discussions and observations from these roundtables will provide important information to the SEC as it conducts the Congressionally mandated study on fair value accounting pursuant to the Emergency Economic Stabilization Act of 2008. The results of the SEC's study are due to be reported to Congress on 2 January 2009.

On 9 July 2008, the SEC hosted a roundtable that addressed fair value accounting.<sup>1</sup> While the July roundtable addressed fair value generally, the 29 October 2008 roundtable focused specifically on fair value as it is used by

financial institutions. The increased focus on financial institutions is predicated on the requirement by Congress that the SEC's study address the effects of accounting standards on the balance sheets of financial institutions, as well as the impact accounting standards have had on bank failures.

In his opening remarks,<sup>2</sup> Chairman Christopher Cox reiterated that the primary role of financial reporting is to serve as a communication tool with investors. However, he noted that financial reporting serves several other purposes as well, including its use by safety and soundness regulators of financial institutions. Accordingly, the discussion on fair value is not simply an accounting matter. Chairman Cox stated his belief that in considering the role of fair value accounting, it is important that differences between the uses of financial information by investors, regulators, and businesses be recognized and appreciated.

The SEC welcomes feedback from any interested parties, including investors,

<sup>1</sup> See our Accounting and Auditing News article from 11 July 2008 for further information regarding the 9 July 2008 roundtable.

<sup>2</sup> The full text of Chairman Cox's opening remarks are available at: <http://sec.gov/news/speech/2008/spch102908cc.htm>

financial institutions, auditors, and others on their study of fair value accounting applicable to financial institutions. Comments may be submitted directly to the SEC's website until 13 November 2008.

Materials from the SEC's roundtable, including a list of participants, comment letters received and other materials are available at <http://www.sec.gov/spotlight/fairvalue.htm>.

### Further discussion

The 29 October 2008 roundtable consisted of two separate panel discussions. Representatives on the panels included investors, issuers, auditors, and other parties with experience in fair value accounting. Additionally, representatives from the Financial Accounting Standards Board, International Accounting Standards Board, and Public Company Accounting Oversight Board, Federal Reserve Board, and US Department of the Treasury were present as observers, as were the Commissioners from the SEC.

The discussion among the first panel was generally focused on the following topics:

- the usefulness of fair value accounting generally;
- the application of fair value accounting; and
- the economic impact of fair value accounting.

The second panel, while discussing many similar topics as the first, was focused more specifically on the following five questions:

- Does the application of fair value accounting increase procyclicality in markets?
- Should management's intent be explicitly considered in a fair value determination?
- Should fair value be limited to situations where there is an active market?

- How could current disclosures related to fair value measurements be improved?
- Are there concerns regarding diversity in practice in the application fair value guidance?

### Themes from the panel discussions

The views expressed by the panelists varied significantly. For example, many panelists stated emphatically that they did not believe fair value accounting was the cause or a contributing factor to the current credit crisis. These panelists noted that accounting information reports economic activity it does not drive it.

Those panelists who generally support the use of fair value accounting, while acknowledging certain challenges in its application, believe that fair value provides investors with the most relevant information regarding financial instruments, and serves to increase both transparency and consistency in financial reporting.

Other panel members disagreed, stating their belief that fair value accounting has exacerbated the credit crisis and has served to unnecessarily diminish the capital of many financial institutions.

Those panelists who generally did not support the use of fair value accounting (as currently defined in Statement 157) expressed a number of concerns regarding its use, including the following:

- belief that fair value understates the "true economic value" of financial instruments when markets are depressed,
- inconsistency between the accounting model and the business model (e.g., community banks),
- perceived conflict with the exit price notion in Statement 157 with the idea that the reporting entity is a going concern,

- unforeseen negative consequences on economic decision making, such as whether to enter into a business combination,
- the application of fair value in a mixed attribute reporting model.

Notwithstanding the divergent views expressed by many of the panelists, there were a number of areas on which there was a general consensus among the group. These areas included:

- a belief that fair value information is relevant to investors and should be communicated in the financial statements. However, panelists disagreed as to the most appropriate way this information should be presented (e.g., disclosures vs. balance sheet recognition,
- the need to use judgment in determining fair value estimates, particularly in situations in which markets are illiquid or non-active,
- recognition that the specter of litigation, liability, and second guessing may inhibit the use of judgment and serve as a deterrent to more robust disclosures (e.g., sensitivity analysis).

### Other areas of discussion

Other topics that generated a significant amount of discussion included:

- the need to differentiate regulatory capital requirements from accounting information primarily focused on providing decision useful information to investors;
- inconsistencies in the accounting literature related to an asset impairment model; and
- potential alternatives regarding the presentation of changes in fair value measurements in the financial statements. One alternative discussed included the decomposition of changes

in fair value between credit impairment and other factors affecting fair value, such as liquidity. Under the suggested alternative, an entity would only report changes in fair value due to credit impairment in net income, with other changes reported through OCI. Displaying OCI on the face of the income statement (separate from net income) was also discussed. While this alternative generated interest across the panel, certain panelists expressed operational concerns about the ability to disaggregate the components of a fair value measurement.

### **Recommendations**

Most panelists agreed that certain improvements could be made regarding fair value accounting. A number of panelists advocated the need for additional guidance. As would be expected, there was a broad range of overall recommendations from the panelists including:

- a complete repeal of Statement 157
- a revision to the definition of fair value within Statement 157,
- additional guidance on other -than-temporary impairments,
- alignment of the guidance within US GAAP to the accounting guidance provided by the IASB within IAS 39; and
- revised disclosure requirements.

While the SEC did not indicate what (if any) course of action it is currently considering, the FASB observer indicated that the FASB intends to discuss disclosure requirements at their next meeting and determine whether or not to add a fair value disclosure project to their standard-setting agenda.

As previously noted, the SEC stated it will consider the information obtained in the roundtable in preparing its findings of the fair value accounting study.

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