

MEMO# 23162

January 7, 2009

SEC Report to Congress on Mark-to-Market Accounting

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TO: ACCOUNTING/TREASURERS MEMBERS No. 2-09
EQUITY MARKETS ADVISORY COMMITTEE No. 1-09
SEC RULES COMMITTEE No. 1-09 RE: SEC REPORT TO CONGRESS ON MARK-TO-MARKET
ACCOUNTING

The Securities and Exchange Commission recently released a report to Congress on the application of mark-to-market or fair value accounting as provided by FAS No. 157, Fair Value Measurements. [\[1\]](#) The Emergency Economic Stabilization Act (“EESA”) required the SEC, in consultation with the Federal Reserve and the Treasury, to study fair value accounting and report to Congress on the quality of information available to investors, modifications to fair value accounting, alternatives to fair value accounting, and other issues.

Consistent with comments submitted by the Institute, the Report recommends retaining fair value accounting for financial reporting. [\[2\]](#) The Report also recommends improvements to existing practice, including reconsidering the accounting for impairments and the development of additional guidance for determining the fair value of investments in inactive markets, including situations where market prices are not readily available. The Report indicates that “investment companies are subject to different standards than those of non-investment companies” and are outside the scope of the Report. The Report’s primary findings and recommendations are summarized below.

Findings

Among key findings, the Report indicates that investors generally believe fair value

accounting increases transparency in financial reporting and enables better informed investment decision-making. The Report also notes that fair value accounting did not appear to play a meaningful role in the bank failures that occurred in 2008. Instead, according to the Report, these failures appeared to be the result of growing probable credit losses, concerns about asset quality, and in certain instances, eroding lender and investor confidence.

EESA required the SEC to study six specific issues. These six issues and the Report's findings are described below:

1. **Effects of Fair Value Accounting Standards on Financial Institutions' Balance Sheets** In the debate concerning fair value accounting, some assert that accounting standards that require fair value accounting may inappropriately affect the balance sheets of financial institutions. The SEC evaluated the prevalence of assets measured at fair value on the balance sheet at selected institutions and the subset of those assets that are marked-to-market through earnings. The Report indicates that a minority of assets (45%) are measured at fair value. The percentage of assets for which changes in fair value affected earnings was significantly less (25%).
2. **Impact of Fair Value Accounting on Bank Failures in 2008** The SEC studied the causes of 22 separate bank failures that occurred in 2008. The Report indicates that fair value accounting did not appear to play a meaningful role in these failures. Instead, they appeared to be the result of credit losses, concerns about deterioration in asset quality, and in certain instances, eroding lender and investor confidence.
3. **Impact of Fair Value Accounting on the Quality of Financial Information Available to Investors** The SEC considered a broad spectrum of investor perspectives obtained through analysis of comment letters, academic research and public roundtables. The Report finds that investors generally support fair value measurements as providing the most transparent financial reporting, thereby facilitating better investment decision-making and more efficient capital allocation.
4. **Process Used by the FASB in Developing Accounting Standards** The SEC studied the governance and structure of the FASB, as well as its process for identifying agenda topics and developing accounting standards. The SEC's analysis of the FASB's processes for developing accounting standards reaffirms that an independent accounting standard-setter is best positioned to develop neutral and unbiased accounting guidance. The Report makes several recommendations intended to make FASB's processes more responsive and timely.
5. **Alternatives to Fair Value Accounting Standards** The SEC studied alternatives to fair value measurements, including the suspension of FAS No. 157. The Report describes strengths and weaknesses associated with alternative measurements bases, such as historical cost. The Report finds that a return to historical cost-based measures in financial reporting would likely increase investor uncertainty. Further, suspension of FAS No. 157 itself would not change fair value accounting requirements, which are prescribed in other long-standing accounting standards. Instead, suspension would remove the currently operative guidance for implementation.
6. **Advisability and Feasibility of Modifications to Fair Value Accounting Standards** The Report summarizes existing actions taken and underway to address challenges associated with fair value measurement. The Report then makes eight separate recommendations.

Recommendations

1. FAS No. 157 should be improved, but not suspended
FAS No. 157 does not determine when fair value should be applied. Instead, it provides a definition of fair value and a framework for its application.
2. Existing fair value and mark-to-market requirements should not be suspended
Fair value and mark-to-market accounting has been in place for many years and abruptly removing it would erode investor confidence. Fair value accounting did not cause bank and other financial institutions to fail. Investors support fair value accounting.
3. Additional measures should be taken to improve the application of existing fair value requirements
Such measures should include enhancing the existing disclosure and presentation requirements related to the effect of fair value in financial statements. Further, the FASB should examine the impact of liquidity in the measurement of fair value, including whether additional application or disclosure guidance is warranted. Additional guidance should be developed to improve fair value measurements, including:
 1. How to determine when markets become inactive,
 2. How to determine if a transaction or group of transactions is forced or distressed,
 3. How and when illiquidity should be considered in the valuation of an asset or liability, including whether additional disclosure is warranted,
 4. How the impact of a change in credit risk on the value of an asset or liability should be estimated,
 5. When observable market information should be supplemented with and/or reliance placed on unobservable information in the form of management estimates, and
 6. How to confirm that assumptions utilized are those that would be used by market participants and not just by a specific entity.
4. The accounting for financial asset impairments should be readdressed
The FASB should consider reducing the number of impairment models that currently exist in GAAP. Further, FASB should consider giving greater prominence to "other comprehensive income."
5. Implement further guidance to foster the use of sound judgment
The use of judgment in accounting and auditing has increased due to the focus on more principles-based standards, such as FAS No. 157. The SEC and the PCAOB should consider whether statements of policy related to the application of judgment in making fair value measurements would be appropriate.
6. Accounting standards should continue to be established to meet the needs of investors
The objective of financial reporting is to provide information to investors. To the extent that the interaction of fair value accounting and regulatory capital requirements has resulted in concerns about pro-cyclicality, such concerns should not be addressed through changes in accounting standards that would reduce investor confidence.
7. Additional formal measures to address the operation of existing accounting standards in practice should be established
While the FASB standard setting process works well, additional measures should be adopted to facilitate the identification and resolution of issues encountered in the

application of existing accounting standards. One such measure is the establishment of a Financial Reporting Forum with representation from the preparer, auditor and investor communities to meet with representatives of the SEC, the FASB and the PCAOB to discuss issues in financial reporting.

8. Address the need to simplify the accounting for investments in financial assets The “mixed-attribute” model used to measure financial assets and report changes in value in earnings causes complexity in financial reporting. While a move to require fair value measurement for all financial instruments would likely reduce complexity, the use of fair value measurement should not be significantly expanded until obstacles related to such reporting are further addressed.

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endnotes

[1] Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting (“Report”). The Report was prepared by the SEC’s Office of the Chief Accountant and the Division of Corporation Finance. The Report is available on the SEC’s website at:

<http://www.sec.gov/news/studies/2008/marktomarket123008.pdf>.

[2] See Memorandum to Accounting/Treasurers Members No. 17-08, Equity Markets Advisory Committee No. 59-08, SEC Rules Committee No. 80-08 [23068], dated November 17, 2008.