CENTER FOR AUDIT QUALITY
Serving Investors, Public Company Auditors & the Markets

November 13, 2008

Florence E. Harmon, Acting Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

SEC Study of Mark-to-Market Accounting, File No. 4-573

Dear Ms. Harmon:

The Center for Audit Quality ("CAQ")[1] is pleased to have the opportunity to comment on the study of "mark-to-market accounting" being undertaken, at the request of Congress, by the Securities and Exchange Commission ("SEC" or "Commission").[2] The CAQ supports the SEC's involvement in the study on the use of fair value measurements in financial reporting, and believes that the SEC can bring an investor-focused voice to the study. Some have argued that using fair value measurements can, in some circumstances, distort the value of certain assets, and that such use has exacerbated the current financial crisis.[3] The CAQ believes that blaming the current crisis on the use of fair value measurements in financial reporting, the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 157 ("FAS 157"), or the application of FAS 157, misreads the fundamental economic and regulatory underpinnings of the crisis, and inhibits efforts to address the crisis effectively. Therefore, although further clarification and improvement of how fair value measurements are made and presented in the financial statements may be beneficial, the CAQ believes that (1) the current use of fair value measurements for financial instruments in the

[1] The CAQ is an autonomous, nonpartisan, nonprofit group based in Washington, D.C. It is governed by a Board that comprises leaders from the public company auditing firms, the American Institute of CPAs and the investor and issuer communities. The CAQ was created to serve investors, public company auditors, and the markets by fostering confidence in the audit process and by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust. The CAQ is affiliated with the American Institute of CPAs.

[2] *See* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008) [hereinafter "EESA"]. Specifically, EESA § 133 states that the SEC "shall conduct a study on mark-to-market accounting standards as provided in Statement Number 157 of the Financial Accounting Standards Board. . . ."

[3] *See, e.g.*, Newt Gingrich, *Suspend Mark-To-Market Now!*, Forbes.com, Sept. 29, 2008, http://www.forbes.com/2008/09/29/mark-to-market-oped-cx_ng_0929gingrich.html. Similar views were espoused by several participants at the SEC's October 29 Roundtable on Mark-to-Market Accounting [hereinafter "October 29 Roundtable"], including William Isaac (former Chairman of the Federal Deposit Insurance Corporation) as well as Aubrey Patterson (Chairman and CEO of BancorpSouth, Inc.) and Bradley Hunkler (Vice President and Controller of Western & Southern Financial Group).

financial statements should not be changed at this time; (2) the definition of fair value and basic objectives of fair value measurements under FAS 157 are appropriate; and (3) neither currently required or permitted fair value measurements nor FAS 157 should be suspended.

We want to emphasize that the CAQ does not, through this letter, take a position on whether fair value measurements should be expanded to apply to additional types of financial assets or liabilities or to nonfinancial assets and liabilities. Although the use of fair value measurements has increased over time, many types of assets and liabilities are still accounted for at historical, amortized cost—the current mixed-attribute accounting model.[4] Any extension of fair value measurements to these other classes of assets should be left to future standards-setting proceedings.

I. Scope Of The SEC's Study And Standards-Setting Procedure

Although the CAQ supports the SEC's involvement in the study of the use of fair value measurements, accounting and financial reporting standards are best established through an independent standards-setting body, such as the Financial Accounting Standards Board ("FASB").

Since 1973, FASB has engaged in an extensive deliberative process before it adopts any accounting standard.[5] FASB's standards-setting process permits robust participation by all constituents, including the SEC. In fact, the SEC's Advisory Committee on Improvements to Financial Reporting ("CIFR"), which was established "to examine the U.S. financial reporting system, with a view to providing specific recommendations as to how unnecessary complexity in that system could be reduced and how that system could be made more useful to investors,"[6] has recently studied this very question and concluded that, "[i]n general, we believe the design of the

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4 The following is a brief overview of various financial institutions, and examples of the types of assets reported using fair value methods or historical cost methods:

- Commercial Banks. Many commercial banks report fewer than forty percent of their assets using fair value methods and, of those assets reported at fair value on the balance sheet, a much smaller percentage reflect changes in fair value through earnings (except in cases where a decline in fair value below cost is considered an other-than-temporary impairment, in which case the impairment is recognized in earnings). In that regard, changes in the majority of the assets that banks hold at fair value are reflected in other comprehensive income, a section of stockholders' equity that is reported to investors but generally is not included by banking regulators in computing regulatory capital. The largest group of assets held by most banks is loans, which are reported at amortized cost less an allowance for loan losses, unless held for sale. Loans held for sale are valued at the lower of cost or market.
- Investment Banks. Investment banks generally follow fair value accounting, with changes in values reported in earnings for all their security positions (both long and short) and all derivatives. Most other assets and liabilities are reported at historical cost, at contract amounts, or at the fair value of collateral to be returned.
- Insurance Companies. Insurers report the vast majority of their debt and equity investments at fair value, with changes in values reflected in other comprehensive income rather than earnings, again except in cases where a decline in fair value below cost is considered an other-than-temporary impairment. However, this reporting is only required in their general purpose financial statements; for insurers' reports to insurance regulators, the majority of debt securities are reported at amortized cost.
- Investment Companies. Investment companies (e.g., mutual funds or hedge funds) are the only financial institutions that are required to report all investments at fair value with changes to fair value measurements reflected in earnings.

  Most non-financial assets and liabilities are not reported in the financial statements using fair value methods, unless an impairment or new-basis event occurs.

5 *See* FASB, Facts About FASB – EITF, http://www.fasb.org/facts/due_process.shtml (last visited Nov. 13, 2008).

6 *See* Notice of Federal Advisory Committee Establishment and Notice of Meeting, Securities Act Release No. 8817, Exchange Act Release No. 55969, 72 Fed. Reg. 36077 (June 27, 2007).

U.S. standards-setting process, including the process of issuing authoritative interpretive implementation guidance, and the role played by each participant are appropriate."[7] The CAQ supports that conclusion.

CIFR, in its final report to the Commission, found that five steps could improve FASB's standards-setting process: (i) increase consideration of investor perspectives; (ii) enhance governance and oversight; (iii) improve process; (iv) clarify the role of interpretations; and (v) improve standard design.[8] The CAQ believes that CIFR's recommendations are generally substantively appropriate. The SEC should endorse CIFR's conclusions and should work with FASB toward continued implementation of these findings.

The CAQ firmly believes, however, that any changes to the standards-setting process should enhance, or at least be consistent with, the most important characteristic of any standards-setting process: independence. The CAQ strongly supports an independent standards-setting process, subject to public scrutiny and free of undue pressures. The urgency of the economic crisis only increases the need for procedural safeguards to protect against interventions that, while well-intentioned, are ultimately misplaced. Procedure and independence are important to ensure the legitimacy of the standards-setting process, and to protect the goals of transparency, relevance, and usefulness in financial reporting that have been hallmarks of decades of standards-setting efforts in the United States. Unconsidered actions could have unintended consequences, such as a divergence between U.S. GAAP and international accounting standards that would set back years of progress toward the ultimate goal of a single set of high-quality, globally accepted accounting standards.

II. Fair Value Serves Investor Interests In Transparency

The greater use of fair value measurements for financial instruments in the financial statements, also called "mark-to-market" accounting, along with related disclosures, has been a key part of the movement toward greater relevance, usefulness, and transparency in financial reporting that has taken place over the last thirty years. The CAQ believes that this movement is appropriate and should not be reversed. The use of fair values for financial instruments provides users of financial statements with useful and relevant information.[9] Specifically, when a company presents the fair value of certain financial assets and liabilities within its financial statements, rather than their historical cost, investors are given an additional insight into the risks to which the company may be exposed in achieving its current earnings and the potential liquidity issues that the company could face if it were to need to sell securities rather than to hold them for the longer term. The movement towards greater use of fair value measurements has resulted in the

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7 *See* CIFR, Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission Ch. 2 (Aug. 1, 2008).

8 *Id.* at 56.

9 The CFA Institute has asserted that fair value is the *most* relevant and useful information that can be provided to investors and creditors. *See, e.g.*, CFA Institute, A Comprehensive Business Reporting Model 8 (July 2007), *available at* http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2007.n6.4818.

inclusion of fair value measurements in new substantive accounting standards, or the amendment of existing standards to provide for use of fair value measurements, beginning in the 1970s.[10]

This trend toward fair value accounting was driven at least in part by past failures.

- During the crisis in the savings & loan ("S&L") industry, the absence of transparency provided by fair value accounting allowed these institutions to increase reported capital by selling their debt security investments in an unrealized gain position, which offset loan loss allowances that they were required to recognize, while at the same time holding on to underwater securities without reporting the extent of the amount of potential impairments in those securities. These factors, together with regulatory forbearance and less stringent capital requirements, disguised the depth of problems at many financial institutions to the ultimate detriment of investors and depositors, and complicated the task of regulators. Although the delays in loss recognition staved the crisis off temporarily, the resulting problems were worse than they would have been had the S&Ls been forced to recognize their deteriorating investment portfolios and any insolvency caused by the ultimate decrease in asset values.[11]

- Similarly, in Japan, the "lost decade" of the 1990s was largely caused by a property value boom followed by a rapid deflation that left many banks holding loans backed by real property the value of which had declined sharply.[12] Writing those loans down could have forced banks into difficulties or even failure, but not recognizing their impairment prolonged the financial crisis and delayed recovery. As investors could not be sure which banks were sheltering bad assets and which were properly capitalized, they simply did not invest in banks, and bank funding rapidly dried up.[13]

In both circumstances, a requirement to measure impaired assets at fair value could have resulted in declines that were less severe over the longer term, less protracted, or both.

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[10] *See* FAS 157 App. D (providing a list, as of the date of FAS 157's adoption, of the existing Statements of Financial Accounting Standards that referred to fair value: Nos. 13, 15, 19, 23, 28, 35, 45, 60, 61, 63, 65, 66, 67, 68, 84, 87, 98, 106, 107, 114, 115, 116, 124, 126, 133, 136, 138, 140, 141, 142, 143, 144, 146, 149, 150, 153, and 156).

[11] William Isaac provided testimony to the Commission during the October 29 Roundtable that the S&L crisis would have been *worse* if fair value had been in effect, as marking assets to market would have resulted in the failure of many S&Ls and farm banks, given the simultaneous recessions in real estate and agriculture. *But see* John W. Hill & Robert W. Ingram, *Selection of GAAP or RAP in the Savings and Loan Industry*, 59 The Accounting Review 667 (Oct. 1989) (arguing that S&Ls strategically used regulatory accounting principles ("RAP") when it would benefit the firm or management). Under RAP, S&Ls were permitted a number of accounting devices that seemed to increase their capital, including the ability to record present gains at fair value, but defer losses on securities or loans already sold—a clear departure from GAAP. When such an institution later failed, the resulting damage was much larger than it otherwise would have been. *See* Ahmad W. Salam, *Congress, regulators, RAP, and the savings and loan debacle*, The CPA Journal (Jan. 1994).

[12] Ricardo J. Caballero, Takeo Hoshi & Anil K. Kashyap, Zombie Lending and Depressed Restructuring in Japan 2-5 (Mar. 8, 2006), *available at* http://ssrn.com/abstract=889727 (arguing that, because unhealthy "zombie" banks were not permitted to fail, no room was created for new, financially-viable competitors to enter the market).

[13] *See* Testimony of Ray Ball, Professor of Accounting in the Graduate School of Business, University of Chicago, at the October 29 Roundtable ("[B]anks were allowed to keep financial instruments on their balance sheets at historical cost for a very long period of time, so that investors in the capital market did not know which were the strong banks and which were the weak banks and capital was misallocated in the banking market for a substantial period of time that inhibited the recovery of the economy.").

In recent years, while FASB added fair value requirements in a number of new accounting standards as a step toward greater transparency for investors, no common methodology for conducting the valuations was provided prior to the issuance of FAS 157. The result was a muddle of "fair value" methods and computations that changed from asset to asset, from liability to liability, and from company to company. This contributed to "inconsistencies that added to the complexity in applying GAAP."[14]

III. FAS 157's Use Of "Exit Value" Is An Appropriate Way To Calculate Fair Value

FASB sought to address the difficulties caused by multiple fair value methodologies with FAS 157, which "defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements."[15] Stated differently, FAS 157 itself does not prescribe any particular accounting treatment or require fair value accounting. Rather, it provides a consistent measurement methodology for applying existing fair value requirements, centralized in one standard. In addition, FAS 157 "simplifies and codifies related guidance within generally accepted accounting principles (GAAP)"[16] and requires increased disclosure of the methods and inputs used in fair value measurements of a company's assets and liabilities.

These improvements were intended to "result in increased consistency and comparability in fair value measurements" as well as "provide users of financial statements with better information about the extent to which fair value is used to measure recognized assets and liabilities, the inputs used to develop the measurements, and the effect of certain of the measurements on earnings (or changes in net assets) for the period."[17] Thus, FAS 157 combines fair value's transparency with greater comparability across companies and classes of assets and liabilities, permitting investors to better assess for themselves the reliability of the fair value measurements that a company presents in its financial statements.

To accomplish this goal, FAS 157 establishes an "exit price" objective for fair value measurements.[18] This "exit price" of the asset or liability must be established between a willing buyer and a willing seller who would put it to its highest and best use.[19] The use of the exit price provides an appropriate objective for fair value measurements that can be applied consistently.

This objective is embedded in FAS 157's three-level system of inputs into valuation techniques. Assets and liabilities measured at fair value are to be valued using Level 1 inputs—quoted prices in active markets for identical assets or liabilities—where available. If Level 1 inputs are not available, Level 2 inputs are used: quoted prices for similar assets or liabilities in active markets, quoted prices for identical assets or liabilities in inactive markets, inputs other than quoted prices

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[14] FAS 157, Summary—Reason for Issuing This Statement.

[15] *Id.* at ¶ 1.

[16] *Id.*

[17] Id. at Summary—How the Changes in This Statement Improve Financial Reporting.

[18] *Id.* at ¶ 7.

[19] *Id.* at ¶¶ 10, 12.

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that are observable, or inputs that are derived from or corroborated by market data. If Level 2 inputs providing a relevant estimate of fair value are not available, e.g., where there is "little, if any, market activity for the asset or liability at the measurement date," only then may Level 3—unobservable inputs—be used. Even where Level 3 inputs are permitted, however, FAS 157's valuation objective is still the exit price for the asset. In addition, companies valuing assets using Level 3 inputs must take into consideration market information if it is reasonably available.[20] This is because the best estimate of fair value remains the market's valuation of the exit price of the asset or liability.

The CAQ believes that the exit price objective for fair value measurements of financial instruments is just as important to investors when markets are illiquid as in other times. As the recent crisis has made clear, management may find it advantageous to sell assets that it otherwise would have held to maturity. Valuing financial instruments that are required to be measured at fair value using something other than an exit price objective, particularly in illiquid markets, would result in inconsistent measurements and would not provide users with the most transparent or relevant information about the value of a company's financial assets.[21]

IV. FAS 157 And Fair Value Are Superior To Alternative Proposals

FAS 157 is designed to provide a consistent framework for measurement of fair value, using to the greatest extent possible the most objective information available. The CAQ supports the principles of fair value measurements under FAS 157 and believes that it should not be suspended by the SEC.[22]

Even if FAS 157 is not a perfect method for estimating the fair value of assets and liabilities required or permitted by other accounting literature to be reported at fair value, suspension of FAS 157 alone would result in a reversion to the multiple valuation procedures that existed prior to FAS 157. The result would be diminished comparability and uniformity among financial statements for investors.

Fair value measurements cannot simply be suspended without putting something else in their place. Alternatives to fair value measurements based on the price at which the asset could be sold range from the price originally paid (historical cost) to other "intrinsic" or "economic" values reflecting an entity-specific viewpoint. Reverting to historical cost accounting (including amortized cost) would result in values that in many instances would bear no relationship to actual current values. Using "intrinsic" or "economic" values—methods that are not uniformly defined—could be based on management's subjective and discretionary judgments, with

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[20] *Id.* at ¶ 30.

[21] Of course, a company should be able to present, in the footnotes to its financial statements or elsewhere, alternative valuation information, or explain to investors that, in the company's opinion, the value of an impaired asset will increase again in the future. The SEC has provided examples of such additional relevant investor disclosures in its "Dear CFO" letters. *See infra* note 23.

[22] EESA seems to suggest that the SEC has the authority to suspend FAS 157 or fair value accounting using an emergency rulemaking procedure. Even if the SEC has authority to suspend accounting standards, the CAQ does not believe that suspension of FAS 157 or fair value accounting on an emergency basis is appropriate, given the significant economic dislocation that would result from such a radical change to financial reporting standards. If alternatives to FAS 157 or fair value accounting are to be developed, that development should be through a new FASB rulemaking, following formal notice and comment, with all procedural protections.

inconsistent and unverifiable results. With either of these alternatives, the result would be diminished transparency and comparability for investors, and would more generally represent an abandonment of the last thirty years of improvements in financial reporting.

Although the last few months have been undeniably painful for this country as well as for the global financial system, the use of fair value measurements for applicable financial instruments simply reported changes in values as they occurred. Even if fair value measurements under today's standards are not perfect, the use of fair value measurements for financial instruments as required by existing standards continues to provide investors with more relevant and useful information than any of its alternatives.

V. Potential Improvements To FAS 157

Although FAS 157 implements an appropriate methodology for fair value measurements, it is no surprise that a new standard such as FAS 157 could be improved through additional clarifications. The SEC and FASB, as well as the IASB, have recently released additional guidance in this area.[23]

However, additional guidance may be needed, particularly in the following situations:

- First, FAS 157 does not provide clear guidance about the circumstances in which it is appropriate to shift from Level 2 to Level 3 inputs when valuing an asset in a time of changing or disrupted market conditions. Guidance to aid in determining when a market is active or inactive, or when a particular transaction would be considered a "distressed" or "forced" sale not constituting evidence of fair value, would assist in exercising judgment in this area.

- Second, while FAS 157 creates a valuation method based on first principles and provides certain examples in its appendices, providing more specific examples of the fair value measurements of various types of assets and liabilities under varying assumed market conditions would be very useful.

- Third, additional guidance on presenting, in financial statements and notes, the periodic changes in asset valuation would be helpful to provide more useful information to investors.[24]

By suggesting that additional guidance may be useful in limited situations, the CAQ does not intend to imply that the current emphasis on accountant and auditor judgment embodied in FAS

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[23] *See* FASB, FASB Staff Position No. FAS 157-3 (Oct. 10, 2008); *see also* SEC Office of the Chief Accountant and FASB Staff Clarification on Fair Value Accounting, Press Release (Sept. 30, 2008); IASB Expert Advisory Panel, Measuring and disclosing the fair value of financial instruments in markets that are no longer active (Oct. 2008). Some of this guidance dates back to March 2008, when the SEC's Division of Corporation Finance sent 30 letters to CFOs that address disclosures in Management's Discussion and Analysis about fair value measurements in increasingly illiquid markets. (A sample letter is available at http://www.sec.gov/divisions/corpfin/guidance/ fairvalueltr0308.htm.) Similar follow-up letters were sent in September 2008. (A sample letter is available at http://www.sec.gov/divisions/corpfin/guidance/ fairvalueltr0908.htm.) The CAQ also would urge FASB to complete proposed FASB Staff Position 157-c to provide guidance on the valuation of financial liabilities.

[24] *See supra* note 7; *see also infra* Section VII.

157 is inappropriate. The CAQ agrees that replacing accountant and auditor judgment with a comprehensive rules-based standard would be counter-productive.[25] Reasoned judgment by accountants and auditors is an underpinning of all principles-based standards, and such judgment should be recognized as accountants and auditors work toward the resolution of these fair value issues.[26]

VI. Potential Changes To Other Regulatory Requirements

The CAQ believes that, although clarifications of FAS 157 as outlined above may be appropriate, the SEC's study should also recognize that changes to prudential regulations governing financial institutions with respect to capital adequacy have long been used to adjust financial statement data where necessary for prudential supervisory purposes. Further, regulatory capital calculations are disclosed in the financial statements. To continue to use prudential regulations to filter or otherwise adjust accounting information for regulatory purposes would be more beneficial than changing generally accepted accounting standards.

Modifications to financial reporting standards may not be an appropriate solution for the follow-on effects that many financial institutions may have experienced as a result of the effects of FAS 157. Rather, other regulatory requirements that address safety and soundness regulatory mandates that are based on the balance sheet—e.g., leverage ratios and capital ratios—could be re-examined by the prudential regulators of those financial institutions.

For example, bank regulators could change the definitions of Tier 1 and Tier 2 capital to add or subtract various classes of assets or include their own specific modifications to the valuations derived under FAS 157, so long as the resultant changes are disclosed.[27] Indeed, prudential regulators already discount for regulatory capital purposes the effects of fair value accounting for available-for-sale debt securities as well as decreases in the value of an institution's own debt liabilities (and thus the related increases in capital) that are the result of a decline in the institution's own creditworthiness.[28]

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[25] As Thomas Linsmeier of FASB appropriately noted during the October 29 Roundtable, the provision of specific guidance for every single conceivable type of CDO or CMO is inappropriate, as the result would be an undesirable repeat of the sheer size and complexity of FAS 133, *Accounting for Derivative Instruments and Hedging Activities*. Striking a reasonable balance between additional guidance and respect for accountant and auditor professional judgment within that guidance is not an easy task, but it is the appropriate goal.

[26] CIFR, for example, has recognized the trend toward "increasing exercise of accounting and audit judgments" and therefore urged the SEC and the PCAOB to adopt policy statements clarifying how the reasonableness of such a judgment would be assessed. *See supra* note 7, at 7 (recommending that any such policy statements include "the available alternatives a company identified; the robustness of a company's analysis of the relevant literature and review of the pertinent facts; the degree to which a company's approach is consistent with current accounting practice; and how a company's conclusions meet investors' information needs"). The CAQ supports the development of a judgment framework of this nature.

[27] The Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA")—enacted in the wake of the S&L scandal—prohibits banking regulators from applying regulatory accounting principles that are any less rigorous than GAAP. As prudential regulators should have the power and flexibility necessary to appropriately oversee the safety and soundness of financial institutions, regulators may need to assess whether FIRREA's limits on flexibility will nonetheless permit them to take fair value measurements into account.

[28] The Basel Committee on Banking Supervision had recommended that the "own credit risk" issue be resolved by removing the fair value option for an institution's own debt securities. *See* Letter from Jaime Caruana, Basel Committee on Banking Supervision to Sir David Tweedie, Chairman, IASB (July 30, 2004), *available at* http://www.bis.org/bcbs/ commentletters/iasb14.pdf. Prudential regulators have taken the appropriate approach by applying their own filters to this information.

In sum, financial reporting is undertaken primarily for the benefit of investors.[29] Where a presentation for investors is not entirely suitable for regulatory use, it is the prudential regulators who have the power and flexibility to adjust their formulae or information requirements to meet their regulatory mandate. It is thus the prudential regulators, and not investors—who are largely dependent on information provided under rules established by others such as the SEC and FASB—who should make the necessary adjustments. Moreover, inasmuch as regulatory capital ratios are disclosed in the financial statements, the application of new regulatory filters to accounting information could increase transparency by providing another lens through which investors may view the financial statement data.

VII. Potential Improvements To Accounting Standards, Including The Financial Statement Presentation Model

The accounting and reporting issues in today's turbulent markets highlight some of the challenges inherent in the current mixed attributes model. As long as some financial instruments are reported at amortized cost (adjusted for incurred losses) and others are reported at fair value, there will be questions about the proper relationship of the two. Such questions include determining when one method is appropriate for a particular class of assets or liabilities, and determining what rules will define a particular class of assets or liabilities.

Standards setters—including both the FASB and the IASB (acting jointly, if appropriate)—should review carefully potential changes that will address these issues. Those changes may range from minor adjustments to more extensive changes to U.S. accounting standards. Any such changes should be pursued on a coordinated global basis, to the extent possible, and in concert with the roadmap for the international convergence of standards.

As stated above, the CAQ supports the principles of fair value accounting, and does not believe that fundamental changes in fair value accounting are desirable or warranted. Some CAQ member firms have indicated, however, that in the near term there are several initiatives regarding accounting and reporting for loans and debt securities, presented in greater detail below, that could be considered without compromising the core principles of fair value measurement.

A. Align the accounting guidance for loan impairments with the accounting guidance for impairments of debt securities

Under GAAP, the requirements for measurement and recognition of impairment losses are different for loans than for investments in debt securities—even though the underlying cash

[29] *See supra* note 9, at 6. "Investors and creditors need timely, relevant, complete, accurate, understandable, comparable, and consistent information . . . to evaluate the potential risk and return properties of securities and to determine appropriate valuations for them. The purpose of audited financial statements, prepared according to high-quality financial reporting standards, is to provide the needed information." *Id.* However, because investors and creditors are "generally not in a position to be able to command the information they need to evaluate and value potential investments," securities regulators require the provision of financial statements as a condition of registration. *Id.*

flows for both asset types might be exactly the same.[30] Although the measurement and recognition of impairment for an asset in loan form is based on incurred credit losses at the measurement date, if that same loan were securitized, impairment would be measured and recognized based on the fair value of the security at the measurement date in relation to its current carrying value. This imbalance means that a change in form from a loan to a debt security, without any corresponding fundamental economic change, compels an entirely different accounting treatment.

- A potential response would be to revise the loss recognition model for other-than-temporarily impaired debt securities by recognizing currently in income only those impairments representing probable losses of contractual cash flows (or expected cash flows, in cases where a debt security does not have contractual cash flows—e.g., interest-only strips). This portion of the impairment would be deemed to be attributable to credit. The non-credit loss portion of the impairment (i.e., the difference between the amortized cost, as adjusted for impairment, and current fair value) would be recognized in other comprehensive income until the security is sold or matures. In addition to providing better alignment between impairment accounting for loans and debt securities, this change should help address the concern that fair value accounting unduly affects the regulatory capital adequacy of commercial and investment banks.

- In applying this approach, a decision would be required to determine whether to base the measurement of impairment losses on loan assets only on incurred credit losses as of the measurement date, or alternatively, expected credit losses to be incurred over the life of the loan. The "life-of-loan" approach to measuring and recognizing credit losses has been debated for some time. Its detractors claim that this approach is inconsistent with fundamental principles of accrual accounting, because it requires recognition of losses that, as of the reporting date, have not yet been incurred. A reconsideration of incurred versus expected loss models could be undertaken as part of broader review of FAS 5, with a view toward simplification of and consistency for all financial instruments.

B. Modify and conform the impairment models under EITF 99-20 and FAS 115

The standard for recognizing other-than-temporary impairment ("OTTI") on investments in debt securities is different under FAS 115 than under EITF 99-20. FAS 115 looks to the "probability of collecting all amounts due according to the contractual terms," while EITF 99-20 is based on evaluating whether there are "any adverse changes in the estimated cash flows that a market participant would use in determining the current fair value." As was the case for loan impairments and debt securities, these standards require different treatment of instruments that in many cases (but not all cases) have the same underlying economics, based only on the question of whether they are securitized or not. Accordingly, the CAQ suggests that consideration be given to bringing these models into conformity as much as possible, while giving recognition to

[30] *See* FAS 5 and FAS 114 for guidance about loan impairments, and FAS 115 and EITF 99-20 for guidance about impairments of debt securities.

the fact that some securitized beneficial interests, such as residual interests, do not have contractual cash flows and possess a high degree of variability in cash flows because of factors such as credit losses, prepayments, and changes in interest rates. To the extent that those beneficial interests are not accounted for at fair value through profit and loss (e.g., under FAS 155), an impairment model similar to EITF 99-20 could be developed to cover those types of assets. Alternatively, the scope of EITF 99-20 could be reconsidered.

In addition, consistent with the comments above about reporting changes in fair value, the CAQ suggests that consideration may be given to whether FAS 115 (and SAB 59) could be further revised such that OTTI would be recognized at the time a credit loss becomes probable—i.e., when it becomes probable that an investor will not receive the contractual cash flows on its investment. Also, the CAQ suggests that consideration be given to eliminating the “ability and intent to hold to recovery” test under FAS 115 and SAB 59, which was never intended to address credit risk, and replacing it with a requirement to recognize an impairment loss (to fair value) in income when it becomes probable an investor will sell an otherwise impaired security. Accordingly, OTTI would be recognized only (1) when there is a credit loss impairment (and then only for probable losses of contractual or expected cash flows); or (2) when it becomes probable that an investor will sell an otherwise impaired security.

Finally, the CAQ supports the SEC’s request that FASB address the appropriate impairment model for hybrid securities, such as perpetual preferred stocks, and encourages FASB to complete that project as soon as practicable.

C. Modify the approach for reporting periodic changes in fair value

Under current GAAP, changes in fair value from period to period are generally reported either in income or in accumulated other comprehensive income, depending upon the nature of the item. Standards-setters could consider modifying this model in the following ways:

- Consider separating, for accounting and reporting purposes, the periodic changes in fair value into two components: (i) probable credit losses (incurred or expected, per the discussion above) in income; and (ii) all other changes in fair value (including, for example, liquidity discounts) in other comprehensive income until it becomes probable that the asset will be sold or the asset matures.

- Consider changes in the format of the income statement to allow for (i) more visibility to the income effects of items reported at fair value and (ii) the inclusion of other comprehensive income on the face of the statement.

These actions could help enhance transparency and usefulness by providing a more consistent framework for recognizing impairment losses, and by reporting all changes in fair value-measured items in a single financial statement.

D. Further enhance and improve transparency through disclosures

The concerns expressed about the application of FAS 157 in distressed or illiquid markets could be addressed, at least in part, through clear and transparent disclosures. These disclosures could include information about the conditions present in a particular market and the assumptions and methods applied in the fair value measurement process.[31]

Entities that apply fair value accounting to financial assets and liabilities could also consider providing disclosures in Management's Discussion and Analysis about the "hold-to-maturity" (or a similarly defined term) values of those assets and liabilities. Such disclosures would help address the concerns of some that fair value accounting forces institutions to use overly pessimistic market prices to value their assets. Investors and other financial statements users could look to these disclosures to make an informed judgment about the financial position and estimated future cash flows of the entity.

VIII. Conclusion

The CAQ acknowledges that fair value measurements in distressed or illiquid markets are challenging, requiring significant judgment by accountants and auditors. Nonetheless, the CAQ believes that fair value remains the most relevant and useful measure for users of financial statements and that FAS 157's use of exit value and focus on observable inputs enhance transparency for investors.

Even if a method other than a FAS 157-based fair value method were to be applied, it would still require a significant amount of judgment by the reporting entity, including judgments about when markets are actually "inactive" and which market participant assumptions should not be considered in determining value.

The CAQ believes that it would be detrimental to the confidence of the marketplace to alter the fair value accounting model in any way that reduces the credibility, consistency, and neutrality of reported information.

Although fair value measurement principles under FAS 157 should be retained, there is room to consider changes to current accounting requirements that might enhance the relevance of financial reporting without undermining the benefits of fair value measurement.

Many of the concerns expressed by those in favor of departing from FAS 157 can be addressed through disclosures about the conditions present in a particular market and the assumptions and methods applied in the fair value measurement process.

[31] The Commission's "Dear CFO" letters—*see supra* note 23—are good examples of the types of additional disclosures that investors may find useful. The guidance in SOP 94-6, "Disclosure of Certain Significant Risks and Uncertainties," may also prove useful for reporting entities, given the current market environment.

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The CAQ again thanks the Commission for the opportunity to comment on the Commission's study on fair value accounting, and we would be pleased to discuss our comments with the Commission or its staff at their convenience.

Very truly yours,

Cynthia M. Fornelli

Cynthia M. Fornelli
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