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A legal update from Dechert's Financial Services Group

SEC Holds Roundtable on Fair Value Accounting and Auditing Standards

On July 9, 2008, the U.S. Securities and Exchange Commission ("SEC") held a roundtable discussion regarding fair value accounting and auditing standards. The roundtable consisted of two panels that approached fair valuation from different perspectives—the first from the perspective of larger financial institutions and the needs of their investors, and the second from the perspective of all public companies, including small public companies, and the needs of their investors. The panels included investors, preparers, auditors, regulators, and other interested parties. [1] The issues discussed included:

- the usefulness of fair value accounting to investors;
- potential market behavior effects from fair value accounting;
- practical experience and potential challenges in applying fair value accounting standards;
- possible improvements to the current standards; and
- experience with auditors providing assurance regarding fair value accounting.

The participants focused on the industry's need for guidance on how to comply with the Financial Accounting Standards (FAS) 157, which became effective in November 2007, as well as how to draft meaningful financial statement disclosure. The participants noted that the SEC should soon be commenting on the first wave of mutual fund financials that have been filed since FAS 157 became effective, which may provide helpful insight.

[1] The participants included: (i) Panel One: Large Financial Institutions: Jane B. Adams, Maverick Capital; Russell B. Mallett III, PricewaterhouseCoopers LLP; Kathy Petroni, Michigan State University; Joseph Price, Bank of America Corporation; Kurt N. Schacht, CFA Institute Centre for Financial Market Integrity; Matthew Schroeder, The Goldman Sachs Group, Inc.; and James S. Tisch, Loews Corporation; (ii) Panel Two: All Public Companies: Leonard W. Cotton, Centerline Capital Group; Sam Gutterman, American Academy of Actuaries; Charles Holm, Federal Reserve Bank; Gary R. Kabureck, Xerox Corporation ; Kenneth B. Robins, Fidelity Investments —Equity and High Income Funds; R. Harold Schroeder, Carlson Capital ; Wes Williams, Crowe Chizek and Company LLC; John B. Wojcik, Bank of the West. In addition, the following individuals participated in both panel discussions as observers: Thomas J. Linsmeier, Financial Accounting Standards Board; James J. Leisenring, International Accounting Standards Board; and Mark W. Olson, Public Company Accounting Oversight Board. The panel moderators were Jim Kroeker, Deputy Chief Accountant, Office of the Chief Accountant, SEC; Thomas Ray, Chief Auditor, Public Company Accounting Oversight Board; Wayne Carnall, Chief Accountant, Division of Corporation Finance, SEC; and Russell G. Golden, Technical Director, Financial Accounting Standards Board. SEC Chairman Christopher Cox and SEC Commissioners Elisse Walter and Paul S. Atkins were also present.

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FAS 157 provides a definition of fair value, establishes a framework for measuring fair value requiring the use of certain methods, and expands disclosures about fair value measurements. FAS 157 requires that firms categorize securities in one of three tiers (in descending order of price transparency). Under the standard, for assets falling into Tier 1, firms can rely on the active market to price the assets. In Tier 2, a category for assets with prices that are not readily available, firms can establish prices by reference to similar assets that trade actively. Finally, for Tier 3, the category for assets trading in the least transparent markets, firm must determine the prices of such assets. The SEC recently has indicated that examiners will carefully focus on how funds value their securities, including consideration of the risk level assigned to each under the guidelines set forth in FAS 157.

Usefulness of Fair Value Accounting

The benefits of fair valuation to investors were widely recognized by the roundtable participants. In particular, certain participants noted that fair valuation is important for market integrity and trust because it is a transparent measure for valuation. Another participant noted that investors find fair valuation useful and analyze the reliability of fair valuation estimates in making investment decisions.

Investor view

Panelists noted that fair value accounting provides investors with the most current and relevant information of any accounting method. Kurt Schacht of the CFA Institute said that investors greatly appreciate and desire fair value accounting. He called it "the only truly transparent" measurement that is complete, relevant, reliable, and up-to-date. He also said that fair value accounting is valuable in illiquid markets because it reveals to investors assets that are under stress. Matt Schroeder of Goldman Sachs stated, "Fair value is the oxygen of the firm. We live by it. It is part of our fabric." He recognized that fair value accounting is more challenging in illiquid markets, but was confident that it can be done by using a pro-active approach. He noted that officers and directors need to understand the market in which they operate and build a "body of evidence" from both information available in the markets and internal knowledge of the asset or liability being valued. He remarked that companies will have to "work harder" in illiquid markets to achieve accurate results, but that fair value accounting is better than any alternative. Jane Adams of Maverick Capital also agreed that investors are best served when assets are "marked to market" (*i.e.*, measured at fair value).

Auditor/Accountants/Actuary view

Russell Mallett of PricewaterhouseCoopers asserted that fair value accounting is the best available method of valuing assets and liabilities. He noted, however, that auditors are especially challenged in illiquid or frozen markets. He said that auditors nevertheless are capable of deriving measurements by engaging in "price discovery," which is the hard work of "getting behind information." He also noted that FAS 157 is a principal standard that does not provide an answer to every fact pattern. Accordingly, experts need to exercise judgment in applying principles and providing best estimates in distressed markets. Sam Gutterman of the American Academy of Actuaries confirmed that auditors can measure fair value in illiquid markets, but under such conditions such figures are estimates that often do not match actual outcome prices. He advocated for the use of experts who will construct complex models and exercise judgment about unobservable inputs.

Corporation view

Most corporations argued that fair value accounting is the most reliable method of valuing assets and liabilities, but corporations tended to be less supportive of using it to value illiquid assets. The corporations holding long term asset-backed securities in particular were less likely to support using fair value methods. James Tisch of Loews Corporation stated that FAS 157 has affected securities they hold whose price is impacted by interest rate movement. He said companies must impair securities that have any level of unrealized loss due to interest rate increases or declare an intent to hold those securities until price recovery, and he disputed that this method of measurement accurately depicted the fair value of securities, implying that FAS 157 unfavorably affected the manner in which securities were being held. Mr. Tisch also raised issue with the reliability of fair value measurements with respect to Level 3 assets because it often seems as if someone is just throwing out a number. Gary R. Kabureck of Xerox Corp. opined that fair value accounting is applied in too many places and he supported using it in more limited situations. He observed that because it is difficult to measure fair value in illiquid markets, it is hard to retain in-house experts. Joe Price of Bank of America supported using fair value accounting, but said he is opposed to the use

of fair value for non-contractual liabilities, most notably litigation.

Potential Market Behavior Effects from Fair Value Accounting

Participants expressed differing viewpoints on the potential market behavior effects of fair valuation accounting in the current market environment. Most participants expressed the view that fair valuation is not procyclical—that is, it reflects what the market was currently experiencing rather than perpetuating problems. Several participants believed that avoiding the use of fair valuation could result in simply extending the duration of problems in the market. In the context of funds in particular, one participant stated that periods of illiquidity from the current crisis do represent actual volatility in the market which should be reflected. However, one participant argued that accounting rules, in fact, do have corporate consequences, and that companies may adjust their behavior to take accounting rules into account.

Investor view

Investors unanimously agreed that fair value accounting does not have a material pro-cyclical effect. Jane Adams of Maverick Capital stated that fair value accounting is a "neutral arbiter;" nothing that fair value accounting reflects basic economics and assists management in making economic decisions. Matt Schroeder of Goldman Sachs said the flipside of not recognizing losses in fair value immediately is seen by what happened to the Japanese: a prolonged, painful recovery period. He commented that FAS 157 is less pro-cyclical than the alternative.

Auditor/Accountants/Actuary view

Russell Mallett of PricewaterhouseCoopers noted that FAS 157 fair value accounting provides the most transparent measurement of current market conditions. He said "there may be an appearance of pro-cyclicality" because it takes time for information to come out and investors react immediately, but if investors had real time information, fair value accounting would not appear as such. "From an accounting perspective it is neutral," he said.

Corporation view

James Tisch of Loews Corporation disagreed with investors and accountants on this point, stating that accounting rules have real consequences on the behavior of corporations and the markets in general. He said companies "will adjust their behavior to take [accounting rules] into account." For example, he said that investors loaded up on mortgage backed securities, but if FAS 157 rules had been in place at the time, investors would not have invested in nearly so many mortgage-backed securities because a large number of them are Level 3 assets.

Practical Experience and Potential Challenges in Applying Fair Valuation Standards

The roundtable discussed the various challenges of applying fair valuation standards. One challenge noted was that as markets and instruments have become more sophisticated, it is difficult to find in-house expertise for valuation, causing firms to look to outside specialists. Participants also noted that in the context of illiquid markets, fair valuation is more difficult and requires more effort to find trading prices. Another participant added that auditors face similar challenges to those faced by firms and that price discovery also involves a significant effort for auditors. As a way of addressing these challenges, one participant emphasized that managers should have a risk management focus and a mindset of looking for the exit value of a position.

Thomas J. Linsmeier, a representative of the Financial Accounting Standards Board, noted that FAS 157 states that fair value should reflect the exchange price in an orderly market, and where a price is not an acceptable measure it must be adjusted to reflect the economic circumstances. For instance, if a price is not representative, adjustments may need to be made, possibly using a model-based measure that includes inputs or cash flows.

Possible Improvements to the Current Standards

The roundtable participants viewed disclosure as critical for implementation of fair valuation, particularly regarding key inputs and assumptions. Many roundtable participants felt that financial statement disclosure

regarding fair valuation should be improved in order to provide greater clarity to investors and gave various suggestions of possible improvements to disclosure.

Investor view

Investors identified flaws in the current system and had suggestions for future improvements. R. Harold Schroeder of Carlson Capital remarked that the public often confuses fair value with market value. He stated that it is imperative to educate investors that fair value is not necessarily market value and that fair value measures are estimates. He stressed that companies need to provide a "sensitivity tool" for Level 3 assets in the form of a table that provides a range of appropriate values and that reveals the assumptions and inputs used to calculate each value. The main problem that Kurt Schacht of the CFA Institute identified was inadequacy of disclosures relating to the fair value accounting methodology as required by FAS 157. Another suggestion to improve disclosures was to feature the relevant information in a single place in the disclosure document with commentary and takeaway points to make it less scattered throughout the document. Wes Williams of Crow Chizek called for a well-defined framework for professionals—not new standards, but rather "interpretive guidance."

Auditor/Accountants/Actuary view

Auditors called for more guidance from the SEC and the Public Company Accounting Oversight Board ("PCAOB"). Sam Gutterman of the American Academy of Actuaries identified the need for more meaningful and effective disclosures on financial statements to provide clarity to investors about the inputs and variables relating to fair value accounting. Thomas J. Linsmeier, a representative of the Financial Accounting Standards Board, noted that FAS 157 states that fair value should reflect the exchange price in an orderly market, and where a price is not an acceptable measure it must be adjusted to reflect the economic circumstances. He suggested that if a price is not representative, adjustments need to be made, possibly using a model-based measure which includes specified inputs or cash flows.

Corporation view

Corporations also agreed that there needs to be more guidance from the SEC on fair value accounting. Joe Price of Bank of America sought additional guidance from the SEC for the use of fair value in distressed and illiquid markets. In contrast to investor and auditor views on disclosures, James Tisch of Loews Corporation said there is already significant disclosures by companies, but because disclosures are written by lawyers and accountants ordinary investors may not understand the information.

The lack of standardized inputs and wide range of results obtainable by shifting inputs in the fair value calculations made in connection with valuing Level 3 assets formed a key issue that the roundtable participants requested the SEC to examine. Participants sought guidance in applying auditing standards to real life situations.

Experience with Auditors Providing Assurance For Fair Value Accounting

Mark Olson, a representative of the PCAOB, mentioned that the PCAOB has issued staff guidance on auditing for fair valuation. He noted that the guidance did not establish new standards but instead was intended as a summary. He also emphasized that the PCAOB looks for professional skepticism and the extent to which an effort is made in fair valuation, particularly with respect to Tier 3 assets. Commissioner Atkins suggested the possibility of a public notice and comment on the PCAOB guidance. He added that although professional skepticism is needed, examiners also need to have a balanced viewpoint to avoid being overly conservative.

One participant noted that as a result of the credit crisis, many firms have developed additional internal guidance to link auditing standards with real life situations. Participants also noted that guidance in applying auditing standards to real life situations would be useful. A particular area noted where guidance would be helpful was in understanding how broker quotes are developed and how to apply broker quotes from an auditing perspective.

Conclusion

In closing, SEC Chairman Christopher Cox stated that the roundtable had provided real world insight as to how fair valuation was viewed by investors and companies and how FAS 157 had fared in the difficult market conditions present in 2008. He noted that investors seemed to view fair valuation as extremely useful, while financial institutions felt that fair valuation was worth the challenges involved because it was better than the alternatives. He recognized, however, that some

representatives of institutions and public companies believed that there were significant challenges in determining fair valuation, and that when values are unreliable there can be unintended consequences. Chairman Cox stated that the SEC would meet with the FASB and PCAOB in order to continue to improve guidance and ensure that fair valuation serves investors and all users of financial statements.

SEC Commissioner Paul Atkins noted that the SEC could play a role in providing guidance on the implementation of fair valuation, particularly with respect to FAS 157. In addition, SEC staff members have indicated that the SEC may issue interpretive guidance on the valuation of mutual funds and related matters. Staff members have indicated that core points may include advice regarding: valuation methods; determination of whether market quotations are "readily available" and, if not, factors to be considered by fund boards in determining the appropriate valuation method; securities traded outside the United States; third-party pricing services; accounting for special factors such as large holdings and restricted securities; money fund valuations; valuation of derivatives; liquidity; and appropriate of valuation-related policies and procedures under Rule 38a-1.

There has been no reliable indication of the time-frame in which the SEC's guidance will be issued, and this was not included as an item on the Spring Regulatory Agenda. The implications of the guidance should be carefully considered when it is published.

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