

# Reporting Challenges & Fair Value Issues

**THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008**

Are fair value standards causing financial firms to incessantly reduce the value of assets (such as mortgage-backed securities) for which there is currently no market? The Emergency Economic Stabilization Act of 2008 gives the Security and Exchange Commission (SEC) the authority to suspend fair value, or mark-to-market, accounting and requires them to conduct a study to determine the impact of fair value accounting. The volatile and declining capital markets have generated numerous accounting and reporting challenges for many companies, and most believe additional challenges are yet to come. In an effort to help management with these challenges, the SEC has released clarification on fair value measurement in conjunction with the Financial Accounting Standards Board (FASB).

REPORT CARD				
GRADING PERIOD	1	2	3	4
READING	A			
WRITTEN COMMUNICATION	A			
MATHEMATICS	C			
SCIENCE/HEALTH	B			
SOCIAL STUDIES	B			
ART	A			
MUSIC	A			
PHYSICAL EDUCATION	C			
Grade Average	B			
Attendance:	Present 48			
	Absent 2			
	Tardy 1			
A = Excellent • B = Good • C = Satisfactory • N = Needs Improvement U = Unsatisfactory • I = Inefficient / Incomplete				
Student:		Grade:		Year:

## THE SEC'S MARK-TO-MARKET STUDY

Under the new legislation (EESA) to help stabilize financial markets, the SEC is required to conduct a study of "mark-to-market" accounting. The study is to be completed by January 2, 2009, in consultation with the Secretary of the Treasury and the Board of Governors of the Federal Reserve System. Under the terms of the EESA, the study will focus on:

1. The effects of such accounting standards on a financial institution's balance sheet
2. The impacts of such accounting on bank failures in 2008
3. The impact of such standards on the quality of financial information available to investors
4. The process used by the Financial Accounting Standards Board in developing accounting standards
5. The advisability and feasibility of modifications to such standards
6. Alternative accounting standards to those provided in FASB Statement Number 157

The SEC is scheduling public roundtables to obtain input into the study from investors, accountants, standard setters, business leaders, and other interested parties.

The International Accounting Standards Board (IASB) has offered to participate in the study that measures the impact of accounting in a credit crisis. The IASB seeks to ensure that any International Financial Reporting Standards (IFRS) guidance is consistent with FASB interpretive guidance regarding fair value for maximum comparability across borders. The IASB has already pointed out a few inconsistencies within U.S. generally accepted accounting principles (GAAP) and IFRS, including reclassifying financial instruments into securities and transferring non-security loans from "held for sale" to "held for investment."

## FAIR VALUE AND MANAGEMENT CONSIDERATIONS

The current economic crisis and financial environment has made the determination of fair value particularly challenging for preparers, auditors, investors and other users of financial information. FASB recently issued a proposed FASB Staff Position (FSP) that would amend FASB Statement No. 157, Fair Value Measurements, to clarify its application in an inactive market by providing an illustrative example to demonstrate how the fair value of a financial asset is determined when the market for that financial asset is inactive. Additional interpretive guidance is currently in progress. In the meantime, the SEC and

FASB have provided immediate clarifications to fair value measurements in the current environment, summarized below along with management considerations regarding accounting and reporting concerns.

### Utilizing assumptions to measure fair value

Fair value should reflect current market conditions. When an active market for a security does not exist, the use of management estimates that incorporate current market participant expectations of future cash flows, and include appropriate risk premiums, is acceptable. Statement 157 discusses a range of information and valuation techniques that a reasonable preparer might use to estimate fair value when relevant market data may be unavailable, which may be the case during this period of market uncertainty. This can, in appropriate circumstances, include expected cash flows from an asset. Companies' financial statements are clearly affected by the current economic climate

and fluctuations.

### Management Considerations:

- Review current methodology for measuring fair value, particularly for complex or illiquid securities, and determine if any changes have been/need to be made to those practices
- Identify key assumptions and how they affect the company
- Determine if additional internal-only models have been used for valuation purposes and how the results were supported by underlying assumptions
- Review changes to key assumptions in light of the current market and business operations
- Estimates of fair value should involve considerations of credit, interest rate and liquidity risk, based on reasonable and supportable assumptions consistent with those used by third-party sources in determining the current fair value of the instrument
- Fair value estimates based on a valuation model should also include an appropriate risk premium reflecting the uncertainty surrounding the cash flows of the underlying assets

### Evaluate/update risk management procedures & internal controls

Current market conditions have prompted many companies to re-evaluate their processes for identifying and assessing risks facing the company. Audit committees are focusing on risk assessment and internal controls, diving deep into the subject to determine if financial or operating risks are being sufficiently identified and evaluated and whether they are being detected early on. Management should consider the effects of current conditions on risks and related internal controls. Audit committees have much to discuss with management and their auditors, including (but not limited to) the risk management and internal control items listed below.

### Management Considerations:

- Review and assess the company's risk management strategy in light of current market events to determine necessary changes and identify controls to support those changes
- Assess and discuss recent internal control performance
- Determine if susceptibility has increased regarding financial, operational, or strategic exposure generated by current market and financial conditions
- Develop a plan to mitigate this exposure and future susceptibility
- Identify if any new material risks have surfaced that affect operations, financial reporting, fraud, or compliance and determine a plan to address these risks

- Update the scope of internal control over financial reporting, including the potential need for additional evidence to support effective operation (positive) conclusions
- Improve financial statement disclosures, as necessary, to adequately address risks, uncertainties and concentration of risks

#### Utilizing market quotes to measure fair value

Quoted prices in an active market provide the best evidence of fair value. However, inactive markets are a different matter. Broker quotes may be one source of input when measuring fair value, but are not necessarily determinative if an active market does not exist for the security. In a liquid market, a broker quote should reflect market information from actual transactions. However, when markets are less active, brokers may rely more on models with inputs based on the information available only to the broker. In weighing a broker quote as an input to fair value, an entity should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote (e.g. whether the quote is an indicative price or a binding offer) should be considered when weighing the available evidence. Judgment is required to determine whether or not a market is active.

#### Management Considerations:

- Understand the methods and inputs used by broker-dealers and other third-party sources used to develop the estimate (i.e., pricing model, cash flow projection, or other valuation technique)
- Broker-dealer and third-party quotes are not necessarily determinative of fair value
- Understand a model's ability to adequately reflect the current market conditions and related risks
- Accountability for valuations of alternative investments cannot be outsourced or assigned to a third party
- Consider all relevant factors and attributes of the company's interest when determining whether to adjust the underlying net asset value of alternative investments for fair value

#### Distressed/disorderly transactions and fair value

The results of disorderly transactions are not determinative when measuring fair value. The concept of a fair value measurement assumes an orderly transaction between market participants. An orderly transaction is one that involves market participants that are willing to transact and allows for adequate exposure to the market. Distressed or forced liquidation sales are not orderly transactions, and thus the fact that a transaction is distressed or forced should be considered when weighing the available evidence. Determining whether a particular transaction is forced or disorderly requires judgment.

#### Management Considerations:

- Understand how observable inputs in an inactive market should be considered when measuring fair value

#### Other-than-temporarily impaired investments

In general, the greater the decline in value, the greater the period of time until anticipated recovery, and the longer the period of time that a decline has existed, the greater the level of evidence necessary to reach a conclusion that an other-than-temporary decline has not occurred.

#### Management Considerations:

- Investors should assess whether an impaired investment is other-than-temporarily impaired at every reporting period.

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- Existing U.S. GAAP does not provide "bright lines" or "safe harbors" in making a judgment about other-than-temporary impairments. However, "rules of thumb" that consider the nature of the underlying investment can be useful tools for management and auditors in identifying securities that warrant a higher level of evaluation.
- Determining whether impairment is other-than-temporary is a matter that often requires the exercise of reasonable judgment based upon the specific facts and circumstances of each investment, including an assessment of the nature of the underlying investment (i.e., whether the security is debt, equity or a hybrid) which may have an impact on a holder's ability to assess the probability of recovery. Consider:
  - The length of the time and the extent to which the market value has been less than cost;
  - The financial condition and near-term prospects of the issuer, including any specific events, which may influence the operations of the issuer such as changes in technology that impair the earnings potential of the investment or the discontinuation of a segment of the business that may affect the future earnings potential; or
  - The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.
- All available information should be considered in estimating the anticipated recovery period.

#### Additional areas for review, assessment and action

Additional areas that require management's attention and evaluation with regard to proper handling include:

- Derivatives
- Auction rate securities
- Consolidation of investment vehicles
- Qualifying special-purpose entities
- Long-lived assets
- Goodwill and indefinite-lived intangible assets
- Income taxes
- Inventory
- Postretirement benefits
- Debt
- Share-based payments
- Revenue recognition
- Restructurings and disposal or exit activities
- Transactions with financial service entities

The above article was designed to help you understand and address certain accounting and financial reporting issues that may prompt the need for additional attention due to current market conditions. As market events continue to unfold, we will keep you updated. We are available to answer any questions you may have regarding how issues in our current economic environment affect you and your company. Please feel free to contact us at any time.



**Scott A. Walters, CPA** is a Partner in the Audit & Accounting Services Department and is based in our Sunrise office. With a particular focus on the interpretation of new accounting pronouncements, implementation of Sarbanes-Oxley compliance and SEC reporting requirements, Scott guides public companies to ensure a comprehensive understanding of corporate governance policies and the need for transparent financial reporting. Contact Scott directly via email at [swalters@daszkalbolton.com](mailto:swalters@daszkalbolton.com) or by phone at 954.691.4567.