

# theInterpreter

## This Just In: Standard Setters on Record-Setting Pace for Issuance of Fair Value Accounting Guidance

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*The downturn in global capital markets sparked a flame on Capitol Hill, which in turn ignited a wildfire within the domestic and international standard setting organizations. The passage of the Emergency Economic Stabilization Act of 2008 mandated the Securities and Exchange Commission (SEC) perform a study*

*of mark-to-market accounting standards, the results of which were submitted to Congress in December 2008. The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) created a Financial Crisis Advisory Group, comprised of leading economic minds around the globe, to aid in advising the standard setting organizations in response to the aforementioned SEC study and the needs of the financial reporting world.*

There is an organized global effort to reduce the inconsistent measurement of fair value and the application of impairment guidance for financial assets. FASB and IASB have committed to aggressive time-frames for the issuance of revised guidance, and their collaboration on projects is paramount due to the impending convergence towards a common, international standard of financial reporting.

While the markets' decline appears to have leveled off, establishing fair value for certain investments and assessing asset impairment will continue to be challenging due to new and developing pronouncements from these standard setting organizations.

The Evolution of Investment Accounting for Insurance Enterprises

SFAS 60, Accounting for Insurance Enterprises, established accounting guidance specific in nature to insurance companies. It requires fixed maturity securities be carried at amortized cost and equity securities at fair value. Fluctuations in fair value only impacted the balance sheet, while realized gains and losses were recognized within earnings. SFAS 60 introduced the concept of "other than temporary" decline in fair value, but merely mandated such declines be recognized as if a sale had occurred.

SFAS 115, Accounting for Certain Investments in Debt and Equity Securities, established a new, categorical method for investment accounting with the introduction of the categories trading securities, available-for-sale securities and held-to-maturity

securities. A major development resulting from SFAS 115 is the need to recognize market value fluctuations as a component of earnings for trading securities. SFAS 115 retained the other than temporary decline concept, and brought greater prominence to the concept of intent to hold as a means of justifying the classification of fixed maturity securities in the held-to-maturity category.

Several shortcomings of these pronouncements were not fully exposed until the bull market, which began in the 90s and abruptly shifted into reverse during 2008. Specifically, the need for meticulous impairment analysis and the consideration of valuation when confronted with inactive markets were not exceedingly germane. The long-running bull market created an environment in which the concepts of other than temporary and intent and ability to hold did not require extensive analysis. Functional markets with high volumes of activity and pervasive asset inflation did not leave many people questioning the significance of a fair value methodology.

While the economic crisis of 2008 led to the recent barrage of accounting guidance, a severe, but short-lived market slide subsequent to the dot-com bust and 9/11 sparked additional investment impairment dialogue. In 2005, FASB issued a Staff Position (FSP), FSP 115-1, which established a framework to evaluate impairment on a security-by-security basis, the severity of the impairment, and the likelihood of recovery. Unfortunately, the guidance was rather subjective and created significant inconsistency in evaluating other than temporary impairment (OTTI). While it isn't extraordinary for two companies to

reach different conclusions regarding OTTI for a particular security, great difficulty exists for users of financial statements when attempting to compare one company's performance to another.

With regard to valuation, in 2006 FASB issued SFAS 157, Fair Value Measurements, which offered a methodology for determining fair value and expanded fair value disclosure requirements. SFAS 157 did not change the recognition requirements of SFAS 115; rather SFAS 157 provided a common definition of fair value and guidance on how fair value might be determined. SFAS 157 also introduced a hierarchical approach, based on inputs used to determine fair value, to enhance disclosures regarding the fair value measurement process. Unfortunately, SFAS 157 was not as clear as the standard setters envisioned. Several FSPs and other guidance have been issued to offer clarity on the application of SFAS 157 since its original release.

A Cry for Help – Recent Accounting Guidance in Response to the Economic Crisis

The most relevant accounting guidance to follow the recent economic crisis is the SEC's study on mark-to-market accounting, and the flow of new accounting pronouncements that has ensued subsequent to the study. Over the past year, in response to the recommendations set forth by the SEC and reinforced by Congress, FASB issued three significant pronouncements, each of which attempts to address issues that have arisen as a result of the economic crisis:

- FSP 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active
- FSP 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly
- FSP 115-2, Recognition and Presentation of Other-Than-Temporary Impairments

FSP 157-3 was released at a time when markets for many types of investments were dysfunctional, yet it retained the notion that fair value is the "price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date under current market conditions." The predominant interpretation of SFAS 157

was that the maximized use of observable inputs required companies to utilize recent, unadjusted transaction prices. FSP 157-3 acknowledged that in some circumstances, observable inputs might require significant adjustment based on unobservable data, such as management's internally-generated assumptions and analyses.

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FSP 157-4 attempts to address the determination of a disorderly transaction, provides common indicators of an inactive market, and indicates that if an investment is determined to have significantly decreased volume and level of activity, reporting entities should determine if observable transactions were conducted in an orderly fashion. If the reporting entity determines observable prices obtained do not stem from an orderly transaction, other valuation techniques should be utilized, such as discounted cash flow models or intrinsic value methodologies. However, FSP 157-4 requires footnote disclosure of the valuation techniques utilized in determination of fair value of investments.

FSP 157-3 and 157-4 effectively offered greater flexibility to move to a level three methodology, thus placing lesser reliance on market transactions that many perceived to be anything but accurate representations of fair value. FSP 157-4 also introduced the notion of using multiple valuation techniques, thereby creating a range from which a best estimate of fair value might be determined.

FSP 115-2 provides revised guidance for evaluating OTTI on debt securities. Prior OTTI guidance focused on the "intent and ability to hold a security" as the impetus for impairment recognition, while FSP 115-2

focuses on "whether the entity (a) has the intent to sell the debt security, (b) more likely than not will be required to sell the debt security before its anticipated recovery, or (c) does not expect to recover the entire amortized cost basis of the security."

In the event a reporting entity does not meet the criteria of (a) and (b) above, but does meet criterion (c), FSP 115-2 expands reporting requirements by bifurcating declines in the fair value of debt securities between credit related factors and "all other factors". If the report entity determines that either (a) or (b) are met, the impairment will be recognized through earnings. If criterion (c) is met, FSP 115-2 indicates that credit related losses result in a charge to earnings (similar to prior OTTI guidance), while non-credit related impairment will be recognized as a component of other comprehensive income (similar to prior treatment of unrealized losses).

## A Glimpse to the Future

FASB and IASB are jointly committed to improving and converging financial reporting standards, with specific, long-term objectives related to financial instruments. IASB elected to follow a three-phase timeline, focused first on classification and measurement, next on impairment of financial instruments and finally to address hedge reporting requirements. FASB, on the other hand, indicated a desire to address recognition, measurement and impairment simultaneously, with a subsequent focus on hedge accounting. While the two groups are progressing down slightly different paths and timelines, great consistency can be expected in the final products, to promote the convergence of reporting standards. Both groups are committed to final standards in 2011 or 2012.

## IASB First to Strike

In November 2009, IASB issued IFRS 9, Financial Instruments, containing guidance on the first phase of IASB's project, recognition and measurement. IFRS 9 uses a single approach to determine if a financial instrument will be measured at amortized cost or at fair value. Essentially, a financial instrument that has basic loan features and is managed on a contractual yield basis would qualify for measurement at amortized cost,

unless management makes an irrevocable election to measure the instrument at fair value. Any financial instruments not meeting the amortized cost criteria, including all equity instruments, would require fair value measurement.

In November 2009, IASB issued an exposure draft related to the impairment of financial assets, Financial Instruments: Amortized Cost and Impairment. Current GAAP and IFRS guidance focuses on fixed income security impairment recognition upon the occurrence of a loss. Based on comments received from the G20 nations, the IASB exposure draft presents the concept of recognizing expected losses over the life of the fixed income security, creating a provision for credit losses to mirror the life of the fixed income instrument. The exposure draft is open for comment through June 2010.

## Domestic Developments

FASB met at various times throughout 2009 to deliberate categorization and measurement and recognition methods for financial statements, and FASB expects to release an exposure draft during the first quarter of 2010 with a comprehensive update on these topics. FASB did reach several decisions in 2009, including the measurement of all financial instruments (with limited exceptions) at

fair value, with unrealized gains and losses recognized in net income or comprehensive income. Presentation of fair value changes in comprehensive income would be allowable only on the basis of “qualifying criteria related to an entity’s management intent/business model and the cash flow variability

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of the instrument”. Fair value changes for all instruments not meeting such criteria, including derivatives, equity securities and hybrid instruments would be required to be presented in net income. Interest and dividends, as well as credit impairments (see earlier discussion of FSP 115-2) and realized gains and losses, would continue to be presented in net income. Organizations will need to classify instruments at initial recognition, and subsequent reclassification

would not be permitted.

While FASB’s direction is certainly inconclusive and tentative, there do appear to be some inconsistencies when compared to the IASB releases; such inconsistencies can be expected to be reconciled by FASB and IASB as the groups continue working towards convergence.

## A Final Thought

In case anyone in the financial reporting arena has been comfortable in recent years, be advised you should continue to hold onto your seats for the foreseeable future. We find ourselves in an environment where not only is the business landscape rapidly evolving, but this economic crisis has instigated a significant level of political involvement. Bifurcation of impairments, converging global standards and principles based guidance (just to name a few) will leave preparers, auditors, regulators and users facing an arduous learning curve. The changes coming our way will be served in the name of transparency and reduced complexity, but be assured it will feel anything but clear and simple!

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