Speech by SEC Staff: Fair Value Accounting– Let's Work Together and Get It Done!

Remarks by

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Introduction

Good morning. I would like to begin by thanking the AICPA for the invitation to speak at this conference. It is truly an honor. Before I move on, let me remind you that my remarks are my own and do not necessarily reflect those of the Commission or its staff.

Today I am going to talk about measuring financial instruments at fair value. This is a topic that some of you heard the Chairman, Chief Accountant and me discuss lately.

The theme of our comments have been the same:

- All financial instruments should be measured at fair value;
- Those measurements should be reliable and transparent;
- And, historical cost information about financial instruments should not necessarily be abandoned.

The majority of my speech today will focus on the practical issues that I believe must be addressed to measure all financial instruments at fair value. Specifically, I believe that:

- Standard-setters must provide more detailed, how-to accounting, valuation, and auditing guidance;
- Outside experts need to be consulted;
- And, preparers, auditors, and users need to be better educated about fair value accounting.

While my speech today focuses on measuring all financial instruments at fair value, these recommendations about the practical issues should be extended to other assets and liabilities when GAAP requires that they be measured at fair value. For example, these recommendations should be applied to improve the accounting for business combinations and stock compensation. The list could go on and on.

Some might ask why now? Numerous conditions exist that have created an urgent need for better guidance on estimating fair values and auditing those estimates, including:

- The economy has become more dynamic and, thus, the need for reliable fair value amounts is becoming increasingly important;
- The SEC staff and certain other regulators have seen and continue to see problems that are attributable to unreliable estimates of fair value;
- Over the years, standard setters have required measuring assets and liabilities at fair value without providing detailed "how to" valuation and auditing guidance for estimating those fair values;
- And, various accounting projects are underway that would require more assets and liabilities to be measured at fair value.

In light of these conditions, there is no time like the present to move forward.

Before I address practical issues, I would like to set the stage by briefly discussing a few conceptual considerations.

Fair Value Measurements – A Conceptual Perspective

What does fair value mean?

First, let me review the accounting definition of fair value. Under GAAP, the fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties, other than in a liquidation. On the other side of the balance sheet, the fair value of a liability is the amount at which that liability could be incurred or settled in a current transaction between willing parties, other than in a liquidation.

If available, a quoted market price in an active market is the best evidence of fair value and should be used as the basis for the measurement. If a quoted market price is not available, preparers should make an estimate of fair value using the best information available in the circumstances. In many circumstances, quoted market prices are unavailable. As a result, difficulties occur when making estimates of fair value.

Is Fair Value Relevant?

Now that we have a point of reference, let's discuss relevance. In today's dynamic and volatile markets, whether it is to buy or sell, what people want to know is what an asset is worth today.

Accounting research supports that assertion. The FASB, after extensive discussions, has concluded that fair value is the most relevant measure for financial instruments. In its deliberations of Statement 133, the FASB revisited that issue and again renewed its commitment to eventually measuring all financial instruments at fair value.

Fair value measurements provide more transparency than historical cost based measurements. Maybe, if companies in the United States and Asia had measured all financial instruments at fair value, regulators, depositors, and investors could have achieved greater regulatory and market discipline and avoided some of the losses that investors and taxpayers have had to pay during previous downturns in the economy.

Reliability Needs Focus

However, with all of the recent emphasis on relevance, some believe that there has not been enough focus on reliability. Reliability is as important as relevance because relevant information that is not reliable is useless to an investor. Not only does that statement make good business sense, it is consistent with our accounting framework as well.

Paragraph 58 of FASB Concepts Statement No. 2 explains, "That information should be reliable as well as relevant is a notion that is central to accounting. It is, therefore, important to be clear about the nature of the claim that is being made for an accounting number that is described as reliable."

That paragraph sums it up well why it is critical that there be balance between relevance and reliability.

What Do Investors Want?

Conceptual discussions are fun – for some – but let's take a minute and consider what investors want. That is, do investors want financial instruments to be measured based on fair value or historical cost?

The FASB, as part of its fair value project, asked certain user constituents if they prefer fair value or historical cost based measurements, and the result was both. They desire fair value information so as to better determine the true value of their investment. At the same time, they want to see the historical results that provide a measure of cash flows and indicate whether management has achieved operating results that were budgeted or predicted.

I believe that investors want fair value information, but not necessarily at the cost of abandoning historical cost information. I also believe that investors need to be educated on what measuring financial instruments at fair value means in the context of financial reporting.

Fair Value Measurements – A Practical Perspective

I would like to spend the remainder of my time discussing the practical side of measuring financial instruments at fair value, from a regulator's perspective.

The FASB should be commended for the significant headway it has made towards requiring all financial instruments to be measured at fair value. To make the project manageable, the FASB has used an incremental project approach – an approach that I support. In light of that, however, we are faced with dealing with the difficulties of a mixed attribute model.

These difficulties include not knowing how to apply the guidance to unique, new transactions because of inconsistent models in the literature, resisting accounting arbitrage, and determining whether impairments are other than temporary. Thus, this is why the FASB continues to move forward with its project to measure all financial instruments at fair value. Investors will be in a much better position to evaluate a company's performance when there is a single model that produces intuitive and consistent results.

The FASB's role is just one piece in the puzzle. The AICPA's role is another. "How to" valuation and auditing guidance needs to be developed. And, preparers, auditors, and users need to be educated on how and why fair value impacts financial reporting. Along these lines, the AICPA should be commended for their accomplishments as well. But, more work needs to be done.

Difficulties with a Mixed-Attribute Model

I realize that many suggest that a practical approach would be for the FASB and other standard setters to just stop. That option would be easy to apply. However, accounting has moved too far down the road to do that, as that would leave us with the mixed attribute model and all of its difficulties.

Let's back up and discuss why the current model is referred to as a mixed attribute model. It is because some financial instruments are measured based on historical cost, some at lower of cost or market, and some at fair value.

To add to the mix, for those instruments measured at fair value, sometimes the changes in fair value are recognized in earnings and other times in comprehensive income. In certain instances, financial instruments are not even recognized in the financial statements until settlement date – and, oh boy, can that lead to surprises. Finally, I must mention that how financial instruments are measured is often a choice. Try comparing one company to another under these circumstances.

Besides the lack of comparability among companies, other difficulties arise because of the current mixed attribute model. Let me elaborate. New and more complex financial instruments are developed with increasing frequency. Often times these instruments are developed for specific, valid business purposes – such as managing risk and reducing the cost of capital or tax liability. All too often, these instruments don't fit any of the models exactly and preparers and auditors do not know which model to apply.

Other times financial instruments are developed to arbitrage the accounting. For example, just hire yourself a good financial engineer and with the sprinkle of a little magic dust, presto change, you can recharacterize your asset. That is, you can change the method of measurement of your financial instrument with little or no change to the economics. And, sometimes, these recharacterizations can be unwound at will. This is very troubling to investors – and the staff.

Financial engineering can lead to the management of earnings by controlling the timing of revenue, gains and losses. With continued emphasis on smooth, stable earnings, financial engineering is a thriving industry in and of itself. Without the mixed attribute model, financial engineering as we know it today would be harder to accomplish.

Another problem that arises because of the mixed attribute model is addressing whether a decline in the value of a marketable security is an other-than-temporary impairment. If only one model existed, this issue would evaporate. In the meantime, please refer to Michael Pierce's comments from yesterday – and note that the staff is expecting registrants to rigorously apply SAB 59 which addresses when a decline is other than temporary.

Because of these conditions, growing pains of a sort, the FASB must continue to move forward with its project on measuring all financial instruments at fair value.

Reliability

That brings us to reliability. Unfortunately, in the current state of the profession, preparers are challenged to make good estimates of fair value when quoted market prices don't exist. As a result, the Chief Accountant has challenged the profession to do better.

The staff has heard from investors, analysts, and other regulators that sometimes the values they see being reported on lack credibility. They question whether the numbers are "good" numbers and whether the auditor has rigorously examined them. The staff shares those concerns given some of the valuations it has seen as Eric Jacobsen discussed yesterday. Further, the effects of a mixed attribute model magnify the concerns about credibility. As a result, it is time for the profession to take action.

If one closely examines these concerns they find many factors contribute including:

- Using inappropriate models such as the cash-in method to estimate fair value measurements when no quoted market price is available.
- Applying appropriate models inappropriately – for example, by using assumptions that do not reflect the risk in the underlying instruments.
- Not fully understanding fair value accounting and how it reflects current changes in market conditions, such as changes in prepayment rates, in the financial statements.

Let me tell you a short story. When I was an FASB Practice Fellow, I was working on a project to explain why the cash-in method of accounting did not appropriately estimate fair value.

One day a constituent came in to explain to the FASB staff why the cash-in method resulted in a good estimate of the fair value of a residual interest in a securitization of loans. He had pages and pages of analysis and a long story to prove his point. After reading his analysis and listening to his story, it was concluded that the cash-in method did not work because it does not consider the time value of money when cash is restricted and unavailable for use for long periods of time – sometimes years.

Shortly thereafter, the FASB staff issued guidance stating that the use of the cash-in method is inappropriate. In addition, they identified one acceptable, alternative model to use for those valuations. Using inappropriate models is just one symptom. Another symptom is using inappropriate assumptions.

Two major issues are a significant source of the reliability issues I just described – the need for more robust accounting, valuation, and auditing guidance and the need for more education. Fortunately, the profession, under the leadership of the FASB and the AICPA, has reacted timely.

For example, when the sub prime-lending crisis arose in 1998, the FASB held focus group meetings with users and preparers to develop disclosure requirements about assumptions to help restore stability and credibility to the market. A summary of these disclosures complete with detailed "how-to" examples were completed by the end of 1998 and posted to the FASB's website for voluntary compliance, while it worked through its notice and comment requirements.

These disclosure requirements, which were adopted by Statement 140, and are effective for most companies in December 2000, remain largely the same because of the timely, cooperative effort between the FASB, members of the accounting profession, and the users of financial statements. Let me reemphasize that this project was completed quickly and effectively because everyone – standard setters, preparers, users, and auditors – worked together and because of the "how-to" examples.

Likewise, the AICPA has shown similar leadership. Recently, the Chief Accountant commended the AICPA for its leadership in this area and encouraged it to not only continue its efforts, but to expand them. He encouraged the AICPA to finish its guidance for valuing IPR&D and so called "cheap stock," as well as its guide on auditing derivatives and investments.

Further, he challenged the AICPA to take a larger leadership role, by developing detailed, broad-based guidance on valuation models and methodologies used (a) to measure fair value, under the oversight of the FASB, and (b) in auditing fair value estimates. This challenge applies to both measuring financial instruments at fair value, which is the primary focus of my talk today, and to improving other fair value measurements applied by GAAP.

Developing More Guidance

I now would like to address the need for more accounting, auditing, and valuation guidance. I agree with the FASB's conclusion not to require a specific model when estimating fair values because quoted market prices are not available. But, what the FASB must do as it continues to work on its framework for fair value measurements, is to ensure that the framework will allow for reliable measurements that are faithful to the economics of the transactions in the market place. To do this, the FASB should continue, as it has done in the past, to consult with experts and coordinate with others that provide the details on valuations and auditing.

I would like to spend a few more minutes on the AICPA efforts. Let me begin with the IPR&D project. While this is not a financial instruments project, I mention it because of how it is being handled. In that project, valuation experts, accounting and auditing specialists, and industry representatives have worked together to develop comprehensive guidance that satisfies the requirements of existing accounting standards while providing meaningful information that is consistent with that recognized and used in the marketplace. That guidance includes the details (including extensive examples) necessary to assist preparers, valuation experts, and auditors "how to" do it. Let me reemphasize two things – first more than just accountants are involved and second the efforts to operationalize the guidance. This is terrific.

The AICPA recently issued Statement on Auditing Standards 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities,* and is working on a separate audit guide on auditing derivatives and securities that is expected to provide the necessary "how to" specifics needed to ensure high quality audits.

The AICPA is in a unique position to lead efforts to develop more valuation and auditing guidance because of its existing resources and access to expertise (including accounting, auditing, and valuation expertise), contacts inside and outside the accounting profession, and relationship with the FASB. The AICPA has the ability to bring together a world-class team of experts to further develop this guidance in coordination with the FASB. Many large accounting firms have done a lot of good work in this area and their guidance should be leveraged by the AICPA as it continues to develop its guidance.

As part of their efforts, it would be helpful for the AICPA to make a list of common measurement techniques and state which ones are acceptable or unacceptable in certain circumstances. The precedent was set for this approach when addressing the cash-in, cash-out issue.

More Education

The development of valuation and auditing guidance is important – but it is only one step in improving estimates of fair value. Efforts to educate are important too. Preparers, auditors, and even some users need to become more educated on fair value estimates – how they are calculated and what they mean. Words like delta and theta need to become important words in our daily vocabulary – and not as names of fraternities and sororities that many of us were once a part of.

But the increased education should not wait until members of the profession are in practice. Educational curricula need to be modified to more effectively teach valuation techniques, the meaning of fair value, and how financial instruments work. The AICPA, as a leader in the accounting profession, is in a unique position to promote the changes necessary to better educate those concerned.

One expected outcome of these efforts is that the internal control systems for measuring financial instruments at fair value and for auditing those measurements will evolve as preparers and auditors become more knowledgeable about how to make fair value measurements.

Remember What Investors Want

As the FASB pushes forward with its framework, it also must remember what information the investors want. As mentioned earlier, investors do not necessarily want to do away entirely with historical cost information. A recent suggestion by the Chief Accountant warrants consideration. He suggested, "perhaps consideration should be given to a process whereby historical cost and fair value numbers are reported side by side, at least for some period of time." Other methods could work too – but the key is to remember what the investors want.

On that topic, I have a challenge for investors – get involved because your voice counts. Members of the FASB and AcSEC read every comment letter that they receive. However, the majority of the letters come from preparers and auditors. Investors, as well as other users, please get involved.

International Considerations

Today, I have been speaking from a domestic perspective. But, before I wrap up I would like to touch on some international aspects. Throughout the world many standard setters are wrestling with issues similar to those that I have described. My comments apply to them as well. In addition, I encourage the FASB and AICPA to continue their international efforts. The staff has been supportive of efforts to improve and converge international accounting standards, but not at the sacrifice of quality or other harm to the investing community. John Morrissey will talk more on international issues in a few minutes.

Summary

In summary, let me reiterate that:

- Only one model should exist for measuring financial instruments.
- That model is fair value.
- Fair value measurements should be reliable and computed in a manner that is faithful to the underlying economics of the transaction.
- Measuring financial instruments at fair value should not necessarily mean abandoning historical cost information.

  To accomplish these tasks, the following actions should be taken to address the practical issues:

- Standard-setters must provide more detailed, how-to accounting, valuation, and auditing guidance.
- The profession must work together and with others outside the profession including users and valuation experts.
- Preparers, auditors, and users must become better educated about fair value accounting.

Furthermore, these recommendations about the practical issues should be extended to other assets and liabilities that GAAP requires to be measured at fair value to improve those measurements as well.

So, let's work together and get it done! That concludes my prepared comments. I would be happy to answer any questions during the Q&A session. Thank you very much.

http://www.sec.gov/news/speech/spch436.htm
