

CASE 1-2 POLITICIZATION OF ACCOUNTING STANDARDS—A NECESSARY ACT?

On October 3, 2008, Congress passed the Emergency Economic Stabilization Act of 2008. This Act mandated that the SEC conduct a study on mark-to-market accounting standards. The SEC had a 90-day period in which to conduct the study.

On December 30, 2008, the SEC released the “Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting.”

The Executive Summary of the SEC report included these comments:

The events leading up to the Congressional call for this study illustrated the need for identifying and understanding the linkages that exist between fair value accounting standards and the usefulness of information provided by financial institutions. In the months preceding passage of the Act, some asserted that fair value accounting, along with the accompanying guidance on measuring fair value under SFAS No. 157, contributed to instability in our financial markets. According to these critics, fair value accounting did so by requiring what some believed were potentially inappropriate write-downs in the value of investments held by financial institutions, most notably due to concerns that such write-downs were the result of inactive, illiquid, or irrational markets that resulted in values that did not reflect the underlying economics of the securities. These voices pointed out the correlation between U.S. GAAP reporting and the regulatory capital requirements of financial institutions, highlighting that this correlation could lead to the failure of long-standing financial institutions if sufficient additional capital is unavailable to offset investment write-downs. Further, they believed the need to raise additional capital, the effect of failures, and the reporting of large write-downs would have broader negative impact on markets and prices, leading to further write-downs and financial instability.

Just as vocal were other market participants, particularly investors, who stated that fair value accounting serves to enhance the transparency of financial information provided to the public. These participants indicated that fair value information is vital in times of stress, and a suspension of this information would weaken investor confidence and result in further instability in the markets. These participants pointed to what they believe are the root causes of the crisis, namely poor lending decisions and inadequate risk management, combined with shortcomings in the current approach to supervision and regulation, rather than accounting. Suspending the use of fair value accounting, these participants warned, would be akin to “shooting the messenger” and hiding from capital providers the true economic condition of a financial institution.

The recommendations and related key findings of the SEC report were the following:

1. Recommendation—SFAS No. 157 Should Be Improved, but Not Suspended
2. Recommendation—Existing Fair Value and Mark-to-Market Requirements Should Not Be Suspended
3. Recommendation—Additional Measures Should Be Taken to Improve the Application of Existing Fair Value Requirements
4. Recommendation—The Accounting for Financial Asset Impairments Should Be Readdressed
5. Recommendation—Implement Further Guidance to Foster the Use of Sound Judgment
6. Recommendation—Accounting Standards Should Continue to Be Established to Meet the Needs of Investors
7. Recommendation—Additional Formal Measures to Address the Operation of Existing Accounting Standards in Practice Should Be Established
8. Recommendation—Address the Need to Simplify the Accounting for Investments in Financial Assets

In April 2009, the FASB issued three staff positions intended to provide additional application guidance and enhance disclosures regarding fair value measurement and impairments of securities. The new rules made it easier for banks to limit losses. The FASB in effect ratified proposals it had put out for comment two weeks earlier.

Source: Financial Accounting Standards Board

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