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Credit Market Services

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July 3, 2008

Florence E. Harmon
Acting Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549–1090

Via Electronic Mail: rule-comments@sec.gov.

Re: File No. 4-560

Submission for Roundtable on Fair Value Accounting Standards

Dear Ms. Harmon:

Standard & Poor's Ratings Services (Standard & Poor's) appreciates the opportunity to provide the Securities and Exchange Commission (the Commission) with our submission for consideration at the Commission's July 9, 2008, *Roundtable on Fair Value Accounting Standards* (the Roundtable). Fair value accounting and reporting issues are critically important to Standard & Poor's analysts, especially considering the current turbulent market environment, the evolutionary state of global financial reporting standards, and the Commission's initiative to improve financial reporting undertaken by its Advisory Committee on Improvements to Financial Reporting.

Our accompanying whitepaper, "Is It Time To Write Off Fair Value?" (also available on RatingsDirect, the web-based source for Standard & Poor's credit ratings, research, and risk-analysis), outlines our views of fair value accounting and financial reporting. It elaborates upon topics the Commission indicated are relevant to the Roundtable discussion, including the usefulness of fair value accounting; practical experience and potential challenges in applying the fair value accounting standards; and aspects of the current fair value standards that can be improved. The views expressed in this letter and in the whitepaper represent those of Standard & Poor's, and do not address, nor are they intended to address, the views of The McGraw-Hill Companies.

We support the basic premise that fair value, when coupled with robust disclosure, is a relevant basis of accounting for financial assets and liabilities. However, we recognize that accounting for assets and liabilities at theoretical market-price measures may produce results that could mask the underlying economics for certain businesses and activities, especially during volatile and uncertain economic and market conditions. Our support of fair value accounting is constrained by what we view as significant shortcomings in related disclosures, the prevalence of "mixed attributes" in measurement, and shortcomings to the presentation in the income statement of fair value accounting results.

We believe certain refinements to fair value accounting should be considered by the accounting standard setters. These include:

- rethinking financial statement presentation, and the income statement in particular, to better inform users of the sources of earnings and value creation, as well as the factors driving these;
- requiring disclosure of the underlying risks, valuation methodologies, assumptions, volatility and sensitivities, and other factors that would enable analysts to consider valuation changes in the context of broader asset-liability and risk-management practices, and business activities;
- allowing greater emphasis on entity-specific information (i.e., not market-based) in valuations when market observations are substantially lacking, or are meaningfully influenced by temporary supply and demand imbalances or market disruptions; and
- requiring footnote disclosure of information regarding the actual market values or the values derived by using indices when market transactions exist, but the company has elected not to use them, or has modified them for valuing its positions, and the reasons for doing so.

As more fully discussed in the attached whitepaper, we believe such additional information, if consistently and clearly disclosed, would allow analysts to better evaluate the reported financial results in the context of past and future performance, and to evaluate whether and how the recorded amounts may develop going forward.

We reiterate our belief that fair-value accounting should continue to have a significant role in the accounting for financial assets and liabilities, but that it should be reinforced and complemented with enhanced disclosures and revisions to the income statement, in order to achieve the desired financial reporting objectives and serve as a useful benchmark for analysts and other financial-statement users. To achieve these improvements, active participation and contributions by all affected constituencies (including companies, accounting standard setters, auditors, investors, regulators, and analysts) is essential to achieving an improved financial reporting discipline, capable of meeting the information needs of investors and creditors, and of supporting the evolving global capital markets for many years to come. We hope the Roundtable will serve as a cornerstone for that dialogue.

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We thank you for the opportunity to provide our submission for consideration in the Roundtable, and would be pleased to discuss our views with any member of the Commission's staff. If you have any questions, or require additional information, please contact Neri Bukspan, Chief Quality Officer and Chief Accountant at (212) 438-1792 (neri_bukspan@standardandpoors.com) or Ronald Joas, Director of Financial Reporting Analysis at (212) 438-3131 (ron_joas@standardandpoors.com).

Very Truly Yours,

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May 27, 2008

Is It Time To Write Off Fair Value?

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Is It Time To Write Off Fair Value?

Standard & Poor's Ratings Services believes financial statements should endeavor to portray the underlying economic position of a company, and fair value accounting should reflect this fundamental principle. In our view, the challenges associated with fair value can only be overcome by recognizing that it is impossible to translate the complexity of an economic event into a single number--whether presented using historical or amortized cost, fair value or any other agreed-upon measurement basis--and consequently, providing additional instructive disclosures and greater transparency around fair value measures is essential.

We support the basic premise that fair value, when coupled with robust disclosure, is a relevant basis of accounting for financial assets and liabilities. However, we recognize that accounting for assets and liabilities at theoretical market price measures may produce results that could mask the underlying economics for certain businesses and activities, especially during volatile and uncertain economic and market conditions. These inherent limitations underscore the need for financial statements to complement fair value measures with additional information about uncertainties in the measurement of assets and liabilities.

Although not new, fair value accounting is gaining increased attention because of:

- the greater impact it has on financial results;
- its ability to influence market sentiment;
- its impact on regulatory measures and compliance;
- its effects on management incentives and compensation;
- the increasingly complex legal and economic environment;
- the growing sophistication of financial products and financing arrangements; and
- the greater incorporation of fair value measures into financial reporting.

Our support of fair value accounting is constrained by what we view as significant shortcomings in disclosures and the prevalence of "mixed attributes" in measurement. Financial statement presentation, and in particular, the income statement, could be rethought to better inform users of the source of earnings and value creation, as well as the factors driving them.

The accounting measures presented in the basic financial statements, in and of themselves, are not sufficient to meet the needs of analysts, especially when depicting the financial position and results arising from positions that are not actively traded or are illiquid. Disclosure of the underlying risks, valuation methodologies, assumptions, volatility, market adjustments and sensitivities, and other factors (including how valuation changes are considered in the context of asset-liability and risk-management practices, and business activities), must be part of the information provided by companies--regardless of changes to how, what, and when fair value should be determined or presented. We believe such additional information, if consistently and clearly disclosed, would allow analysts to better evaluate the reported financial results in the context of past and future performance, and to evaluate whether and how the recorded amounts may develop going forward.

Despite efforts to require companies to disclose more information regarding the underlying risks, exposures, and assumptions of their positions, and despite some notable recent improvements, we find that disclosures, in general, remain significantly lacking--often boilerplate, and inconsistent among peers--and difficult to follow, because they are dispersed in many footnotes to the financial statements and other commentaries such as the management

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discussion & analysis (MD&A) section, or are simply incomprehensible.

Notwithstanding the significant challenges we recently observed with the application and use of fair value measures, Standard & Poor's supports fair value accounting for financial instruments. However, we believe certain refinements to fair value accounting could be considered. These include:

- allowing greater emphasis on entity-specific information (i.e., not market-based)in valuations when market observations are substantially lacking, or are meaningfully influenced by temporary supply and demand imbalances or market disruptions (e.g., clarifying accounting rules and auditing interpretations on the use of market inputs or prices to permit companies to place lesser weight on these when there are clear indications that the market is disrupted, grossly dislocated, or illiquid); and
- requiring footnote disclosure of information regarding the actual market values or the values derived by using indices when market transactions exist, but the company has elected not to use them, or has modified them for valuing its positions, and the reasons for doing so.

While we believe current market conditions may have been exacerbated by the use of fair value accounting, markets also have been affected by the sheer opacity and uncertainties associated with its use--a problem that may be greatly rectified with the aid of more transparent and forward-looking disclosure. We recognize the inherent limitations of fair value and do not contend that fair-value measures are a panacea for financial reporting, nor do they provide a complete portrayal of an enterprise's economic reality. However, because a one-size-fits-all solution is not possible--and because there is the need for a consistent benchmark, representing a single measurement for all companies--we believe a common, comprehensive, and agreed-upon framework using fair value for financial instruments is the next-best solution.

We reiterate our belief that fair-value accounting should continue to have a significant role in the accounting for financial assets and liabilities, but that it should be reinforced and enhanced with more informative disclosures and revisions to the income statement in order to achieve desired financial reporting objectives. To succeed in these improvements, active participation and contributions by all affected constituencies (including companies, accounting standard setters, auditors, investors, regulators, and analysts) is essential, ultimately leading to an improved financial reporting discipline that will be capable of meeting the information needs of investors and creditors, and of supporting the evolving global capital markets for many years to come.

Our focus in this article goes beyond the current market issues that surround valuation of fixed-income securities and derivatives, as there is no assurance that the next reporting challenge will emerge in these same areas. Accordingly, we believe the fair value effects worthy of discussion are much larger in scope, and the solutions considered must be more holistic.

Current State

Many companies and market participants have urged the Financial Accounting Standards Board (FASB), the International Accounting Standards Board (IASB), and the Securities and Exchange Commission (SEC) to stop or substantially modify fair value accounting rules. Current illiquid and volatile markets are challenging the usefulness of fair value in its ability to adequately portray companies' financial positions, especially in the financial services sector. Some market participants question whether fair value provides useful information for investment and credit decisions, while companies' executives contend that the performance measures produced using fair value create

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financial reporting that is not only misleading and disconnected from the reality of their business activities, but also create unjustified and unexpected economic effects, including covenant and regulatory capital stress and liquidity shocks. Many have also faulted the pro-cyclicality of fair value accounting for creating a spiral of declining valuation arising from forced asset sales. For many financial institutions, mark-to-market losses, coupled with the triggering of significant margin and regulatory capital calls, have forced rapid asset liquidation, exacerbating the loss of value and diminished counterparty confidence, and constrained liquidity. (In this discussion, we use the terms "fair value" and "mark-to-market" interchangeably.)

Market conditions have brought numerous issues surrounding fair value accounting to the forefront of the debate, including:

- whether recent write-downs are too conservative or aggressive, and whether they were taken too late or too early;
- whether management has too much discretion in setting the parameters and estimates used in valuing a company's assets--or too little, insofar as auditors may force companies to use market-based benchmarks that are overly depressed for purposes of valuing their positions;
- the lack of transparency surrounding fair value information provided in financial statements and press releases;
- the pervasive effects of subjective fair value measures on drivers of executive compensation and management incentives;
- whether the information provided is adequate to allow investors, creditors, analysts, and other users of financial statements to discern valuation trends and related risks--while others contend that financial reports are sufficiently voluminous and no additional information is needed or could even be meaningfully read and interpreted by investors; and
- earnings volatility and how much of it is representative of real economic volatility.

Considering the above, it is apparent that fair value is not the only relevant gauge. We consider other measures and information to be germane to meaningful analysis of an entity's financial performance, capitalization, and liquidity prospects. Indeed, as was clearly demonstrated during the recent cycle, to be up to the task for our analysis, fair value measures must be complemented with appropriate disclosures that provide information beyond the monetary amount of a financial statement line item, and include related pertinent information, such as the account composition, manner of measurement, availability of a liquid market, susceptibility of the amounts to change, range of potential outcomes, and the circumstances under which the value may change in the future.

Fair Value Accounting Is Not New

It is a popular misconception that fair value accounting is new, when, in fact, the concept has been around for decades, embedded in various accounting standards. In fact, the U.S. was at the forefront in the application of fair value when FASB Statement (FAS) 107 was issued in 1991, requiring all companies to disclose the fair value of all financial instruments (assets as well as liabilities) in financial statement footnotes. Conceptually, the application of fair value measurements is not limited to financial instruments but is embedded in the valuation of non-financial instruments such as inventory, which must be recorded at the lower of cost or market value, asset impairments, and business combinations.

Both the IASB and FASB have indicated their preference toward measuring financial assets and liabilities at fair value (see IASB Discussion Paper, Reducing Complexity in Reporting Financial Instruments, March 2008, issued jointly with the FASB and available at www.iasb.org). This preference is not without controversy, and many

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constituents have pointed to weaknesses in its application, with concerns that relate predominantly to measurement uncertainties, ensuing earnings volatility, the ability of the values to be audited, diversity in methods and assumptions, and the potential for abusive practices. While the debate is not new, the controversy is somewhat incongruous in light of the fact that during the past two decades, fair value accounting has incrementally taken on an increasing role in financial reporting in response to attempts to address shortcomings within accounting models--especially for mitigating the effects of mixed attributes reporting, and delays in loss recognition and the recognition of obligations. Recent financial reporting and market experiences are likely, however, to deter any aggressive expansion of the use of fair value by the accounting-standard setters, barring a more comprehensive study of the potential effects of a solution.

Fair Value Cures Mixed Attributes' Ills

Financial reporting systems promulgated under U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) tend to suffer from what is referred to as the "mixed attributes" shortcoming: Certain assets and liabilities are measured at fair value and others at historical cost or another hybrid method--e.g., amortized cost or lower of cost or market. The prevalence of the mixed attributes model generates accounting mismatches in the financial statements that fail to fully capture the economic reality of an enterprise. As a simple example, consider a financial company that provides a guaranteed annuity contract to its investors. The annuity is funded through investments in a diversified asset mix that includes traded and non-traded equity and debt securities, real estate, commodity contracts, and investments in private-equity partnerships. An accounting mismatch is created if the annuity obligation is marked to market (or to the value of the payout if paid today), while some underlying investments are recorded at their historical cost. The results reflected in the income statement will not reflect the period's economic income; therefore, a mismatch will arise in both the income statement and the balance sheet. We recognize that the effects of mixed attributes in accounting in its current state are unavoidable and will likely continue for some time. However, we believe these should be minimized to the extent possible in favor of a presentation that is more faithful to the underlying economic basis of the transaction, business, or environment in which a company operates. In this respect, incorporation of fair value measures resolves many of the challenges caused by the mixed attribute model.

In limited cases, the mixed attributes approach may be appropriate, for example, for a bank that manages its businesses in a distinct fashion--i.e., its banking book is managed distinctly from other activities (such as trading) and is matched funded. For instruments that are principally held to maturity, accrual accounting may cure many of the ills associated with interim volatility during the term of the loans and result in measures that will be more conducive to a meaningful analysis (where loan provisioning would serve as a reasonable proxy to fair value). However, because hedging and risk-management practices are frequently intertwined among the different books, hedges are affected on a macro or a partial basis, and assets are occasionally transferred from the banking to the trading (or held-for-sale) books--especially during periods of uncertain economic conditions--it is rarely the case where accrual accounting is able to fully convey these complexities. Further impeding a complete separation is the ongoing portfolio rebalancing, under which particular hedges are pointed at different exposures--caused, for example, by an early payoff or termination of a hedged position. Because of these interrelations, current hedge accounting, as well as the introduction of optional fair value accounting, has proven ineffective in allowing for an accurate, discrete depiction of banking and trading results.

The greater the cross-over and the enterprise-wide risk-management activities, the greater the accounting challenge

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in appropriately untangling these relationships. Although we would prefer such a discrete presentation in cases where this can be done and when it is consistent with the underlying manner in which the business is being run, we recognize that in many cases it would be difficult or even impossible--and a complete separate matched-funding of books is rarely practiced by multinational and multi-activity institutions. Further, the more prompt recognition of risks (both credit and interest rate) under a fair value regime can contribute to greater transparency and recognition of asset deterioration. Historical evidence has shown that loan provisioning may be backward-looking and often masks real forward-looking fundamental credit deterioration. In this context, for example, fair value reporting may lend itself to improved reporting.

Challenges Exist With Fair Value Accounting

In the search for where to place the blame for the recent market turmoil, it was perhaps inevitable that market participants would look at fair value accounting. Critics point to the volatility arising from recent market turbulence as the reason to do away with fair value, arguing that a multitude of issues can be traced to its application. Many of these critics argue that reporting assets at their historical cost--or using "smoothed values" or "delayed recognition" of fair value effects--would serve as a more reliable and objective measure. Note that the use of historical cost is somewhat of a misnomer, because it includes depreciable or amortizable assets, or those adjusted for impairment or to the lower of cost or market. In this discussion, "historical cost" is used interchangeably with "accrual accounting" (see Sidebar 1: Fair Value Challenges In Today's Environment, which enumerates many of the recently encountered issues and challenges associated with fair value measurement).

Is fair value relevant?

The challenges surrounding fair value during the current market disruption have triggered a chorus of complaints questioning whether fair value is relevant. Put in the context of the value to analysts of financial reporting systems, this may seem to imply that fair value measures, should be dispensed with altogether. We disagree, and believe fair value measures are best used as a starting point for further analysis of financial results.

Some of the volatility created by fair value may be spurious, caused by periodic bouts of market turbulence during which changes in fair value bear little resemblance to values that may ultimately be realized. It is by no means obvious or even desirable that fair value reporting forces companies to recognize problems prematurely or excessively, when volatility does not reflect credit losses but is instead indicative of market instincts toward fear or greed. Indeed, in certain situations we have seen this volatility creating undue capital volatility that is destabilizing and does not reflect underlying economic positions. This is not to say that true impairment of economic value should not be recognized; rather, some concept of economic value should be the guiding principle when dealing with illiquid markets. Considering whether the values reflected would ever be realized or paid introduces the need to consider a multitude of factors that speak more specifically to the particular circumstances of a company. However, current guidance requires the use of market-based rather than company-specific assumptions, such that these other and often pertinent factors may not be reflected in the reported values (see Sidebar 2: Fair Value--What Is It?).

Utility of the income statement

The current state of financial reporting represents an amalgamation of fair value and historical cost. This is confusing when considering what earning measures are supposed to represent, insofar as certain elements of earnings are recorded at fair value, others at historical cost, and still others at some hybrid measure (see Sidebar 3: Financial Instruments And The Measurement Maze). Other items--such as changes to existing core deposits and

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unrecognized intangibles--are not measured at all on the balance sheet but are nevertheless important to the change in the economic position of the company. In this context, it is quite difficult to discern what an "earnings measure" encompasses.

The traditional meaning of the income statement is changing as earnings may be accelerated in a fair value environment. Similarly, common measures used in financial analysis that are derived from the income statement are undergoing changes--with increased focus on cash-based measures to provide another vantage point on earnings (because of volatility, as well as the uncertainty and timing of the realization of recorded amounts). To illustrate the fundamental quandary, in a hypothetical full fair-value environment, earnings would theoretically equal the discount factor (or required market return) multiplied by net equity, plus or minus the effects of changes in estimates. This occurs because expected earnings are recorded at their present value in the current accounting period, and earnings in future periods merely represent the effects of deviations from past estimates, including the introduction of unexpected elements that were not incorporated in the previous period's fair value estimates (e.g., unexpected new business). As a result, an income statement based on full fair value, including the measures it produces, might become largely irrelevant to analysts.

Under fair value accounting, the income statement loses analytical value to the extent that periodic changes in fair values are condensed in a single line item. Critical data about earnings trends and drivers are no longer apparent. A comprehensive approach to a fair value framework must provide sufficient information to explain not only the composition of earnings but also information about the components of earnings, and how and why the reported earnings diverge from cash earnings. Common analytical measures will have to change to provide another vantage point on the quality, drivers, and composition of earnings, and fair value changes during the period. These issues exist currently in the current partial-fair value regime, but are driven to extremes in a full fair value presentation (which we present to illustrate these issues), thereby highlighting the necessity of adequate disclosure surrounding these values.

Consider the analysis of a bank's income statement: A contemporaneous mark-to-market of assets and liabilities on the balance sheet can have an impact on the income statement that obscures the bank's underlying operating performance. For many institutions with large trading portfolios, or those that have implemented fair value reporting to a greater extent (by applying, for example, FAS 159, "Fair Value Option"), the income statement may serve largely as a reconciliation of the change in valuations of assets and liabilities. Carried to the extreme, the entire balance sheet could be seen as a trading account, and the income statement results would be lumped into a single line item of trading income. To a large extent, we see the results of this type of presentation in investment bank reporting, where changes in fair value are reflected in aggregated income statement line items, resulting in a loss in the sense of the components of profits. Consider the following:

- Net interest income measures would theoretically be the same for all banks, because all assets and liabilities would be priced to yield the market rate.
- Non-interest income would be all changes in the net present value of future expected cash streams from balance sheet assets. Certain assets (such as rights for future income from assets under management) are not captured at all on the balance sheet.
- Provisions for loan losses would no longer be presented, as all loans would be marked to market, including changes in credit spreads.

With the increased usage of fair value reporting, the answers to fundamental questions we evaluate as part of our

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analysis might be obscured. Those questions include:

- How much did the bank "earn" on amounts it lent during the period?
- Was the money lent at a fair risk-adjusted rate?
- Were the loans matched funded?
- Has the borrower deteriorated in creditworthiness during the period?
- How successful were risk-management practices in providing an offset?
- Were the valuation changes originated from changes in fundamental credit risk or in market drivers (such as interest and currency exchange rates)?

These and other questions would be answered via incorporation into theoretical pricing methods, and adjustments based on those answers may be embedded either in a single line item or allocated among several income-statement captions--depending on highly complex accounting rules, the applications of which are often not immediately transparent to analysts. More fundamentally, the meaning of interest expense, and how it should be calculated and presented, is unclear in a fair value environment.

In this context, the analyst's job would involve second-guessing models--a complex task even if appropriate disclosures were to be made. The information in financial statements tends to have precedence in analysis to the information in footnotes, because of the reliance and focus of market participants on the "bottom line", regulatory focus on capital measures based on GAAP, and counterparties' usage of financial statements for covenant purposes. As a result, further consideration must be given to the "packaging" of the information in financial statements in a manner that would better facilitate forward-looking analysis and adjustments by users to accommodate their particular needs (e.g., regulatory capital measures).

The IASB and the FASB have recognized issues related to the utility of the financial statements and have undertaken a key multiyear project to radically redesign the income statement and the information it conveys. The objective of this joint project is to establish a common, high-quality standard for presentation of information in individual financial statements (and greater linkage among them) that the boards believe will significantly improve the ability of financial statement users to:

- understand an entity's present and past financial position;
- comprehend the past operating, financing, and other activities that caused an entity's financial position to change, and the components of those changes; and
- use the financial statement (along with information from other sources) to assess the amounts, timing, and uncertainty of an entity's future cash flows.

Although much of the project is still in development, the initial proposals would result in income statement presentation and disclosures that have the potential to improve many of the shortcomings we have discussed. The boards are expected to issue a preliminary document summarizing their recommendations for comments during the third quarter of 2008 (see the project summary available at: http://www.fasb.org/project/financial_statement_presentation.shtml).

Measurement and presentation

Analysts clearly are challenged with fair value measurements. The challenge is three-fold, involving:

- concerns about reliability and subjectivity;

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- inconsistencies in measurements--e.g., mixed attributes; and
- the broader lack of disclosures that would allow them to go behind the numbers and understand the relationship to business drivers and the potential for valuations to change over time.

Analysts and other market participants often have raised concerns regarding companies' using their own valuation models in the absence of an active or liquid markets, asking whether a model is appropriate and how the assumptions were developed--while endeavoring to assess comparability with peers.

The need to adjust for risk also could change values meaningfully. In the case of a loan, for example, factors such as collateral value, the borrower's profile, prepayment risk, and fluctuating interest rates could pose valuation challenges and divergence among market participants. Analysts are aware that valuation, of complex financial instruments in particular, is not an exact science (see Financial Institutions Group Provides More Transparency Into Adjustments Made To Bank Data, published April 26, 2007, on RatingsDirect).

The Center for Audit Quality (CAQ) addressed market liquidity in a white paper released in October 2007, stating that (emphasis added):

"Some observers of current market conditions have asserted that market pricing is irrational, and they have suggested that entities should instead default to a model-based measurement that is based on the economic fundamentals' of the asset. However, FAS 157 states that the use of an entity's own assumptions about future cash flows is compatible with an estimate of fair value---as long as there are no contrary data indicating the marketplace participants would use different assumptions. If such data exist, the entity must adjust its assumptions to incorporate that market information---."

(See "Measurements of Fair Value in Illiquid (Or Less Liquid) Markets", Oct. 3, 2008, available at www.aicpa.org/caq/download/WP_Measurements_of_FV_in_Illiquid_Markets.pdf)

In a letter from the SEC in March 2008 alerting registrants of disclosure issues they may wish to consider in preparing the MD&A, the Division of Corporation Finance stated (emphasis added):

"Fair value assumes the exchange of assets or liabilities---in orderly transactions---. Under SFAS 157, it is appropriate for you to---consider actual market prices, or observable inputs, even when the market is less liquid than historical market volumes, unless those prices are the result of a forced liquidation or distress sale. Only when actual market prices, or relevant observable inputs, are not available is it appropriate for you to use unobservable inputs which reflect your assumptions of what market participants would use in pricing the asset or liability---. Current market conditions may require you to use valuation models that require significant unobservable inputs for some of your assets and liabilities. As a consequence, as of January 1, 2008, you will classify these assets and liabilities as Level 3 measurements under SFAS 157."

(See SEC Sample Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements), March 2008, available at www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm.)

Although analysts are challenged by fair value, financial statements presented based solely on a historical cost-based accrual accounting are equally challenging. Under these circumstances, the reported values would, in most situations, bear little resemblance to their current market values. Consider also that a company could choose to sell assets for which value has appreciated--and thus recognize gains--while retaining those that have depreciated. Here

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too, analysts may argue that financial statements provide significantly less than optimal information regarding the economic position of a company. It is equally important to note that, given the mixed attributes embedded in current fair value/accrual balance sheet representations, it is often unclear how assets or liabilities are accounted for, and on what basis.

Contrasting the accrual value approach is the other extreme of full fair value financial statements. Presentation on this basis would seemingly result in financial statements becoming an image of the market capitalization of a company. Simplistically, this type of presentation eliminates the issues caused by the mixed attribute model. Of greater importance, however, and as discussed more fully in the preceding section, is the broader utility (or lack thereof) of an income statement in a fair value universe.

We recognize that financial statement presentation based on either extreme would result in degradation in the utility of the financial statements as a whole and would not meet the needs of analysts or other users. However, use of fair value measures for financial instruments likely:

- would reduce the incentives and ability of companies to manage earnings by cherry-picking instruments and accounting classifications;
- provide an early warning about emerging risks and benefits;
- and would mitigate many of the issues caused by the mixed attribute model.

As a result, fair values for financial instruments appear to be the most useful analytical starting point for our analysis.

Reliability of fair value measures

Model-driven fair values are imperfect numbers, subject to significant discretion and vulnerable to volatility. In particular, so-called "Level 3" assets and liabilities have become the subject of significant scrutiny and misunderstanding. FAS 157, "Fair Value Measurements", establishes a hierarchy to the priority for inputs into determining a fair value (see Sidebar 2). This hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3), and requires categorization based on the lowest category of significant input. That is, even if only one significant input is unobservable, it must be classified as Level 3--even if the value is primarily driven by higher-level inputs. Market participants have seemingly largely misunderstood this guidance to call into question any asset or liability valuation (or change in valuation), believing that the entire valuation is little more than a management "guesstimate." In addition, many financial instruments or investments--such as private investment partnerships and shares in privately owned companies--do not have market values (or liquid markets) and must be valued using models or management estimates. These positions, by definition, are valued using unobservable data. Again, this is not a novel issue introduced by FAS 157; it was embedded in GAAP-based valuations, including when a requirement existed to reflect assets at the lower of cost or market, or when an "other-than-temporary" impairment needed to be recognized. Further, these types of analyses are ingrained in company processes for making buy/hold/sell decisions for their non-traded positions, and in their risk and asset-liability management practices.

The greater introduction of fair value measures creates more situations where valuations and inputs may not be directly verifiable. Rather, they are tied to internal valuation and validation processes that often differ significantly among peers, presenting challenges to users and auditors alike. It is also important to note there are a vast number of assumptions and estimates inherent in modern-day financial statements that are as subjective as any inputs into the valuation of a Level 3 asset or liability. Examples include actuarially determined loss reserves by insurance

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companies, loan loss reserves, and litigation losses. Even calculating useful asset life to determine depreciation can involve significant judgment, the application of which can be equally subjective and can materially impact reported earnings and capital. As part of everyday business operations, management engages in many judgments, assessments, and determinations. Yet exercise of such judgment and its impact on financial reporting is rarely questioned in the same fashion as fair value measurements although arguably that judgment should be subject to the same level of scrutiny.

Fair value measurements are not an exact science, and assumptions may be conservative or aggressive. Similarly, values may not be reliable or relevant when using assumptions that are simply inappropriate--e.g., the use of certain indices during periods of significant illiquidity in the trading of securities of which it is composed, or using indices that do not represent a security's terms, conditions, and payment characteristics.

For example, the introduction of the credit derivative indices for the residential (ABX) and commercial mortgage-backed securities (CMBX) markets, while seeming to provide a measure of transparency and a means to value these types of securities, have shown the limitations of applying a simple measure to value complex and illiquid securities. The cash flows and structures of structured finance transactions vary from deal to deal, so valuing them requires an individualized analysis. Even more important, the composition of these indices may not reflect a broad enough range of transactions that would allow market participants to view the index as representative of the market. What the indices have shown is that a macro approach misses many of the analytical nuances of each transaction, which otherwise would result in significant differences in valuation. As such, using the indices to value portfolios in effect applies a blunt instrument when a scalpel may be more appropriate.

Nonetheless, it seems undue blame is being placed on the results of applying fair value. Focus should instead be placed on the assumptions and disclosures analysts and others need to assess the inherent risk and loss in value of securities. And certainly, these have not gone unremarked upon by regulators, even before recent market dislocations. Mark Olson, chairman of the Public Company Accounting Oversight Board (PCAOB), raised several significant concerns regarding the auditing of fair value measurements during a speech in June 2007, saying:

"First, valuation requires training, and many auditors may not have extensive training in valuation techniques. Second, auditors should be mindful that financial statement preparers can be biased (even if unknowingly so) in their assessments of fair values. As a result of this potential bias, preparers may fail to consider alternative valuation scenarios. Third, auditors should keep in mind that internal controls surrounding fair value measurements may be different from those over typical business transactions."

(Remarks of Mark W. Olson, June 7, 2007, at the Compliance Week Annual Conference, available at http://www.pcaob.org/News_and_Events/Events/2007/Speech/06-07_Olson.aspx)

Undoubtedly, disclosure requirements and the valuation and related audit processes are in dire need of a fresh look--in particular, the need for financial statements to inform users about assumptions, limitations, and the inherent uncertainties in the measurement of assets and liabilities. This is a necessary element of any evolving financial framework that also will mandate greater communication of methods, assumptions, and changes.

Mark-to-market accounting identifies, but can create incentives for, risk

In the context of current market disruption, mark-to-market accounting has had two significant effects: It results in recognizing potential credit losses by discounting them to the present day; and it can further accentuate stated losses, in that quoted markets tend by their nature to overshoot, especially given illiquidity at times of stress.

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In an accrual-based hold-to-maturity world, credit losses would be taken over time as permanent impairments in value occur, and as a result, are often recognized on a time lag. Conversely, mark-to-market accounting is arguably more proactive and may "telegraph" credit deterioration (or improvements) more quickly than accrual accounting. However, because it also prices in a risk premium for unexpected (i.e., not likely occurring) losses (which is missed by incurred-loss provisioning), mark-to-market accounting has arguably amplified the volatility associated with underlying credit problems, such that current mark-to-market losses could well be greater than the ultimate credit losses.

Further, mark-to-market accounting may amplify results on the upside as well as the downside. Part of the dramatic growth in banks' fixed-income revenues before mid-2007 was likely attributable to the marking to market of positions amid ever-tighter credit spreads. Marking to market in favorable conditions may have resulted in profits from long-term trades being booked early in the life of the transaction, even though the risk remains over the duration of its life (which might also turn out to be longer than expected at the outset, if liquidity--and, thus, the bank's ability to exit a position--evaporates).

Mark-to-market accounting may distort incentives in entities in which compensation tends to be tied to trading revenue. Employees in such situations have an incentive to focus on short-term results rather than long-term risk. Moreover, as profits and compensation became front-loaded, the need for further revenue and profit growth may have led to greater and greater leverage in positions. We believe this may be a reason why the amount of risky trades increased and grew in leverage. Some companies already have addressed this problem by implementing changes to their compensation structures to combat this propensity.

Optional and partial application of fair value impedes analysis

Compounding the analytical challenge is the optionality afforded under many accounting standards allowing companies to pick from several alternative methods for similar transactions or economic scenarios--e.g., fair value options, optional hedge accounting, or classifying securities as trading or held-to-maturity. In many cases, selective application of fair values may contribute to minimizing the mixed attributes friction, but may also introduce inconsistencies among peers and products, and the potential for non-transparent accounting arbitrage.

In situations where fair value is being applied on an elective basis--as allowed, for instance, by FAS 159 and IAS 39--we believe there must be a clear rationale. For example, FAS 159 allows for a contract-by-contract election to apply fair value. Similarly, other statements allow for optionality in applying fair value. Generally speaking, in our analysis we look favorably on elections for fair value that are based on a desire to mitigate an existing financial statement's reporting mismatch or to present a more economically faithful representation of the underlying economics of the transactions, as well as a company's financial position. In the absence of any such linkage, we nonetheless consider the impact (because it may be part of an economic capital management program without a specific hedge or asset-liability link). We also closely examine situations in which there is an election made where there is no economically based hedge or desire to implement one (as in cases where the election was made to achieve an accounting result rather than an economic one) and adjust the reported information to better reflect our view of the current and ongoing economic financial position of the company.

Somewhat similar issues arise for securitized assets, especially in gain-on-sale accounting, where assets are sold but the bank continues to generate cash from them. Even though the cash flows from assets securitized and those retained by a bank may be virtually identical, the earnings recognition diverges between accounting methods for securitized assets and those financed on balance sheet. In addition, there may be a difference in income recognition

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between banks that earn money from purchased servicing rights and those that service their own assets, even though the economic effects are identical.

The incremental and piecemeal incorporation of fair value in accounting has resulted in the creation of new issues along with the mitigation of old ones. Partial fair value reporting results in a failure to recognize a corresponding gain or loss that may be the cause for the change in fair value of an instrument or position. For example, changes in an issuer's creditworthiness give rise to a change in the fair value of its obligations--e.g., debt to which a fair value option is applied, or derivative obligations. However, changes in creditworthiness often arise from an amalgamation of effects that include changes in the value of financial assets and liabilities that could be marked to market, as well as changes to the value of non-financial assets or liabilities that are not recognized--for instance, an economic impairment of assets, such as internally generated goodwill or a contingent obligation that is not recognized in the accounts pursuant to GAAP. The failure to present linkages to other offsetting economic positions represents a conceptual inconsistency in fair value reporting and poses a significant challenge to analysts.

In our analysis, we may eliminate the earnings and balance sheet effects arising from fair-valuing of a company's own obligations (again, see Financial Institutions Group Provides More Transparency Into Adjustments Made To Bank Data, published April 26, 2007, on RatingsDirect). Similarly, certain items such as contingent liabilities and other financial products that may have embedded assets are under-priced from an economic viewpoint. For example, commitments to lend and even funded loans can, using certain analytical methods, be shown to be under-priced (e.g., the intangible assets that may be generated as a result of customer behavior within a particular book of business or portfolio that results in an ongoing customer relationship). Such a relationship has value that is not allowed to be accounted for as an asset. Similar issues relate to core banking deposits that are valued on a bank's balance sheet without giving effect to their below-market-interest-rate nature, as they are payable "on demand," yet many remain on banks' books for extended periods and have significant positive economic value. Although we recognize this is an inherent limitation of the partial fair value regime currently in place, we equally believe that this can be mitigated with better disclosure, allowing analysts to understand the drivers that caused the valuation changes.

Accounting And Risk Management

In assessing the pros and cons of fair value accounting, we cannot overlook the fact that companies often manage volatility in different ways, and in certain cases, separate the management of accounting volatility from economic risk and volatility.

Accounting provides guidance on how fair values may be determined, and stipulates that data from observable market sources must be given the highest priority. However, market participants might not share the same economic position, insights, or perspectives. Company A's liquidity position may differ significantly from Company B's, such that A has the ability and intent to hold the positions until recovery, and manage the process of recovery. Meanwhile, B may have immediate liquidity needs of which the market may largely be unaware. Further, companies may hold blocks of securities of the same issuer that may give rise to a premium (because of the ability to control or influence management decisions) or a discount (because liquidating these positions at once would result in flooding the market). In fact, under U.S. GAAP, companies are precluded from reflecting block premiums or discounts. Because this is company-specific information, these differences will not necessarily affect valuations. As such, accounting and economic results are often fundamentally different. Indeed, internal models often provide indicators

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that are important to risk-management practices, which differ from accounting interpretations. Press releases from companies that have recorded significant losses from fair value write-downs are often quick to explicitly indicate a different economic loss from the reported accounting loss.

Where an entity has not developed a well-structured enterprise risk management program, there may be a fundamental disconnect between financial reporting and the operations and risk functions of the company. This often reflects the different needs and perspectives of internal participants in that they frequently do not interact in an integrated and comprehensive fashion. A company's accounting department may determine a value for financial reporting purposes; the trading desk may determine a value to evaluate and make a buy/hold/sell decision; and those in charge of risk management may determine entirely separate valuation and concentration considerations based on their own perceptions of risk and the need for exposure management in the context of enterprise-wide dynamics.

Good risk-management programs require multiple values that may encompass market values (observed or estimated); values derived from fundamental analysis; sensitivity and volatility analyses providing a measure of volatility around those values; and simulations that provide for extremely adverse situation values (stress tests) and capture "tail risk" events. Major losses frequently coincide with major shifts and changes in values of broader markets. Values or scenarios should encompass these. Moreover, concentration risks and correlation among a company's specific positions will give rise to different internal valuations when positions are considered in the aggregate, unlike their discrete measure mandated by GAAP.

In this regard, forward-looking values are predominantly useful to proactively manage or avoid undesired or outsized risk. As a result, the usefulness of historical cost-based valuations is greatly limited. If there is an accounting value that isn't forward-looking, the first step to providing usable risk-management information is to reassess that value with forward-looking techniques.

For values to be useful for risk-management purposes, they must be developed consistently across all risks. Extreme and/or emerging risk values (sometimes called stress tests) must be based on assumptions that tie into hypothetical adverse situations. The results of these stress tests can be discounted by management if there is insufficient belief that they are real, but if adverse results become more prevalent, it makes the values more difficult to ignore.

The current banking and insurance regulatory environment is evolving as well. Changes include the introduction of the Basel II regulatory banking framework and Solvency II for insurance companies in Europe. These frameworks unequivocally place less emphasis on accounting measures as a direct indicator of risk, or on GAAP equity measures as a benchmark to define regulatory-capital compliance. We believe these are important and healthy developments that would further contribute to emphasizing accounting as a starting point and not an end-game.

Standard & Poor's Analysis

A focus on the underlying economics

Inherently, our analytical methodology endeavors to encompass the perceived discrepancies between financial reporting and our view of the economic basis of a company and its credit prospects. Given the current illiquid markets for many securities, it is not surprising that valuations may differ significantly from expected economic losses, depending on a particular entity's circumstances. Where a company may have significant upcoming liquidity needs that would force the liquidation of positions, and cause it to mark down in asset values, another company's economic situation may allow it to retain the position until such time as the assets recover in value.

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In this regard, we emphasize what we view as a fundamental distinction between accounting and analysis--often overlooked in this debate--that is critical in considering the financial reporting framework that would be useful to analysts. The accounting regime endeavors to find a single number to use in presenting financial data; the analyst (by definition) endeavors to pick apart the numbers and stress the data. Good analysis must look at multiple perspectives--and often uses adjustments and scenario analyses as a technique to depict a situation differently for a specific purpose, or to gain another vantage point. Further, in analyzing financial results, analysts evaluate data both retrospectively and prospectively. Retrospective analysis of financial data is useful in evaluating an issuer's past performance compared with its peers, trends, or budget. Prospective analysis is critical in forecasting a company's ability to generate resources sufficient to service its financial obligations. To help make forecasts meaningful, it is important to understand and distinguish past occurrences that indicate future performance--as well as those that may not.

In our analysis, we consider numerous qualitative and quantitative financial and non-financial factors--i.e., economic, regulatory, and geopolitical influences; management, risk management, and corporate governance attributes; key performance indicators; competitive trends; product mix; intellectual-property rights; and cost structure. In this context, when we evaluate recent losses taken, we consider a variety of factors, including (but not limited to):

- account linkages to asset-liability management and enterprise risk management programs, wherein losses may be offset on an economic basis (rather than on a financial reporting basis);
- liquidity needs that may result in forced sales of assets into illiquid markets;
- management's intent and ability to hold positions until value recovers;
- the level of capitalization, including regulatory capital measures; and
- cash flow and other analyses based on our internal views of default risk.

Consider the analysis of bank loans, if the implication of fair value were that the loan loss reserve line is no longer reported separately (or in the footnotes). This effectively commingles credit-trend effects with those of market-related moves on a loan portfolio's valuation. Both elements must be disclosed for our analysis. Even if loans could be marked to market perfectly so that analysts could be confident of the values on the balance sheet at a given date, marking loans to market would make it virtually impossible for analysts to disentangle the results of a bank's credit decisions and underwriting quality from the impact of its asset-liability management and unexpected interest-rate movements--or from random changes in credit spreads. This is only one of the many examples where analytically salient information can be lost. (These disclosures, in whole or in part, may currently be required under U.S. or other GAAP; we use loans solely to illustrate the concept, which can be analogized to many other assets or liabilities.)

Our credit-risk analysis must also consider the potential for the underlying estimates or expectations to change. As a simplified example (ignoring the time value of money): Although the fair value of a contract with a binary outcome of equal probabilities of a $500 gain or a $100 loss is $200, an appropriate analysis must assess the range of possible outcomes. In addition, the fair value amount reported on the balance sheet for the contract ($200) does not represent either of the potential outcomes. An analysis of this contract would involve quite different considerations from those involved in analyzing a contract with the same monetary value representing an investment in U.S. Treasury securities. Accordingly, disclosures of potential volatility or sensitivity to underlying critical estimates--and a discussion of plausible outcomes--are essential to complement the fair value measure.

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Our analysis and methodology determine the amount and extent of adjustment to be made to reported amounts, dependent on the facts and circumstances particular to each rated entity and its peers. Indeed, many of the ratios used in our analysis tend to be distorted by fair value measurements (such as loan loss reserves, leverage ratios that are distorted because of valuing debt obligations, and expenses/revenues when revenues no longer bear any resemblance to cash coming in the door) and may require adjustments to the reported amounts to reflect the true underlying credit risks of the enterprise. Analysts must also be cognizant of the potential of amounts to sharply change, regardless of how precise a valuation might be, whether market-based or model-driven. In discussing fair value in financial reporting, it is critically important to understand and distinguish between uncertainty that is embedded in valuation methodologies (i.e., in selecting models and assumptions) and volatility inherent in a particular instrument being valued (i.e., market volatility). These often are mixed up.

How we consider earnings volatility

Analysts naturally ascribe greater credence to realized mark-to-market gains or losses than to those that are unrealized. There is a greater level of uncertainty associated with unrealized items especially when valuations aren't grounded by observable and liquid market data. Analyzing performance in a fair value environment is made more complex by the fact that there is no consistent trail allowing for the tracking of a realized item back to where it was reflected as unrealized. Further, a valuation on a balance sheet date may be precise, but market conditions will change. Given the current reporting structure, it is extremely difficult--arguably, impossible--to track the income that will be recorded on a debt security sold two years from now to the write-downs taken in the past two quarters, because this information may not be available or apparent from disclosures, or is subject to large fluctuations.

We attempt to decipher whether that change in value is transient, whether it is offset by an equal and opposite value on the liabilities side, or whether the value is expected to be ultimately realized. For example, our definition of adjusted capital for banks excludes changes in value of the accrual book recorded as a component of equity (other comprehensive income) that are assumed to be part of a strategy for asset-liability management. Conversely, we deduct from equity any assets that the bank believes have suffered a permanent loss of value, even if an accounting system has not required it (again, see "Financial Institutions Group Provides More Transparency Into Adjustments Made To Bank Data").

Volatility often is viewed as artificial, especially if it is expected not to result in a realization of gain or loss. Consider a debt instrument that pays $100,000 upon maturity in two years, with an 8% fixed rate of annual interest. Even if the probability of default doubled at the end of the first year, to 6% from 3% at inception, the risk of default remains remote. A fair value measure will reflect a loss in the income statement that will likely have to be reversed upon maturity. Further, if interest rates mildly increase or decrease during the loan term, the value of fixed-rate debt will change in every quarterly reporting period until maturity. Given this, many have doubted the utility of fair value because the volatility masks the reality that no gain or loss is likely. Applying this example to a large population of assets and liabilities, one can understand how earnings volatility can detract from any meaningful earnings-trend analysis, especially because marking to market reflects an amalgamation of factors--e.g., credit, underwriting, liquidity, and market interest rates--each has its own implication for income statement analysis and volatility.

On the other hand, consider what happens when volatility represents a fundamental shift in market sentiment. If the risk of loss increases to 25%, 50%, or 90%, the question becomes at what point it is appropriate to reflect the change in probability in earnings, if at all, or whether the accounting should only reflect the change in value upon the occurrence of a realization (settlement or payoff). A more difficult question arises with respect to the volatility associated with interest rate changes. Assume that interest rates for a loan similar to the above increased subsequent

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to funding to 10%, so that now the borrower pays a below-market rate. The lender clearly suffered an economic loss (in the absence of a hedge), yet likely will recover its investment and full interest over time. Should the accounting reflect this economic "loss" in the first place? If so, what about marginal period-to-period rate changes that could also introduce volatility? Fair value accounting reflects these changes in economic value; equally, it would recognize the recovery of the values over subsequent periods.

Finally, in a fair value environment, valuations theoretically will converge over time toward the ultimate realized amount--i.e., there is no "gain" or "loss" on the day a transaction is settled because all has been recognized previously as part of the periodic mark-to-market. Further, volatility in a fair value regime means a change in estimates as compared with past estimates. The analysis of mark-to-market accounting represents a departure from a traditional income statement and earning analysis, and analysts will have to rethink what an income statement really projects in the context of its ability to serve as a precursor of future performance. As such, we often ask issuers for further information to gain a better understanding of the linkages between realized and unrealized, core and non-core, and current and future earnings impacts.

Are There Any Solutions?

Decision-useful information must be the focus of change

One way of assessing the efficacy of accounting measures is to determine whether they help or hinder our analysts and other users of financial statements in answering important questions about performance or risk management. Questions to be answered for financial and other institutions include:

- How much cushion does capital represent in staving off regulatory intervention or insolvency? Are there unrealized gains or losses that would affect this assessment?
- How healthy and sustainable are earnings? The components of the financial statements and related footnotes should provide clear information on lending spreads, the amount of revenues from distinct sources or business lines, expense management, effects of the use of derivatives and risk-management activities.
- What is the quality of the company's credit decisions? How well is it able to predict and price risks? How is the portfolio tracking expectations and peers regarding defaults and delinquencies? Are reserving policies appropriate?
- What is the track record for managing market risks in terms of both trading activities and broader asset-liability management?

A useful financial reporting model would reflect precisely measurable items at the measured amount, while giving enough information about uncertain items to allow analysts to understand the estimates and assumptions supporting the amounts. Sensitivity analyses and additional information must be provided so that analysts can understand management's views of future performance, and how and why recorded amounts may change.

Companies should be responsible for presenting a value consistent with their valuation practices and the broader accounting framework, and their auditors for verification of the process (though not necessarily the value). Analysts need to be able to understand valuation drivers and their potential to change. In this regard, we find the new disclosures provided by FAS 157 and IFRS 7 helpful in understanding the broader valuation strata in which assets and liabilities are classified. This better enables analysts and investors to hold management accountable when future results deviate meaningfully from those anticipated, and also for sub-par disclosures compared with peers.

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Of further note is that several constituents, including banking regulators, the Institute of International Finance, and accounting-standard setters are studying valuation practices and related disclosures. FASB also formed a valuation resource group in 2007 to assist in providing valuation guidance. Although we believe that valuation and disclosure practices will improve as a result of these efforts, and perhaps become more consistent and consistently monitored, it is important to recognize that an ultimate harmonization of valuation among companies cannot be achieved without overly detailed rules addressing every possible product, economic scenario, and variant in detailed prescriptive rules--an impossible and undesirable task, in our view.

Robust disclosures are vital

The difficulties associated with fair value can only be overcome by recognizing that it is impossible to translate the complexity of an economic event into a single number. We believe that providing only the fair value amount in a financial report will not necessarily enable better investment or credit decisions. In fact, if a single amount is presented without meaningful disclosures enabling forward-looking analysis, it will likely introduce much greater confusion (as is evidenced by the current environment).

Even if all market participants agreed upon a particular methodology for reporting values, and disclosed all necessary information regarding that valuation, the values and disclosed information could instantly become obsolete because of market gyrations. As a result, the financial statement, regardless of the accounting convention(s), is merely a starting point to further analysis. Ultimately, the reported values can be agreed on such that there are no concerns regarding valuation, whether based on historical cost or fair value. Even so, within the context of a forward-looking analysis, "the number is not the number" when considering the potential volatility and risk of change inherent in any value. The fundamental solution is to focus on disclosing actionable information necessary to assess the causes and potential effects of prospective change.

Providing measures without disclosures cannot be effective, given the vast complexity of the business environment. Accordingly, the discussion on the appropriate accounting regime must be expanded to include both measurement and presentation--and not only whether measurement uses historical cost or fair value. For the analysis of financial institutions, for example, some of the initiatives adopted to date on fair value accounting have clearly improved transparency; others, however, have been somewhat more problematic, with reporting requirements either complicating the analysis of operating performance measures, accelerating income recognition based on an array of assumptions, or unequally or partially marking-to-market assets and liabilities, or long and short positions intended as economic hedges (see Standard & Poor's Ratings Services Comments On Fair-Value Option Reporting Standards, published May 1, 2006, on Ratings Direct, and Sidebar 4 for related Standard & Poor's articles.)

In this context, it is hardly surprising that the demand for greater information has increased exponentially. Non-financial measures and data, including operational and other industry-specific data, key performance indicators, risk management, governance information, and environmental and corporate responsibility measures have received greater scrutiny. These attributes weigh heavily on investment and credit decisions, and could have significant influence over financial results. These demands highlight another popular fair value accounting misconception: That companies are not allowed to provide greater disclosure regarding the impact of mark-to-market accounting on their financial statements. In fact, the SEC has emphasized the need to provide further disclosures, in a letter sent to certain companies, identifying a number of issues to be considered for MD&A disclosure in upcoming filings (again, see the SEC Sample Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements), March 2008).

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While it is clear that the focus has been on the impact of changes in fair value on balance sheets and income statements, much less attention has been placed on the increasing disconnect to a company's cash flows disclosures. Standards for cash-flow presentation are relatively old and are in need of a revisit (FASB Statement No. 95, Statement of Cash Flows, issued November 1987). Cash-flow statements for financial institutions tend to blend financing and operating activities, and meaningful disclosures are rarely present regarding classification and drivers to enable a more meaningful liquidity analysis (information that could also be incorporated in the MD&A disclosures).

It is difficult to strike a balance in meeting user needs for information while managing information overload. Indeed, several pertinent questions arise:

- Should a company address the informational needs of all, some, or a few particular users, and what are the informational needs of each--e.g. regulators, analysts, investors and creditors?
- What level of detail should be provided? Should information sufficient for analytical needs be provided, or should information be disclosed in a more aggregated fashion?
- How much information is too much?
- How does a company ensure that the information is useful to investors and creditors?
- What method of delivery would meet the varying needs of different users?

While robust disclosures have never been considered an appropriate alternative to good accounting, their importance to analysts increasingly is evident because of the ever more complex nature of the business environment and items to be valued. We believe there is no trade-off between accounting and disclosures--both are essential and intertwined. The value in a particular financial statement line item alone can't provide complete decision-useful information to financial-statement users.

"Smoothed" values unlikely to smooth the way

An alternative proposed by some market participants to fair value may be to allow the use of smoothed values when market observations are substantially lacking or are influenced by temporary supply and demand imbalances (such as when sales giving rise to market observations or those affecting an index are sporadic and more akin to a distressed sale), and resulting values are not reflective of what they believe to be the underlying economics. While the resulting valuation assertions may be accurate, they raise difficult questions that must be weighed in their potential to undermine a consistent reporting framework. Is one crystal ball regarding future valuation better than another, thereby allowing valuations to depart from the market? We concur that this may well be the case, and do not argue that systems and models that are being used to for trading or enterprise risk management should necessarily encompass this notion or fully rely on it. But we believe the accounting regime must establish its measures on a consistent base.

Accounting must find a single measure to present in the financial statements that, coupled with disclosures, would allow analysts and investors to make their own assessments. The alternative of allowing managements to conclude when volatility is artificial and when it is real, when an impairment is temporary and when it is permanent, when the company can hold instruments to maturity and when it may be forced to sell, has caused significant uncertainty and, in some cases, necessitated the introduction of anti-abuse requirements to the accounting standards. These requirements have not served the market or our analysts well and often mandated the auditors to infer management's intent from documentation and intricate technical requirements. We clearly recognize the merits of reflecting the economics associated with intent but note that, while beneficial in certain respects, it is troublesome

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because it can result in identical instruments being reflected in the accounts of the same enterprise using different values--a quite perplexing outcome, especially when intent becomes significantly more difficult to ascertain in turbulent times.

Recent conditions have shown that, for many institutions, regardless of intent, changes in conditions can force actions such as early liquidations of investments or holding of originated loans on the books for a longer term rather than selling. Changes in conditions may render the notion of intent irrelevant and grossly inaccurate--especially when a company's fortunes are quickly deteriorating, making past assertions and assumptions inaccurate.

Similarly, while the use of smoothed valuations may reduce volatility, it can grossly camouflage economics. Consider, for example, the valuation of a diversified portfolio of recent years' originated residential mortgage-backed securities or subprime collateralized-debt obligations valued at an average price for the past 12 months. This may well serve as an input to an internal asset-liability management tool, but when users of financial statements are provided with valuations, these would ideally be the current amounts. Smoothed valuations and a further explanation of volatility and its underpinnings, would preferably be placed in the notes to foster greater consistency in reporting. The alternative would be to find a consistent smoothing period for each asset type, consider changing market dynamics in adjusting the period to be smoothed, and to consider when to exclude what is perceived as abnormal periods from the smoothed value. These aspects make the use of smoothed values significantly challenging to our analysts and speak to support for fair value of financial instruments in the context of providing a consistent starting point to our analysis.

That said, we believe current rules mandating the use of market inputs or prices can be relaxed or clarified to permit companies to depart from market-based inputs when there are clear indications that the market is disrupted, grossly dislocated, or illiquid. In those cases, companies would be permitted to place greater emphasis on company-specific assumptions to the extent they are supportable and are verified by third parties, such as auditors. In all cases, companies would be required to disclose the actual fair values observed (or calculated) using market indicators, and the reasons they believe the use of current market indicators is inappropriate or need to be modified. Additionally, we expect that the values would correspond with those used internally.

Inherent in this approach is our belief that if methodologies and disclosures are determined to be deficient or noncomparable to peers, market forces (analysts, investors and regulators) would ultimately force improvements through such things as increased capital costs to address the additional uncertainty surrounding valuations. Combined with increased transparency and disclosure of information that would provide the underlying assumptions, management's rationale, current valuation, factors that can cause an early disposition of the securities or positions, and sensitivity analyses surrounding these factors, this approach has the potential to mitigate uneconomic earnings volatility during a period of market disruption.

There Is No One-Size-Fits-All Solution

Values or operating measures communicated by accounting rules, as sophisticated and complete as they may be (or as we would like to believe they are), should not be analysts' sole method of evaluating performance and financial prospects. Simply put, the amounts alone cannot be used as a precursor of future operating results--or as the only indicator of solvency or credit risk of an entity, its liquidity position, or the adequacy of its risk management.

Although we recognize its inherent limitations, fair value accounting, coupled with robust disclosure regarding the

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significant assumptions and sensitivity analyses, nevertheless in most cases is the most relevant starting point to our analysis. Given that a one-size-fits-all solution cannot be created, a common, comprehensive, and agreed-upon framework is the next-best solution. This will make financial reporting easier to understand and will greatly facilitate comparisons between periods and among peers. Moreover, and perhaps more important, we expect that entities would be encouraged by accounting-standard setters and regulators to more fully describe how they view their businesses and manage their prospects, including if (and why) they believe the accounting does not fully capture the economics of their situation. We believe this is necessary, especially given the inherent limitations of any accounting model and the trend toward principles-based standards.

It is also important to recognize that different users of financial reports often have distinct objectives, all of which could contribute to developing a preference for a particular reporting framework. Banking and insurance regulators are most concerned about the safety and soundness of an institution and may be more supportive of conservative valuations and accounting. Equity investors, meanwhile, may be focused on future earnings prospects and competitive position, whereas debt investors may be focused on these factors as well as on collateral availability and the priority of claims. Accounting rules should present a balanced approach to valuation--that is neither conservative nor aggressive--especially when a conservative posture in one period entails an aggressive posture in the following, or vice-versa. Disclosures should allow users to stress and manipulate the data for their own purposes.

In addition, expanded and more informative disclosures about valuation practices and measures--including their susceptibility to future volatility--will undoubtedly increase market participants' confidence in these measures. It will also drive greater alignment of models, valuation techniques, and assumptions used among peers, and result in a more coherent and comparable framework. This, in turn, will likely improve market liquidity and efficiency. It will enhance values by reducing the discount market participants impose because of uncertainties and will contribute to counterparties' greater confidence.

While we believe current market conditions may have been exacerbated by the use of fair value accounting, markets have also been affected by the sheer opacity and uncertainties associated with its use--a problem that may be greatly rectified with the aid of more transparent and meaningful disclosure. We recognize the inherent limitations of fair value, and do not contend that fair value measures are a panacea for financial reporting challenges, nor do they provide a complete portrayal of an enterprise's economic reality. However, because a one-size-fits-all solution is not possible--and recognizing the need to have a consistent benchmark that would represent a single measurement for all companies--we believe a common, comprehensive and agreed-upon framework using fair value for financial instruments is the next-best solution.

We reiterate our belief that fair value accounting should continue to have a significant role in the accounting for financial assets and liabilities, but that it should be reinforced and enhanced with more informative disclosures and revisions to the income statement in order to achieve the desired financial reporting objectives. To succeed in these improvements, active participation and contributions by all affected constituencies (including companies, accounting standard setters, auditors, investors, regulators, and analysts) is essential, ultimately leading to an improved financial reporting discipline that will be capable of meeting the information needs of investors and creditors, and of supporting the evolving global capital markets for many years to come.

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Sidebar 1: Fair Value Challenges In Today's Environment

The use of fair value accounting has several inherent limitations. Coupled with extreme market conditions, fair value volatility can jolt financial results. Outlined below are issues, challenges and related consequences observed during the recent market dislocation (not intended to be all-inclusive, and in no particular order of significance):

- Fair value measures--as precise as they may be--can change quickly and fiercely in a volatile environment;
- Positive asset valuation does not mean that liquidity is plentiful--even liquid markets can dry up swiftly, precluding efficient monetization of assets previously believed to be liquid;
- Many companies relied on the availability of robust markets to value their assets but found that many assets became illiquid, necessitating model-based valuations;
- Many companies faced marking instruments to market in the absence of a liquid market, but lacked adequate modeling expertise or could not address the significant increase in volume with existing staff;
- Market participants employ vastly different valuation models, methodologies and assumptions;
- The accounting hierarchy for fair value, which mandates the use of market values when available and are not reflective of "forced liquidation" values (see Sidebar 2), caused companies to take deep "haircuts" based on values derived from sporadic market transactions;
- Market inputs used for valuation, often incorporating severe liquidity haircuts, exaggerated losses that may be reflected using fundamental default probabilities;
- The accounting methodology that references an "exit price" for securities is conceptually and practically difficult to apply when an entity cannot exit a position or an exit market does not exist, resulting in often nontransparent estimates and counterintuitive financial results--e.g., a gain on own-debt obligations when a company's fortunes deteriorate;
- Although the accounting hierarchy disclosures prescribed by FAS 157 and to a different extent under IAS 39 may provide some information on liquidity (presuming that Level 1 encompasses more liquid assets), the disclosures broadly falls short of providing information on liquidity prospects;
- Uncertainties in valuations and a lack of transparency regarding underlying collateral and risks hinder the ability to monetize assets without significant liquidity discounts being applied;
- Concerns about liquidity hampered the efficiencies of the repo market, resulting in steep valuation haircuts and the inability to quickly and efficiently monetize assets which in turn, may have forced a sale of assets by market participants in the absence of alternative liquidity resources;
- Complex financial instruments are valued using complex algorithms and modeling techniques, some of which were untested in distress and became less effective or non-functional in the absence of sufficient market data;
- The effects and effectiveness of derivatives positions in mitigating losses was unclear; the volatile market conditions caused "series breaks" in risk-management practices because of deviation from past correlations, often resulting in loss of hedge accounting;
- Accounting write-downs caused erosion in regulatory capital measures (although the treatment is not always reciprocal), covenant violations or loss of covenant head room, and margin calls--often mandating hasty sales of assets that further exacerbated the decline in market indicators (as a result of the prevalence of distressed sales);
- Some market indices are ineffective as valuation indicators for many positions when the market references for these indices become illiquid and when applied to positions that are not representative of them;
- Counterparty risks, market risks, and contingent liquidity calls were not fully evident in financial statement footnote disclosures, generating surprise announcements and further eroding investor confidence in financial

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reporting;

- Information about credit risk and potential risk sensitivity analyses affecting valuation were rarely present in financial reports in a coherent and meaningful fashion;
- The combined effects of the above further depressed the value of financial institutions' issued equity and debt securities, and increased their perceived counterparty risk--further contributing to write-downs in portfolios by others who had direct holdings of the institutions' securities or of securities or transactions guaranteed by, or referencing, them. This caused a systemic cascade that amplified write-downs and eroded counterparty confidence;
- Massive write-downs taken, with exposures previously hidden, have caught investors, creditors, analysts, and regulators off-guard, causing extreme measures and further erosion of confidence;
- The complexity associated with the mixed attributes model, and the variety of accounting options and requirements for substantially similar economic scenarios, make it extremely difficult for managements to explain the interaction between accounting, economics and risk management, and for analysts to decipher financial results;
- The cash-flow statement, especially for financial institutions, does not provide meaningful analytical value in assessing liquidity and cash-flow prospects;
- Compensation and incentives were misaligned with long-term objectives and risk-management practices, encouraging front-loading of profits and imprudent valuation practices; and
- There were several notable breaches of risk-management practices, large valuations errors, and the departures of senior risk management and accounting personnel, causing broader concerns about prudence of internal controls and risk-management practices.

Sidebar 2: Fair Value--What Is It?

The definition of fair value under FAS 157, "Fair Value Option" and IAS 39, "Financial Instruments: Recognition and Measurement" is substantially similar. Fair value is defined by FAS 157 as "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," and by IAS 39 as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction." Both statements prescribe hierarchies for the determination of fair value, which give the highest credence to valuations derived from quoted prices in active markets. The objective of articulating a hierarchy is to foster greater consistency in disclosure of items measured at fair value and to assist users in understanding the methodologies used. FAS 157 specifically requires the use of exit price for valuations and makes it clear that entry and exit prices conceptually differ--i.e., the transaction price is a current entry price. IAS 39 is not clear on whether the measurement objective is based on current entry or exit value principles.

FAS 157 establishes the following three level hierarchy for valuations:

- Level 1: Valuation based on (unadjusted) quoted prices for identical assets or liabilities in active markets that the reporting entity has the ability to access at the measurement date.
- Level 2: Valuation based on inputs that are observable either directly or indirectly for similar (but not identical) assets. It includes: (i) quoted prices for similar assets or liabilities in active markets or for identical or similar assets or liabilities in markets that are not active; (ii) inputs other than quoted prices--e.g., interest rates, loss severities, credit risks, and default rates; and (iii) inputs that are derived principally from, or corroborated by,

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observable market data--e.g., by correlation or other means.
- Level 3: Valuation based on inputs that are unobservable. These inputs are used when observable inputs (Level 1 or 2) are not available and should incorporate the entity's own assumptions about the assumptions that market participants would use. Accordingly, entity's specific data would be adjusted if available information indicates that market participants would use different assumptions.

Like FAS 157, IAS 39 indicates that the best evidence of fair value is quoted prices in an active market. If the market is not active, fair value is determined using a valuation technique (similar to Level 2 or 3 under FAS 157). It specifies that valuation techniques must consider the fair value of another instrument that is substantially the same and that the techniques be similar to those commonly used by market participants. Also, the valuation technique should make maximum use of market inputs and rely as little as possible on entity-specific inputs. IAS 39 provides an exception that allows an unquoted equity instrument to be carried at cost when its fair value cannot be reliably measured. This exception is not afforded for bonds and non-equity instruments, and is not available under FAS 157.

FAS 157 requires specific disclosures of assets and liabilities measured at fair value pursuant to each of these measurement levels, and mandates expanded disclosures about items classified in Level 3 and ensuing gains or losses. Similarly, IFRS 7 requires disclosures about the valuation methods used and about the assumptions applied in determining fair values. It also requires a disclosure about whether fair values are determined, in whole or in part, directly by reference to published price quotes in an active market or are estimated using a valuation technique.

Although FAS 157 did not introduce any change to the items that are required to be measured at fair value under U.S. GAAP, it introduced two subtle, yet important concepts: It allows "day one" gains to be recorded on instruments valued using company-specific inputs, and it provides a more precise and strict definition for determining fair value (such as defining the market in which an instrument is expected to be traded as the principal or most advantageous market, and defining orderly transaction and market participants). Day one gains arise whenever an entity's measurement of fair value differs from the transaction price. Unlike FAS 157, IAS 39 permits day one gain only if the estimate of fair value is based entirely on observable market inputs.

Fair value measurements assume transactions occur in the "principal" market for that entity, or, in the absence of a principal market, the most advantageous market in which the company may transact. It should come as no surprise that different companies may have different principal markets and may be able to transact in different markets. Similarly, the myriad assumptions and inputs that may play into determining fair value may differ between companies. Even if the same assumptions were made in valuation, different weights might be applied such that the resulting values might yet be significantly different.

This is not to imply that these values are inherently wrong in any sense. Rather, it shows that flexibility inherent in the guidance may be appropriate in better reflecting the different markets and environments in which companies operate, and potentially allows the best representation of the value of the asset or liability to the company. Further, it is inherent in a system that allows management to use estimates in accounting, the complete alignment and synchronization of which is beyond what is possible even in a rules-based accounting regime, and even more pronouncedly (and, we emphasize, appropriately so), in a principles-based environment. Even so, broad guidelines on disclosures could be provided by the accounting-standard setters, where the audit committee and the board of directors (together with the internal and external auditors) are tasked with monitoring and ensuring they are complied with in a consistent and unbiased fashion.

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The following exemplifies how recent market disruptions have highlighted differences in perceptions of fair value under FAS 157.

Normal vs. distressed markets

Under normal conditions, in relatively liquid markets, fair values are based on transactions between willing buyers and sellers. In distressed conditions, fair value derived from market transactions, is called into question as being unrepresentative because it is affected by "panic" or distress-driven prices, or is based on sporadic transactions, compared with normal conditions.

Management intent and ability

Fair value measurements notwithstanding, the underlying economics of transactions and securities may be significantly affected by management's intent to retain ownership of the security, or ability to control payouts over a longer period. Where management has no intention of selling into a potentially dislocated market and has the ability to retain the position, or is under no obligation to make current payouts, the current fair value may not be representative of the ultimate economic fair value to be realized in the longer term.

Hypothetical markets

Markets may become disrupted to the extent they essentially cease operating. In such environments, management must determine the fair value as if a market existed, such that they are based on hypothetical market values that may differ significantly from those derived from liquid markets.

Buy-sell spreads

In non-distressed or dislocated markets, buy-sell spreads are relatively slim, taking into account the security's terms and conditions. In dislocated markets, buy-sell spreads often widen in response to uncertainty regarding perceived risk and liquidity needs.

Sidebar 3: Financial Instruments And The Measurement Maze

This excerpt from the Joint IASB/FASB Discussion Paper on Reducing Complexity in Reporting Financial Instruments, illustrates the myriad measurement methods required or allowed today for financial instruments. While not a complete list of all measurements, it illustrates the many ways in which financial instruments are (or may be) measured. Some of the measurements are IFRS or U.S. GAAP requirements only and some are requirements in both. Navigating through this maze and appreciating the potential nuances and ensuing financial-measures effects is not a simple feat for accounting experts or analysts.

Financial instruments presented as assets:

- Equity method
- Consolidation--recognition of individual assets and liabilities of the issuer of the equity instruments
- Proportionate consolidation
- Fair value with gains and losses in earnings
- Fair value with gains and losses in other comprehensive income until realised
- Fair value with gains and losses in other comprehensive income until realised except required impairment losses that are reported in earnings immediately
- Fair value with part of the gains and losses in earnings and part of the gains and losses in other comprehensive income (cash flow hedge accounting)

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- Cost less required impairment losses that are reported in earnings
- Cost with discount accretion, premium amortisation, accrued interest and required impairment losses in earnings
- Cost with discount accretion, premium amortisation and accrued interest plus or minus some changes in fair value if some of the changes in fair value of the instruments are hedged under fair value hedge accounting
- Cost plus accreted discount or amortised premium with a separate line item for accrued interest
- Lower of cost or market value
- Carrying value less allowances for uncollectible amounts
- For loans and receivables subject to troubled debt restructuring, as specified in SFAS 15--Accounting by Debtors and Creditors for Troubled Debt Restructuring
- Carryover basis of the transferred assets allocated on the basis of relative fair values of the portions sold and retained
- Not recognised unless an amount is receivable

Financial instruments presented as liabilities:

- Fair value with gains and losses in earnings
- Fair value with part of the gains and losses in earnings and part of the gains and losses in other comprehensive income (cash flow hedge accounting)
- Net issue proceeds plus accreted discount or amortised premium with accrued interest
- Net issue proceeds with discount accretion, premium amortisation and accrued interest plus or minus some changes in fair value, if some of the changes in fair value of the instruments are hedged under fair value hedge accounting
- If treated as a substantial modification of the terms of an existing financial liability, gains or losses on extinguishment of original liability reported in earnings with recognition of a new financial liability at its fair value
- Initial measurement at fair value and subsequent measurement at the higher of (a) the amount determined in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets ;and (b) the amount initially recognised less, when appropriate, amortisation reported in accordance with IAS 18 Revenue
- Face value with accrued interest (if any)
- Recognised at acquisition date fair value and amortised over the estimated life (if acquired in a business combination)

Some of the measurements described above include the effect of impairment losses. Impairment losses are also recognised in many ways under IFRS and US GAAP, including:

a) fair value with changes in earnings

b) fair value with changes in other comprehensive income except for those impairments that are required to be reported in earnings

c) lower of cost or market with changes in earnings

d) undiscounted allowance for incurred losses with changes in earnings

e) discounted allowance for incurred losses with changes in earnings (estimated cash flows discounted at the rate implicit in the loan at inception)

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f) cost with some impairments recognised in earnings and other impairments not recognised

The different ways to measure financial instruments and report unrealised gains and losses may result in:

a) two identical instruments being measured differently by the same entity, because:

- management's intentions for realising the value of an instrument may determine the way it is measured
- management has the option of measuring many financial instruments at fair value
- the way in which an instrument was acquired may affect its measurement (for example, interests received by the transferor in securitisation transactions)
- the percentage of total ownership interests that an investor holds in an investee affects how the investment is accounted for

b) two identical instruments being measured differently by entities in different industries. Under US GAAP, specialised measurement practices apply to broker-dealers, investment companies, pension plans, mortgage bankers, insurance companies and others.

Sidebar 4: Related Standard & Poor's Articles

FAQ: IFRS Reporting And Options For Banks In A Souring Market, published Dec. 20, 2007, on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis.

Toward A Global Financial Reporting Standard For Insurance: Standard & Poor's Comments On The IASB's Preliminary Views On Insurance Contracts, published Oct. 15, 2007, on RatingsDirect.

Marking To Market When There Is No Market, published Oct. 15, 2007, on RatingsDirect.

Accounting Ramifications Of The Recent Mortgage-Lending Disruption For Financial Institutions, published Oct. 2, 2007, on RatingsDirect.

A Look Inside Corporate Canada's Love-Hate Relationship With Fair Value Accounting, published Aug. 13, 2007, on RatingsDirect.

The Road To Convergence: U.S. GAAP At The Crossroads, published July 16, 2007, on RatingsDirect.

IFRS For Insurance: Opportunity Revived As The CFO Forum Steps Up Its Involvement, published Nov. 23, 2006, on RatingsDirect.

What Potential Analytical Hurdles Come From Fair Value Option Accounting For U.S. Financial Institutions?, published Oct. 27, 2006, on RatingsDirect.

Standard & Poor's Ratings Services Comments On Fair-Value Option Reporting Standards, published May 1, 2006, on RatingsDirect

Financial Institutions Group Provides More Transparency Into Adjustments Made To Bank Data, published April 26, 2007, on RatingsDirect).

The Clash Between Accounting Standards and Business Needs, published April 2, 2003, on RatingsDirect.

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IAS Rules to Inject Transparency, Volatility into European Bank Financial Statements, published Feb. 17, 2003, on RatingsDirect.

Mark-to-Market Accounting for Financial Institutions Offers Both Benefits and Quandaries, published Oct. 18, 2002, on RatingsDirect.

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