THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

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The Secretary
Securities and Exchange Commission
100 F Street, NE
Washington
DC 20549-1090

By email: rule-comments@sec.gov

Dear Sirs

SEC STUDY ON MARK-TO-MARKET ACCOUNTING

The Institute of Chartered Accountants in England and Wales welcomes the opportunity to submit evidence to the SEC's study on mark-to-market accounting.

The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

Our members occupy a wide range of roles throughout the economy. This evidence was developed by the Financial Reporting Committee of the Institute, which includes preparers, analysts, standard-setters and academics as well as senior members of accounting firms.

We are not able to comment on some of the questions raised in the SEC's study, namely those focused on the US impact and experience of fair value accounting. However, accounting and regulatory issues are increasingly international. In particular, the requirements in International Financial Reporting Standards (IFRS) on financial instruments are closely aligned with US GAAP and so European companies have faced similar experiences to their US counterparts and these may have a bearing on the SEC study. The evidence and findings of the SEC's study will be read with great interest around the world, and we hope that our international perspective on those issues on which we are able to comment will be of value to the enquiry.

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Our comments focus on the use of fair value for certain financial instruments, reflecting the scope of the SEC study. However, there is a broader debate to be had on the role of fair value in financial reporting generally, and this issue will be addressed by the leading international financial reporting standard-setters in due course.

1. The effects of fair value accounting standards on a financial institution's balance sheet

This is no doubt a question on which the study will receive valuable empirical evidence from US financial institutions.

In general terms, the effect of fair value is of course to strengthen balance sheets when asset prices have risen and to weaken them when asset prices have fallen. While changes in asset prices are the result of complex causes, in terms of the economic cycle, it would be expected that asset prices would be higher during the upswing of the cycle and lower in the downswing. The effects of fair value on the balance sheet will therefore tend to reflect the different stages of the economic cycle.

We return to the possible economic effects of this at 6 below, but it needs to be borne in mind that the effects of fair value accounting must be judged against the objective of accounting standards, which is to give relevant information to investors about company performance. While the financial statements may form the basis for other uses, for example prudential capital levels within financial institutions, the relevant regulators can adjust the financial statement figures as they see fit for their purpose – or could even require figures calculated on an entirely different basis. Hence these other uses should not undermine or subvert the primary focus of investor information.

2. The impacts of fair value accounting on bank failures in 2008

We can only comment here on UK experience, which nevertheless may be relevant to the US. In the UK, a number of banks have had to be rescued by government support or by sale to another institution. Although fair value accounting has sometimes given warning of problems at these institutions, it is not generally regarded as a causal factor in their demise. Rather, the causes of failure are usually seen as:

- significant holdings of financial assets that depend directly or indirectly on lending against property assets (either in the UK or abroad, especially the US) and whose value is seen to be impaired; and
- actual or forecast difficulties in meeting financing needs. This is usually the immediate cause of failure. But it is arguable that the market's unwillingness to provide funds to meet financing needs reflects its concerns about the value of institutions' assets and therefore about the recoverability of funding provided to the institutions in question.

We believe that, generally speaking, fair values bring problems to light earlier, allowing them to be dealt with expeditiously. However, in the case of some of the institutions that have recently failed, events leading to the failure were so rapid that any periodic (eg quarterly) reporting of fair values had no significant effect.

3. The impact of fair value accounting standards on the quality of financial information available to investors

In the UK, there is a strong view among investors that fair value accounting for financial instruments, to the extent that it is currently required, has provided useful information and significantly increased the transparency of reporting by relevant institutions. It should be noted, though, that many financial instruments are not currently required to be measured at fair value and we do not see a case for requiring *all* financial instruments to be measured on this basis.

4. The process used by the Financial Accounting Standards Board in developing accounting standards

We are not able to comment on this.

5. The advisability and feasibility of modifications to such standards

We are not in a position to comment on FAS 157, *Fair Value Measurements*, in a US context, which is clearly its principal application. However, the International Accounting Standards Board (IASB) has consulted on whether the approach in FAS 157 would be appropriate for adoption in IFRS.

While there is much in FAS 157 that we support – including the improved disclosures using the three-level fair value 'hierarchy' – we do have some concerns with it as a possible basis for global harmonisation. We should point out, though, that these concerns reflect the wide range of contexts in which references to 'fair value' appear in IFRS and do not, therefore, relate purely to financial instruments.

Our response to the IASB's consultation on *Fair Value Measurements* is on the public record and we set out our specific concerns there.

We accept that in current circumstances there may be practical difficulties in applying the requirements of FAS 157 and of IFRS standards requiring fair value measurements. We therefore welcome the guidance on these matters recently given by:

- the SEC Office of the Chief Accountant and FASB Staff in *Clarifications on Fair Value Accounting* (30 September);
- FASB Staff in FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* (10 October); and
- the IASB Expert Advisory Panel in *Measuring and Disclosing the Fair Value of Financial Instruments in Markets That Are No Longer Active* (31 October).

6. Alternative accounting standards to those provided in FAS 157

Accounting standards should always be open to modification in the light of experience, and there will clearly be many lessons learnt from experiences over the past two years. The SEC's present study will make a significant contribution to the debate on what these lessons are and how or whether they indicate the need for changes in accounting standards. At this stage in the debate, we wish to comment on just one question, which is: whether fair value accounting should be retained for those financial instruments for which it is currently applicable or whether an alternative measurement basis should be adopted?

Most items in accounts are still measured on a historical cost basis, and in general we believe that this is a satisfactory approach. The reason that fair value rather than historical cost has been adopted for certain financial instruments is that for these items fair value is likely to provide a better indication of financial position and performance.

We are aware of concerns that fair value can be misleading in circumstances such as the present, when many markets are inactive or non-existent. We accept that when markets are inactive, fair value measurements are less reliable and therefore less useful – by comparison with measurements taken from active markets. There are real problems in valuing many assets at the moment, but we do not see that reverting to historical cost for items currently measured at fair value would in general be an improvement:

- in the case of derivatives, it would take us back to the old regime where many financial instruments were simply invisible in the accounts;
- and it would create new valuation problems in determining whether provisions for impairment need to be made against the historical cost of some items.

We are also aware of the argument that fair value measurements are pro-cyclical. It is possible to some extent that they are, but this is a question that calls for thorough research before any changes are contemplated. It is equally arguable, as we have stated above, that fair value measurements prompt faster action to deal with a potential downturn (because they expose difficulties earlier). It is quite possible, therefore, that in certain respects fair value accounting is pro-cyclical while in others it is counter-cyclical. So far as it is pro-cyclical, its effects need to be considered in the context of the broader benefits of transparency and counter-cyclical capital adequacy requirements.

We would be happy to provide further evidence on these issues if it would be helpful to the SEC's study.

Yours sincerely

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