

8 October 2008



To: Mr. Russell G. Golden
FASB Technical Director

LETTER OF COMMENT NO.

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I have been thinking of the controversy re fair value measurements (mark-to-market costing) and I wonder if a simple solution is, possibly, the most appropriate at this moment.

There are those, as you know, who believe that fair value costing is a key cause of the current financial crisis and must be set aside. At the same time, accountants and regulators are insisting that "reality" demands that fair values are reported. One report from one of the big-Four firms noted that "reality" demanded fair value. That seemed rather thoughtless in the face of an extremely high level of uncertainty. **(See Note 1)** To read the speeches of Paulson which are included at the end of the final draft report of the Paulson Advisory Committee on the Auditing Profession is to realize how inaccurate his assessment of our financial status was – in hindsight.) To use or not use fair value measurement is not the question. Persisting with either/or seems unwise.

An initial question: Is referring to the current situation as "an inactive market" sufficiently informative of what is happening? At hearings of the Senate Banking Committee and of the House's Oversight of Financial Markets Committee terms such as "paralyzed market," "dried up market" and "frozen market" are used. Each of these may be too colloquial for a technical release as you are providing. However, there must be a better characterization than "an inactive market" which doesn't give a hint that this crisis is generated within the financial world.

A powerful assumption supports fair value: There is a market for the securities! We are now characterizing the market as "frozen." The challenge to fair value makes sense. Yet, the answer is not to abandon fair value at this time. (Look to the Japanese experience in the 1990s for a failure to disclose fair values) I support fair value costing as the only choice when there is a market for CDOs, CDSs, etc.

One Possibility: At this moment, why not permit reporting companies to use preFair Value costing in their primary presentation of financial statements with full disclosure? In this preFair Value Costing set of financial statements, every item that is subject to fair value measurement when there is a market is printed in RED! A clear notation will identify in (red!) footnote XX for presentation of a What-If disclosure of those segments of the financial statements that are relevant for Fair Value disclosure in an active market. (The reader can quickly determine what is happening with both presented) Presenting both will enhance the transparency goal of financial reporting.

A regulatory body -- the SEC, The Federal Reserve Board, or Department of Treasury -- would operationally (quantitatively) determine the point at which the market overall is "frozen", or if only portions of the market are "frozen" the regulator would so note the point. Such a point would trigger the preparation of what is suggested above. With computerized electronic capabilities, the preparation of what is needed is feasible and could be done on a timely basis. (Think of the 3 page Paulson bailout plan became a 450 page report in less than 14 days!)

Another Possibility: There are so many questions about the success of the Bailout plan; therefore, the questions related to "market value" or even "potential market value" aren't easy to answer and any answer is likely to have an error surrounding it that doesn't give much comfort about the status of the figure. I am reminded of a strategy used by the

Bureau of the Census. In projecting population levels, the Bureau staff provides three series – highest, middle, lowest. Their explanations are clear so citizens understand what is being presented. (Note, for example, *Current Population Reports: Projections of the United States by Age,* (P25-1130, issued February 1996)

Could two or three predictions be reasonable? Assume there are three models for predicting future values, each of which has some reasonable probability of being realized. . The initial set of financial statements would be based on the *most* supportable of three levels for key assumptions re factors considered. The effects of the other two would be provided in clearly presented graphs/tables and explanations. Assuming that far more people than earlier understand what is happening in our global economy, reasonable explanations will be understood and appreciated by investors and others. (See **Note 2**)

(I am not an expert re GAAP. . . . the above is driven by what I have perceived to be serious problems in the auditing and internal controls related to the increasing numbers of financial “products” designed by our astute (clever?) financial model builders! (See **Note 3**)

Would you do a favor for me? Would you convey to Mr. Thomas J. Linsmeier my appreciation for his excellent – thoughtful and indepth – presentation on the first morning of the Conference on Deviations from Historical Cost at the Stern School of NYU on Friday September 19.

Best wishes in your efforts to provide useful guidance at this critical time.

Mary Ellen Oliverio
moliverio@pace.edu
212 666 5187

Notes on following pages 3 and 4

Fair Value Measurement

Note 1:

It is difficult to accept that recent fair values are “reality.” AIG’s 10-Q (as of June 30, 2008) submission to the SEC has 10 pages of explanation of how they measured fair values. However, on October 4, in *A.I.B. Uses \$61B of Fed Loans (NY Times)* From what was stated in that article, many were surprised that AIG drew down just a significant segment of the loan. An analyst at Standard & Poor’s noted that it “is much larger than we had previously anticipated.

In the hearings of the House of Representatives Committee on Oversight and Government Reform, the nominal value of the debt was estimated to be about \$600T with real value approximately 10 percent of that amount! (I was unable to listen to the full hearings on Wednesday; it is possible that there were comments made later that modified the estimates.) Martin Feldstein stated that “More than \$700 billion is needed to buy all of the impaired securities. . . . The impaired assets are not just mortgages but the complex derivatives based on those mortgages: the collateralized debt obligations. . . . even if rated AAA, often have market prices close to 50 percent of their notional value.” (Martin Feldstein, *The Problem Is Still Falling House Prices, WSJ 10/4/08*)

Of course, values may have dropped at a rapid rate, so it is difficult to judge the wisdom of fair value measures by AIG in the above noted 10-Q. Furthermore, several weeks ago when the papers were reporting the status of AIG, estimates of debt began at \$20B. . . and soon was as much as \$60B. . . it didn’t appear that there was much confidence in any figure announced. (This is stated highly tentatively because values may have been changing significantly day by day! I just learned that AIG is getting an additional \$35B)

However, to say that fair value represented “reality” seems a simple-minded level of assessment at this point.

Note 2:

From reading several hundred inspection reports (the disclosed portions) of the PCAOB, it is clear that many deficiencies related to estimates. Auditors fail again and again to adhere to the guidance provided in AU342.

If what I attempted to describe in the second suggestion was done, possibly entities and their auditors would gain some needed experience in determining what was critical in determining relevant assumptions and following through with implementation of such assumptions when they actually determined estimates.

A look at the reality of what is actually happening in many publicly owned U. S. companies that must report to the SEC does not leave a sense of comfort, for example, that the management process detailed in 342.11 is the reality of management implementation of what is their responsibility. From what I hear when practitioners are

absolutely candid about what they find as management strategy for estimates sounds parallel to what the Big-4 described as the lack of internal control when the first SOX Section 404 audits of internal control were undertaken. In one comment letter from the Big-Four, the weaknesses noted in internal control reflected “deferred maintenance.” Yet, the amendment to the 1934 Securities Exchange Act (in the December 1977 Foreign Corrupt Practices Act) established statutory requirement for internal control. There appears to be similar “deferred attention” to proper determination of estimates.

You are likely to think the following is off subject. However, you and your colleagues have a view of what is happening that is unique and I am amazed at what you could do!

Note 3: I am guessing that your responsibility at FASB is establishing accounting guidance. Possibly, the matter of how derivatives and all the so-called complex instruments are traded is not your task. But, I am guessing you interact with regulators.

In a 1900 book about Clearing Houses in the United States (James Cannon, a vice president in a New York bank, was the author), there is a fascinating account of the development of the Clearing-House Loan Certificate. As you and your colleagues may well know (I just read this book last Friday – it was off site at our New York Public Library) the first clearing house was here in Manhattan and established by local bankers in 1853, although the outline of what was needed had been provided in a 124 page booklet by Albert Gallatin in 1831!). While the initial purpose of the clearing house was to just see that canceled checks were returned to the banks in which they originated, the group soon realized there were other matters that needed to be considered. . . one such matter was how to help one of the members of the clearing house when in distress – that was the motivation for the Clearing House Loan Certificate. So they issued such certificates when there was a bank facing serious problems. However, they were aware of the potential risk if these were then sold in secondary markets. . . etc. . Therefore, these certificates sold (I think I am recalling this correctly) to other banks, but purchasers knew that **clearing house loan certificates were not available for resale.**

As I listened to the hearings yesterday morning and heard someone talk about the 8 iterations following that initial loan related to a mortgage, for example, and heard the speaker talk about the bundling and rebundling, and the slicing, and reslicing, I wondered: **Given all the regulators we have, why wasn't there some assessment of what was happening?** Also, a brief note in the Business Section of Sunday's *New York Times* (10/5/08) noted that after the Great Depression, there were instituted safeguards to reduce the possibility that what happened at that time would not happen again. However, Paulson noted that there weren't sufficient “tools in the kit” to handle what is happening. **Again, why didn't some regulator see that the financial world was changing and assess the adequacy of the safeguards established beginning in the mid 1930s?**

Did the FASB as they considered the accounting for derivatives realize how they would become collateralized debt obligations with AAA ratings and sold as cash equivalents to unsuspecting investors and alert regulators? And now we have nominal value estimated to be possibly 10 times actual value.