CENTER FOR AUDIT QUALITY
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Wednesday, April 18, 2007 Contact: Jill Bratina 202-609-8120

Statement by Cindy Fornelli, Executive Director of the Center for Audit Quality, on Financial Accounting Standards Board rule FAS 159

Washington, D.C. -- "We issued our alert in response to questions raised by our member firms and their clients related to both the early adoption of FAS 159, the Financial Accounting Standards Board rule which allows entities to record financial instruments on their balance sheets at fair market value, and the need for additional clarification in adopting this standard.

"Our alert was based on our current understanding of the issues surrounding the adoption of the standard, obtained in part from discussions with member firms as well as discussions with the SEC staff. We are committed to enhancing the quality of member firms' public company audit practices through the development of technical alerts and by liaising with the regulators."

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The following is the full text of the CAQ Alert issued to CAQ members on April 17, 2007:

FAS 159 Early Adoption Date Approaching – Factors to Consider

The deadline to early adopt Financial Accounting Standards Board Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, (FAS 159) is quickly approaching for calendar year-end entities. All calendar year-end entities must decide whether to early adopt FAS 159 within 120 days of January 1, 2007 (i.e., the end of April).

Center for Audit Quality member firms have raised questions related to the early adoption of FAS 159 by their clients and expressed the need for additional clarification in adopting this standard. As a result, the Center is issuing this Alert, which includes matters to consider in analyzing an early adoption of FAS 159. This alert is based on our current understanding of the issues surrounding the adoption of FAS 159, obtained in part from discussions with member firms as well as discussions with the SEC staff.

Description of FAS 159

Under FAS 159, entities are provided with an option to report selected financial assets and liabilities at fair value. The standard permits an entity to elect the fair value option on an instrument-by-instrument basis; and once the election is made, it is irrevocable. As stated in paragraph 1 of FAS 159, "The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This statement is expected to expand the use of fair value measurement..." In addition, FAS 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. FAS 159 does not eliminate disclosure requirements included in other accounting standards, such as the requirements for disclosures about fair value measurements included in Financial Accounting Standards Board Statements No. 157, Fair Value Measurements (FAS 157), and No. 107, Disclosures about Fair Value of Financial Instruments (FAS 107).

Effective Date and Transition Provisions

The effective date of FAS 159 is for fiscal years beginning after November 15, 2007. There is an opportunity to early adopt FAS 159 as of the beginning of a fiscal year that begins on or before November 15, 2007, as long as certain additional conditions are met: (1) the choice to adopt early must be made within 120 days of the beginning of the fiscal year of adoption (for calendar-year end entities, by the end of April); (2) the entity must also early adopt all of the requirements of FAS 157 as of the early adoption date; and (3) the entity has not yet issued financial statements in the current fiscal year.

Under the transition provisions of FAS 159, entities are allowed to reconsider the accounting for eligible financial instruments existing on the adoption date. Eligible financial instruments include, but are not limited to, held-to-maturity and available-for-sale investment securities, and financial liabilities (i.e., debt obligations). Entities report the effect of the remeasurement to fair value at adoption as a cumulative-effect adjustment to the opening balance of retained earnings.

Important Considerations

As described above, FAS 159 clearly articulates the principles and objectives of the standard. Principles-based standards should be applied in a good faith manner consistent with those objectives and principles. Although FAS 159 allows for early adoption of the fair value option to held-to-maturity and available-for-sale investment securities held as of the early adoption date, including those securities in unrecognized loss positions (underwater securities), auditors should exercise appropriate professional skepticism and be alert for circumstances in which an entity proposes to adopt FAS 159 in a manner that is contrary to the principles and objectives outlined in the standard.

For example, assume an entity purports to adopt FAS 159 by electing the fair value option for certain eligible underwater available-for-sale and held to maturity investment securities, and certain financial liabilities. Shortly thereafter, the entity disposes of those investment securities and settles those liabilities. The entity does not elect the fair value option for newly purchased investment securities and newly issued liability instruments. The totality of these actions appears to indicate that the entity has little or no intent to utilize the fair value option as a measurement attribute with respect to these classes of financial assets and liabilities on a go forward basis, contrary to the principles and objectives outlined in FAS 159. Accordingly, the entity's purported adoption of FAS 159 is not substantive and would not be considered a proper application of FAS 159.

In other situations where the answer is less clear, entities and auditors should use professional judgment when considering whether a purported adoption of FAS 159 is substantive based on the specific facts and circumstances. Some of the factors to consider and potential implications that may impact an entity's assessment of the appropriateness of early adoption of FAS 159 include:

- Is the entity able to adopt all of the requirements of FAS 157 at the same time it plans to early adopt FAS 159? The early adoption requirements of FAS 159 include required concurrent early adoption of FAS 157.

- Is the planned approach for adoption of FAS 159 primarily to obtain the accounting result of recording unrealized losses directly in retained earnings? Are the entity's reasons for adopting FAS 159 consistent with the FASB's stated objectives for issuing FAS 159, which include expanding the use of fair value measurements in periods subsequent to adoption?

- Has the entity communicated to its board of directors, audit committee, analysts, or others (a) its plans with respect to those assets and liabilities for which the entity proposes to elect the fair value option and (b) its intention (or lack thereof) to apply the fair value option as a measurement attribute in future periods?

- Depending on the specific facts and circumstances and the timing of the early adoption election, would the sale of securities subsequent to adoption of FAS 159 that were previously classified as held-to-maturity or available-for-sale call into question management's prior assertions regarding their intent and ability to hold impaired securities until they recovered in value or maturity?

- How does the planned adoption approach compare to the entity's disclosures in prior periods of the potential impact of FAS 157 and FAS 159 as required by Securities and Exchange Commission (SEC) Staff Accounting Bulletin No. 74?

- Have management and the audit committee considered the disclosure requirements related to early adoption, including disclosures of the reasons for electing the fair value option and why it was elected for some but not all eligible items within a group of similar eligible items, and the implications of those disclosures?

Because specific circumstances will vary from entity to entity, management, audit committees and the auditor should carefully consider the facts and circumstances when assessing the factors described above and any potential implications on the related accounting and disclosure. If an entity proposes to adopt the fair value option merely to achieve an accounting result that is contrary to the principles and objectives in FAS 159 (i.e., recording unrealized losses directly in retained earnings coupled with little or no intent to apply the fair value option as a measurement attribute with respect to these classes of financial assets and liabilities on a go forward basis), the auditor should reach a conclusion that the entity's proposed accounting departs from generally accepted accounting principles.

In those situations where early adoption of FAS 159 is deemed appropriate, and where unrealized losses are being recorded directly in retained earnings in connection with the early adoption of FAS 159, entities should provide clear and transparent disclosures of the reasons for electing the fair value option for specific eligible items and for not electing the fair value option for other eligible items within a group of similar items, including a discussion of any accounting motivations of such elections, with the other required disclosures of FAS 159. Specific questions regarding the appropriate adoption and application of FAS 159 may be directed to the SEC's Office of the Chief Accountant through its formal pre-clearance process. These matters will be considered by the SEC staff on a case by case basis based on an entity's specific facts and circumstances.

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