

Year-End Considerations Related to Illiquid Market Conditions

Recent conditions in financial markets present significant challenges for 2007 financial reporting. Year-end financial reporting processes are now being completed and audit committee members will need to be aware of how market conditions impact financial reporting by their companies.

For example, companies may have exposure to market value declines directly through an investment portfolio, including mutual funds, that invests in “high-yield” sub-prime backed paper and other affected securities, as well as through pension funds and their related assets. Others may be exposed through commitments to fund loans or underwrite securities, or through explicit or implicit commitments to provide credit or liquidity support to other entities. Also, the contraction of liquidity in some markets imposes significant challenges to determining fair values of assets and liabilities.

Measuring Fair Value in Illiquid Markets

Under GAAP, investments accounted for at fair value must be valued at the quoted market price in an active market whenever such markets and quoted prices are available. The contraction of credit and unwillingness of buyers to be in some markets has caused some investments to be traded in low volumes and such limited transactions

that the question arises as to whether quoted market prices in active markets are available. For example, if an auction fails on an “auction rate reset security” this may be an indication that market participants are unwilling to purchase such securities based on the minimum bid required. That may indicate that the fair value of the security is less than its face amount. The fair value cannot be determined based on market quotes but is likely to be less than face value.

Investments for which market quotations in an active market are not available must be fair valued based on assumptions that would be used by a market participant under existing market conditions.

Other Considerations

Members of audit committees of financial institutions (such as banks, investment firms, insurance companies, and others) should be aware of special considerations that apply to activities of such entities. Entities that make commitments to make loans or underwrite the securities of others, or that have taken investment

positions with the intent to dispose of those positions, will need to consider whether the commitments are to obtain assets with fair value that is less than the committed cost and whether an imbedded loss must be recognized.

Financial intermediaries that have interests in entities that issued commercial paper or other asset backed obligations may need to consider whether or not there has been a realignment of risks and rewards and whether the asset backed issuer should be consolidated as a variable interest entity.

Additional Reading

KPMG’s *Defining Issues*® 07-30, “The Accounting Implications of Illiquid Markets,” summarizes three white papers issued recently by the Center for Audit Quality on the above topics. (<http://www.kpmg.com/aci/DI.asp#Illiquid>)

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