News Bulletin

October 13, 2008

Fair Value and the Recent Market Turmoil

The recent credit market turmoil, including the subprime meltdown and investigations into the failed auction rate securities market, has resulted in dramatic reductions in the trading prices of, and reduced liquidity in the markets for, securities and financial instruments at the focus of the crisis. Institutions recording the value of their assets based on current market prices have taken large write-downs, as prices have fallen and active markets, such as the mortgage-backed securities ("MBS") and auction rate securities ("ARS") markets, have disappeared. Market observers have noted that in some cases, the current fair value of these assets may be less than the present value of expected cash flows from these assets. This disparity between perceived and market 'value' has called into question applicable accounting standard Financial Accounting Statement 157, *Fair Value Measurements* ("FAS 157").[1] As discussed below, questions as to the impact of FAS 157 have been raised, resulting in updated statements from the U.S. Securities and Exchange Commission (the "SEC") and the Financial Accounting Standards Board (the "FASB"), and inclusion of provisions in the Emergency Economic Stabilization Act of 2008 related to the future of FAS 157.

Background

In September 2006, the FASB issued FAS 157 in order to create a uniform definition of fair value and provide guidance for applying the definition of "fair value" to promote consistency, comparability and transparency in fair value measurements. Although many SEC reporting entities began adopting FAS 157 in early 2007, the statement is effective for financial statements issued for fiscal years after November 15, 2007, or in the case of nonfinancial assets and liabilities, such as goodwill, for fiscal years after November 15, 2008, provided that early implementation has not already occurred.[2] FAS 157 applies to existing pronouncements that require or permit fair value measurements except for pronouncements that: (1) address share-based payments; (2) contain practicability exceptions to fair value measurements; (3) require or permit measurements that are based on, or otherwise use, vendor-specific objective evidence of fair value or inventory pricing; and (4) address fair value measurements for purposes of lease classification or measurement under FAS 13.[3]

What is Fair Value?

Fair value accounting is a market-based measurement for determining the value of assets and liabilities on a reporting entity's books. The purpose of fair value measurements is to provide investors with the current value of assets and liabilities, rather than historic or future values. Prior to FAS 157, the FASB did not have a standard definition and framework for determining fair value across its many fair value based pronouncements. The FASB implemented FAS 157 to provide consistency and transparency in all fair value measurements required under accounting rules. FAS 157 defines, establishes a framework for measuring, and mandates expanded disclosures

[1] FASB Statement No. 157, Fair Value Measurements, September 2006, *available at* http://www.fasb.org/pdf/fas157.pdf.
[2] FASB Staff Position FAS 157-2 (February 12, 2008).
[3] FASB Statement No. 157, Fair Value Measurements, September 2006. *See also* FASB Staff Position FAS 157-1 (February 14, 2008).

about fair value. FAS 157 defines fair value 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"[4] and applies under accounting pronouncements that require or permit fair value measurements.[5] The key parts of the definition are:

> (1) an orderly transaction, which is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for such sales; not a forced transaction, such as a distressed sale or forced liquidation. The objective is to determine the price that would be received to sell the asset or to transfer the liability at the measurement date (the exit price);
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> (2) a principal market, which is the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability; and
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> (3) a market participant, which is defined as a buyer or seller in the principal market for the asset or liability who is: (a) independent of the reporting entity; (b) knowledgeable about the asset or liability and the transaction; (c) able to enter into the transaction; and (d) willing to transact for the asset or liability.

Given recent market turmoil, the terms "orderly transaction" and "principal market" have become increasingly important. Since FAS 157 assumes sales are made in orderly transactions, reporting entities who were early to implement FAS 157 were left to make estimates and assumptions about asset values where no market exists except for a distressed market. In addition, the increase of distressed sales in an inactive market left questions as to whether or not a principal market existed for such assets. FAS 157 had an exception stating that distressed sales did not need to be used as a basis for fair value reporting, but it was unclear how broadly that exception could be interpreted. Financial institutions that believed there was still value in the assets and that current market prices were indicative of distressed sales disagreed with their auditors who insisted that write-downs reflect the prices at which the securities were bought or sold, as those prices reflected objective price measurements, regardless of the nature of the market conditions. Some auditors believed that if there were one or two sales within a market that an active market existed, and those sales could provide a real market price.

How is Fair Value Determined?

Fair value is determined based on market prices, where available, and if not available, then on a series of technical requirements set forth in FAS 157. Fair value measurements are determined based on the degree of certainty associated with the valuation of each asset or liability. The fair value hierarchy created by the FASB classifies inputs, or assumptions, used by market participants when pricing such asset or liability. Where available, market participants use information based on market data obtained from independent sources when determining fair value. Observable, independent data such as a quoted price in an active market would be a level 1 input, the highest level of the hierarchy. Absent independent, observable sources, a market participant will use its own assumptions about the pricing of the asset or liability based on the best available information. Depending on whether observable data from a similar market is used or if unobservable data, such as a pricing model is used, the assumptions will fall within the level 2 input, or level 3 input categories, respectively. Level 3 inputs require the most subjective judgment by the reporting entity and, therefore, are the lowest level of the hierarchy.

Level One Inputs

Level one inputs are unadjusted, quoted prices in active markets for identical assets or liabilities that the reporting company can access on the measurement date. The market should trade at a sufficient frequency and volume to provide pricing on an ongoing basis. The quoted price for an individual asset should be multiplied by the quantity of that asset held by the reporting entity, even if typical trading volume could not absorb the quantity held.

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[4] *Id.*
[5] *Id. See also* FASB Staff Position FAS 157-1 (February 14, 2008).

Whenever a quoted price is available in an active market, it should be used to measure fair value, except in limited circumstances. When a reporting entity holds a large number of similar assets, such as various debt securities with similar terms, in an active market where quotes are available but not immediately accessible for each individual asset, fair value may be measured using an alternative pricing method, such as matrix pricing. When the quoted price in an active market might not represent fair value on the measurement date because a significant event occurred after the close of a market but before the measurement date, reporting entities should establish a policy for identifying such events and consistently reviewing measurements to determine what value is appropriate. Events may include principal to principal transactions, brokered trades or announcements.

Level Two Inputs

Level two inputs do not have observable market prices but have inputs based on them. Level two inputs can be obtained by using prices that are not current, price quotations that vary substantially over time or among market makers, or in markets where little information is released publicly. Level two inputs can also include other observable factors relating to an asset or liability, such as interest rates and yield curves, prepayment speeds, loss severities, default rates, or factors derived principally from observable market data by correlation or other means.

Adjustments to level 2 inputs should occur if factors specific to the asset or liability will affect value. Such factors include the location of the asset or liability, the condition of the asset or liability, the extent to which inputs relate to items that are comparable to the asset or liability, and the volume or level of activity in the market within which the inputs are observed. Significant adjustments may result in a level 2 measurement being reclassified as a level 3 measurement.

Level Three Inputs

When no observable inputs are available due to little or no market activity on the measurement date, the value must reflect the reporting entity's own assumptions that would be used in pricing the asset or liability. Factors to consider when making valuation assumptions include whether the asset is sold in a distressed sale, or whether the value of the asset is "other than temporarily impaired." The determination requires the exercise of reasonable judgment based upon the specific facts and circumstances of each investment. Although the reporting entity is not required to seek out all available information about market participant assumptions, it cannot ignore information that indicates market participants would use different assumptions than the reporting entity has used if that information is reasonably available without undue cost and effort.

What Additional Factors Must be Considered?

When determining fair value, a fair value measurement should include adjustments for risk if a market participant would include these in pricing the related asset or liability, even if such risk is difficult to measure. A reporting entity should make adjustments for any risk that would be modeled for pricing purposes; any risk associated with restricted assets, if applicable; and nonperformance risk, including the credit risk of the reporting entity.

Why Have Recent Market Conditions Raised Concerns about FAS 157?

In recent months, when faced with increasing losses, write-downs, reduced capital and tightening liquidity, institutions sold MBS at increasingly reduced prices. These stressed sales then established increasingly lower floors for the determination of the fair value of the same and similar MBS. It has been suggested that, in many cases, the resulting balance sheet value given to MBS is less than the present value of the expected cash flows from those assets, even after taking into consideration the current housing environment and increased expected losses on MBS. As liquidity concerns arose, the impact spread to the ARS marketplace. ARS are securities for which the interest rate is regularly reset through a Dutch auction. If there are not enough orders to purchase all securities being sold at the auction, a failed auction occurs and the rate is set to the maximum rate defined for the issuer. The financial institutions forced to write-down values of their MBS portfolios were also broker-dealers in the ARS market and would usually bid on their own behalf to prevent auctions from failing. However, without the financial institutions willing or able to bid at reset dates, auctions began to fail and the market ceased operating. Currently, markets for MBS and ARS are inactive and many holders of these securities have been forced to turn to distressed sales to improve their liquidity or to avoid bankruptcy.

To understand how reporting entities involved in such markets were impacted by FAS 157, a discussion of the impact to ARS holders is illustrative. Holders of ARS accounted for the securities as cash equivalents prior to 2005 or 2007, depending on their auditor's view of what constituted a cash equivalent.[6] The reclassification caused many reporting entities to leave the ARS market. Those who remained began valuing ARS under the guidance in Financial Accounting Statement 115, *Accounting for Certain Investments in Debt and Equity Securities* ("FAS 115").[7] FAS 115 requires that the reporting entity value its securities as "held-to-maturity securities," "trading securities," or "available-for-sale securities." Under FAS 115, trading securities and available-for-sale securities must be measured at fair value, which is determined by guidance provided in FAS 157. Most ARS holders classified their ARS securities as "available-for-sale securities" and relied on the active market to value such assets at par value. With an active market no longer available, ARS holders must now independently determine fair value for the securities. In doing so, the reporting entities must determine if the securities are suffering from other than temporary impairment. If it is probable that the reporting entities will be unable to collect all amounts due (or obtain par value on a sale), an other than temporary impairment may have occurred, regardless of whether the holder expects to recover principal and interest that are in excess of fair value. Regardless of whether actual credit loss will be sustained, the severity of a decline in value, in and of itself, is an important factor in evaluating whether a security is other than temporarily impaired. If the decline in fair value is judged to be other than temporary, the cost basis of the ARS must be written down to fair value as a new cost basis and the amount of the write-down must be accounted for as a realized loss. The new cost basis cannot be changed for subsequent recoveries in fair value; instead, subsequent increases in the fair value must be included in the separate component of shareholders' equity until realized.[8] This has led to massive write-downs for reporting entities that are holding ARS, even though they have yet to realize any actual losses.

SEC and FASB Have Recently Provided Additional Guidance Regarding FAS 157

Recently, members of Congress and financial industry groups, such as the American Banking Association (the "ABA"), have raised concerns that FAS 157 caused or exacerbated the current market crisis by forcing a downward spiral of valuations based on distressed institutions. The requirements to use fair value measurements have been criticized for producing inaccurate results in the current market turmoil. Commentators note that it would be preferable for reporting entities to record only realized gains and losses. Testimony given before Congress raised concerns that as a result of FAS 157 financial institutions have been forced to book losses on securities that may have value after the credit market crisis has passed. In a letter to the SEC, the ABA stated that the current accounting standards "never anticipated the wide variance and price disconnects that we are experiencing today."[9] Proponents of FAS 157 believe that even if FAS 157 has exacerbated the current market crisis, it is still the most accurate and transparent means for valuing assets and liabilities, and that reporting entities will benefit when normal markets return and market participants "bid up" the value of their holdings. Proponents believe that suspending or revising FAS 157 would be a disservice to investors who deserve to know the current value of a reporting entity's assets and liabilities. As a result of such concerns and differing viewpoints, financial institutions, accounting groups, and others have requested guidance from the SEC and FASB as to how to determine fair value measurements in the current economic climate. Since September 30, 2008, the SEC and FASB have provided guidance, proposed amendments to FAS 157, and have been granted authority by Congress to study the implications of FAS 157.

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[6] Both Deloitte and PricewaterhouseCoopers issued releases in 2005 stating that despite the liquid auction market and frequent interest rate resets, ARS were long-term investments and should not be classified as cash equivalents. Other auditors allowed for such classification. The FASB eliminated the cash equivalent classification in 2007.

[7] FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, May 1993, *available at* http://www.fasb.org/pdf/fas115.pdf.

[8] *Id.*

[9] *See* http://www.mercurynews.com/business/ci_10610548 (last viewed on October 10, 2008).

SEC and FASB Joint Statement

In a joint statement issued on September 30, 2008, the SEC and FASB offered guidance to reporting entities regarding the determination of fair value of assets and liabilities in the current economic environment.[10] The guidance focuses on how to measure fair value in inactive markets, how to account for the effect of disorderly transactions and how to determine if the losses associated with an asset or liability are long-term losses (other than temporary impairments) or the result of temporary impairment.

The statement sets forth factors that should be considered in determining what constitutes an inactive market, such as whether there is a large spread in the market between the bid and ask prices for a security and whether there are relatively few bidders in a market; and it warns that broker or market quotes may not be determinative in inactive markets unless they reflect actual transactions. It also states that sales made in disorderly transactions are not determinative of the value of similar securities and therefore do not affect fair value measurements and should not be applied throughout the market. Instead, other institutions may continue to rely on internal assumptions relating to cash flow and risk. The statement also makes clear that the value of an asset or liability must be written down if not temporarily impaired. Factors to consider when determining whether an asset is "other than temporarily" impaired include decline in value, the period of time until anticipated recovery, the probability of recovery, the period of time that the decline has existed, and whether or not the holder of the asset has the ability to retain its investment until the anticipated recovery. Lastly, the statement announced that the FASB is preparing to propose additional guidance on fair value measurement under U.S. GAAP.

The International Accounting Standards Board (the "IASB") issued a statement on October 2, 2008, stating that the joint statement is in line with IAS 39, *Financial Instruments: Recognition and Measurement*, the international financial reporting standard that discusses fair value accounting and that the IASB will ensure that any IFRS guidance on fair value measurement is consistent with the clarification that has been provided by the SEC and FASB.[11] On October 3, 2008, the IASB also announced that it will immediately assess any inconsistencies relating to the issue of reclassifications between IAS 39 and FAS 157 and will determine how to address them in the upcoming weeks. The IASB agreed to work closely with the FASB to develop an approach to issues related to the valuation of financial assets and liabilities resulting from purchases made through government programs, if and when such programs are initiated.[12]

Emergency Economic Stabilization Act of 2008

On October 3, 2008, President Bush signed the Emergency Economic Stabilization Act of 2008 into law (the "EESA").[13] Section 132 of Title I (known as the Troubled Assets Relief Program, or TARP) grants authority to the SEC to suspend by rule, regulation, or order, the application of FAS 157 for any issuer or with respect to any class or category of transaction if the SEC determines that it is necessary or appropriate in the public interest and is consistent with the protection of investors. Although it does not require that the SEC suspend the application of FAS 157, Section 133 does require the SEC to study fair value accounting and report on: (1) the effects of such accounting standards on a financial institution's balance sheet; (2) the impact of such accounting on bank failures in 2008; (3) the impact of such standards on the quality of financial information available to investors; (4) the process used by the FASB in developing accounting standards; (5) the advisability and feasibility of modifications to such standards; and (6) alternative accounting standards to those provided in FAS 157.[14] The SEC has issued a request for comments and will hold public roundtables to obtain input from market participants and other

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[10] Press Release 2008-234, SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting, September 30, 2008, *available at* http://www.sec.gov/news/press/2008/2008-234.htm.
[11] IASB Press Release, October 2, 2008, *available at* http://www.iasb.org/News/Press+Releases/IASB+staff+position+on+SEC-FASB+clarification+on+fair+value+accounting.htm.
[12] IASB Press Release, October 3, 2008), *available at* http://www.iasb.org/News/Press+Releases/IASB+announces+next+steps+in+response+to+credit+crisis.htm.
[13] See Public Law 110-343 (known as H.R. 1424 prior to enactment).
[14] *See* SEC press release 2008-242 and Release No. 33-8975.

interested parties.[15] A report of such study must be completed by January 2, 2009, and must contain the findings and determinations of the SEC, including such administrative and legislative recommendations as the SEC determines appropriate.

FASB Guidance

On October 10, 2008, the FASB adopted new guidance for how banks should value assets in a distressed market.[16] The FASB voted to provide some flexibility in applying fair value accounting where there is no market for a security. The new guidance, which is consistent with the joint statement issued by the SEC and the FASB on September 30, 3008, provides an example of how to determine fair value of a financial asset in a transaction that is a distressed sale or forced liquidation, in an otherwise inactive market. The guidance reiterates the notion that distressed sales or forced liquidations are not orderly transactions and therefore are not an accurate measure of fair value; yet, at the same time the FASB is clear that even in times of market dislocation, not all sales represent distressed sales or forced liquidations. Reporting entities must consider the facts and circumstances surrounding a particular transaction and use significant judgment when determining if a sale is an orderly transaction or not.

The new guidance is effective upon issuance and will apply to the next reporting period for which financial statements are issued, including prior periods for which financial statements have not been issued. It allows companies to use estimates of value, taking into account expected future cash flows and risk discount rates, when an active market for a security does not exist. The guidance replaces proposed FASB Staff Position relating to FAS 157 released on October 3, 2008.[17]

Recent actions by the SEC and the FASB suggest that FAS 157 is here to stay. However, further government action, such as buying back certain securities in an attempt to stabilize the financial markets, may change that. For now, rather than use the power the SEC was granted to suspend FAS 157, the organizations have continued to offer guidance in the changing market and provide clarification to reporting entities struggling to implement it. Until the SEC releases its report in January 2009, fair value measurements likely will remain a topic of discussion for those in the financial and accounting industries.

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[15] *Id.*
[16] *See* FASB Staff Position 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* (October 10, 2008).
[17] Proposed FASB Staff Position P FAS 157-d, October 3, 2008, *available at* http://www.fasb.org/fasb_staff_positions/prop_fsp_fas157-d.pdf.