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Wall Street in Crisis:
Fair Value & the Recent Market Turmoil

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The recent credit market turmoil, including the subprime meltdown and investigations into the failed auction rate securities (ARS) 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 ARS markets, have disappeared. Market participants 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 we discuss below, commentators have raised questions concerning the impact of FAS 157. This has resulted in new guidance from the U.S. Securities and Exchange Commission (the SEC) and the Financial Accounting Standards Board (the FASB), and the inclusion of provisions in the Emergency Economic Stabilization Act of 2008 requiring a review 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." 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]

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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 based on, or that 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. 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 or 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 about fair value. Fair value is defined 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 requiring or permitting 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 if the asset were sold or if the liability were transferred at the measurement date (the exit price);

2. a principal market, which is the market in which the reporting entity would sell the asset or transfer the liability that has the greatest volume and level of activity for the asset or liability; and

3. a market participant, which is defined as a buyer or seller in the principal market for the asset or liability that 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 that were early to implement FAS 157 were left to make estimates and assumptions about asset values where no market existed, other than a distressed market. In addition, an increasing number of distressed sales in an otherwise inactive market left questions as to whether a principal market existed for such assets. FAS 157 had an exception stating that distressed sales need not be used as an indicator of "fair value," but it was unclear how broadly that exception could be interpreted. Financial institutions that believed there was still value in their 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 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 an active market nonetheless existed.

How is Fair Value Determined?

Fair value is determined based on market prices, where available, and if not available, then based on a series of technical requirements. 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 an asset or liability. Where available, market participants use information based on market data obtained from independent sources. 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 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.

Level 1 Inputs

Level 1 inputs are unadjusted, quoted prices in active markets for identical assets or liabilities accessible by the reporting company on the measurement date. The market should trade at a sufficient frequency and volume to provide ongoing pricing information. 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 that quantity.

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 having 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 the appropriate value.

Level 2 Inputs

Level 2 inputs do not have observable market prices but have inputs based on them. Level 2 inputs can be obtained 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 2 inputs also can 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 or the condition of the asset or liability, the extent to which inputs relate to items comparable to the asset or liability, and the volume or level of activity in the market. Significant adjustments may result in a Level 2 measurement being reclassified as a Level 3 measurement.

Level 3 Inputs

When no observable inputs are available due to limited 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 these 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. 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 those used by the reporting entity if that information is reasonably available without undue cost and effort.

What Additional Factors must be Considered?

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 mounting 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 similar MBS. It has been suggested that, in many cases, the resulting balance sheet value attributed 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. The impact also spread to the ARS market. 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 auction, a failed auction results in the interest rate being set at a maximum, or penalty, rate. Many of the financial institutions facing significant write-downs 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, the MBS and ARS markets are inactive and many holders of these securities with immediate liquidity needs have been forced to turn to distressed sales.

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] At about this time, ARS holders 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." 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 auction market to value theses assets at par. With the auction market closed, ARS holders must now independently determine the fair value of these securities. This involves determining whether the ARS are suffering from other than temporary impairment. If it is probable that the holder 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 in excess of fair value. Regardless of whether an actual credit loss will be sustained, the severity of a decline in value 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 ARS holders, 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 Bankers Association (the ABA), have raised concerns that FAS 157 caused or exacerbated the current crisis by forcing a downward spiral of valuations. The fair value methodology has been criticized for producing inaccurate results in this aberrational market. Commentators note that it would be preferable for reporting entities to record only realized gains and losses. Congressional testimony raised concerns that financial institutions have been forced to book losses on securities that may have value after the credit market crisis has passed. The ABA stated that these accounting standards "never anticipated the wide variance and price disconnects that we are experiencing today."[9] Proponents of FAS 157 believe that even if the pronouncement has exacerbated the current 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. As a result of these discussions, financial institutions, accounting groups, and others requested guidance from the SEC and FASB for determining fair value in the current markets.

SEC and FASB Joint Statement

In a joint statement issued on September 30, the SEC and FASB provided guidance regarding fair value determinations during the current economic crisis.[10] Their guidance focuses on measuring fair value in inactive markets, accounting for the effect of disorderly transactions and determining whether losses are long-term (other than temporary impairments) or the result of temporary impairment. The statement sets forth factors to be considered in determining what constitutes an inactive 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. Instead, institutions may rely on internal cash flow and risk assumptions. 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 the decline in value, the period of time until anticipated recovery, the probability of recovery, and whether the holder has the ability to retain its investment until the anticipated recovery.

The International Accounting Standards Board (the IASB) issued a statement on Oct. 2, stating that this joint statement is in line with IAS 39, *Financial Instruments: Recognition and Measurement*, which is the international financial reporting standard on fair value accounting. The IASB also indicated that it would ensure any guidance on International Financial Reporting Standards concerning fair value is consistent with the SEC and FASB statement.[11] The next day, on Oct. 3, the IASB announced it will assess inconsistencies between IAS 39 and FAS 157. The IASB agreed to work closely with the FASB to develop an approach to valuation of financial assets and liabilities resulting from purchases made through government programs.[12] On Oct. 17, the IASB and FASB announced they will create a global advisory group that will help ensure that reporting issues arising from the global economic crisis are considered in an internationally coordinated manner.[13]

Emergency Economic Stabilization Act of 2008

Also on Oct. 3, President George W. Bush signed the Emergency Economic Stabilization Act of 2008 into law (the EESA).[14] Section 132 of Title I (known as the Troubled Assets Relief Program, or TARP) grants the SEC authority to suspend 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 in the public interest and consistent with investor protection. Section 133 requires 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.[15] The SEC has issued a request for comments and will hold public roundtables to obtain input from interested parties.[16] A report of such study must be completed by January 2, 2009.

FASB Guidance

One week later on Oct. 10, the FASB adopted new guidance for banks valuing assets in a distressed market.[17] The FASB voted to provide some flexibility in applying fair value accounting where there is no market for a security. The new guidance 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 not accurate measures 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 yet 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 Oct. 3.[18]

Response to Recent Guidance

On Oct. 13, the ABA responded to the FASB's recent guidance by sending a letter to the SEC requesting that, among other things, the SEC (1) override the final guidance and replace it with guidance that clarifies that fair value in an illiquid market does not include forced or distressed sales; (2) provide guidance on "other than temporary impairment;" and (3) suspend the proposal on accounting for securitizations until the results of the SEC study are finalized.[19] The ABA stated that their position was in line with the European Union's recently released declaration that the use of immediate market value for valuation purposes may no longer be appropriate due to illiquid markets.[20] The SEC, in turn, sent a letter to the FASB on Oct. 14, requesting that the FASB immediately address issues relating to perpetual preferred securities and the application of the other than temporary impairment model to such securities.[21]

Recent SEC and FASB actions suggest that FAS 157 is here to stay. However, further government action, such as buying back certain securities in order 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 to reporting entities struggling to implement the pronouncement. 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.

NOTES

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).
4. FASB Statement No. 157.
5. FASB Statement No. 157. *See also* FASB Staff Position FAS 157-1 (February 14, 2008).
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. FASB Statement No. 115.
9. *See* http://www.mercurynews.com/business/ci_10610548 (last viewed on October 10, 2008).
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. *See* 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. *See* 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. *Available at* http://www.fasb.org/news/nr101608_2.shtml (last viewed October 17, 2008).
14. *See* Public Law 110-343 (known as H.R. 1424 prior to enactment).
15. *See* SEC press release 2008-242 and Release No. 33-8975.
16. SEC press release 2008-242 and Release No. 33-8975.
17. 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).
18. 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.
19. *Available at* http://www.sec.gov/comments/4-573/4573-19.pdf (last viewed October 17, 2008).
20. *See* Declaration on a Concerted European Action Plan of the Euro Area Countries, October 15, 2008, *available at* http://www.eu2008.fr/PFUE/lang/en/accueil/PFUE-10_2008/PFUE-12.10.2008/sommet_pays_zone_euro_declaration_plan_action_concertee.
21. *Available at* http://www.financialexecutives.org/eweb/upload/FEI/SEC%20Letter%20to%20FASB%20on%20OTTI%20for%20PPS%2010%2014%2008.pdf (last viewed October 17, 2008).