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SEC Study Recommends Keeping Mark-to-Market Accounting

Background

On December 30, 2008, the Securities and Exchange Commission (the “SEC”) issued its study¹ on fair value accounting.² The study recommends that existing fair value accounting and mark-to-market standards, including Financial Accounting Statement 157 (“FAS 157”), should not be suspended. The report recommends improvements to existing accounting practices, including reconsidering the accounting for impairments and the development of additional guidance for determining fair value of investments in inactive markets, including situations where market prices are not readily available.

FAS 157 provides a uniform definition across accounting principles and a common framework for the application of fair value, as well as requiring additional disclosures relating to fair value measurements. 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.” As the subprime mortgage crisis grew into an international financial crisis, preparers and auditors of financial statements became concerned with the impact of the application of FAS 157. Some asserted that fair value accounting, along with the accompanying guidance on measuring fair value under FAS 157, contributed to instability in the financial markets by requiring potentially inappropriate write-downs in the value of investments held by financial institutions, most notably due to concerns that such write-downs were the result solely of market prices established in inactive, illiquid, or irrational markets creating values that did not reflect the underlying economics, or ongoing cash flows, of the securities. Others, particularly investors, argued that fair value accounting served to enhance the transparency of financial information and was vital in times of stress, suggesting that suspending FAS 157 would weaken investor confidence and result in further market instability. For a more detailed discussion on FAS 157 and its impact on the financial crisis, see our client alert [“Fair Value Accounting and the Recent Market Turmoil”](#).

As mandated by the Emergency Economic Stabilization Act, the report addresses the following six key issues:

- The effects of such accounting standards on a financial institution’s balance sheet;
- The impact of such accounting on bank failures in 2008;
- The impact of such standards on the quality of financial information available to investors;
- The process used by the Financial Accounting Standards Board (the “FASB”) in developing accounting standards;

¹ The Emergency Economic Stabilization Act of 2008 directed the SEC, in consultation with the Board of Governors of the Federal Reserve System and the Secretary of the Treasury, to study mark-to-market accounting standards as provided by the FASB Statement of Financial Accounting Standards No. 157, Fair Value Measurements applicable to financial institutions, including depository institutions, and to submit a report to Congress with the findings and recommendations by January 2, 2009.

² The study is available on the SEC website at <http://www.sec.gov/news/studies/2008/marktomarket123008.pdf>.

- The advisability and feasibility of modifications to such standards; and
- Alternative accounting standards to those provided in FAS 157.

The study makes eight recommendations:

- FAS 157 should be improved, but not suspended;
- Existing fair value and mark-to market requirements should not be suspended;
- While the SEC does not recommend a suspension of existing fair value standards, additional measures should be taken to improve the application and practice related to existing fair value requirements (particularly as they relate to both Level 2 and Level 3 estimates);
- The accounting for financial asset impairments should be readdressed;
- Further guidance to foster the use of sound judgment should be implemented;
- Accounting standards should continue to be established to meet the needs of investors;
- Additional formal measures to address the operation of existing accounting standards in practice should be established; and
- The need to simplify the accounting for investments in financial assets should be addressed.

Observations and Recommendations

In connection with the study, the SEC hosted three public roundtables, reviewed over 100 public comment letters relating to FAS 157, researched public records, read academic reports relating to fair value accounting, and performed empirical analysis on a cross-section of financial institution balance sheets, income statements, call reports, thrift financial reports, and analyst reports. The main observations and recommendations are discussed below.

No Suspension of FAS 157, or Fair Value Accounting Generally

Based on the findings of its investigation, the SEC concluded that FAS 157 needs to be improved, not suspended. 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. The study notes that the suspension of FAS 157 would not eliminate fair value accounting; rather, it would remove measurement and disclosure guidance while reverting to inconsistent, and sometimes conflicting, guidance for measuring fair value. The report stated that this result would be especially problematic in the current financial markets where eroding investor confidence is of great concern.

The report also indicated that existing fair value and mark-to-market requirements should not be suspended. Because fair value and mark-to-market accounting has been in place for years, the SEC is concerned that removing it would further erode investor confidence. Investors believe that fair value accounting provides meaningful and transparent financial information, especially because over 90% of investments marked-to-market are valued based on observable data obtained in active markets. The report stated that unlike historical cost, a methodology that some commenters viewed as reliable but not relevant, many commenters viewed fair value measurements useful when evaluating the current financial health of a company.

Need for Additional Guidance from the FASB

Most of the recommendations made by the SEC were directed at improving fair value accounting for issuers, auditors and investors. The SEC has requested that the FASB develop additional measures to improve the

applications and practices related to existing fair value requirements, particularly as they relate to both Level 2 and Level 3 inputs. The FASB should develop additional guidance and other tools for determining fair value when relevant market information is not available in illiquid or inactive markets, including consideration of the need for guidance to assist companies and auditors in addressing: (1) how to determine when markets become inactive and whether a transaction or group of transactions is forced or distressed; (2) how the impact of a change in credit risk on the value of an asset or liability should be estimated; (3) when observable market information should be supplemented with and/or reliance placed on unobservable information in the form of management estimates; and (4) how to confirm that assumptions utilized are those that would be used by market participants and not just by a specific entity. The SEC acknowledged that the FASB has already provided some additional guidance in this area but still feels more guidance is needed, especially in the area of fair value measurements related to the valuation of liabilities.

In addition, the SEC suggested that the FASB simplify accounting standards and readdress accounting for financial asset impairments. Noting the increased complexity of financial instrument reporting, the SEC recommended that both the FASB and the International Accounting Standards Board work together to simplify the reporting of complex financial instruments. It even suggested the possibility of reporting all financial instruments at fair value, but not until current implementation obstacles are overcome. The report recommends improvements to current impairment accounting models, including: (1) reducing the number of models utilized for determining and reporting impairments; (2) considering whether the utility of information available to investors would be improved by providing additional information about whether current declines in value are consistent with management expectations of underlying credit quality or probable cash flow declines; and (3) reconsidering current restrictions on the ability to record increases in value when market prices recover, as is currently permitted under international financial reporting standards. The report noted that existing impairment guidelines are not consistent with reporting guidelines for impairment charges for other non-securitized investments, which results in investors receiving information that is not recognized, calculated, or reported on a comparable basis.³ The report also suggested that other comprehensive income or "OCI," where certain impairments are disclosed, could be given prominence by requiring its inclusion in the income statement.

The SEC concluded that additional accounting standards should be established to meet investor needs. There is a need for enhancement of existing disclosure and presentation requirements related to the effect of fair value in financial statements; and enhancement of educational efforts, including those to reinforce the need for management judgment in the determination of fair value estimates. By providing clear disclosure of inputs and judgments made when preparing fair value measurements, investors can more accurately evaluate the financial information provided by issuers. The FASB should assess whether the incorporation of credit risk in the measurement of liabilities provides useful information to investors, including whether sufficient transparency is provided in current practice. The FASB also should examine the impact of liquidity in the measurement of fair value, including whether additional application and/or disclosure guidance is warranted for illiquid markets. While commenters noted the impact of financial reporting standards on regulatory accounting, including regulatory capital, the SEC made clear that general purpose financial reporting should not be revised to meet other parties' needs if doing so would compromise investor needs.

Additional formal measures to address the operation of existing accounting standards also should be established to avoid unintended implementation issues. The FASB should take care to avoid unforeseen implementation issues when adopting new accounting rules by creating a post-adoption review process. In addition, input from a

³ On December 19, 2008, the FASB issued an exposure draft of FSP EITF 99-20-a, which would revise EITF Issue No. 99-20 to provide for the use of judgment in assessing whether an impairment loss is expected to be temporary. Specifically, the FASB exposed an amendment to eliminate the notion of "market participants" so the impairment requirements under EITF Issue No. 99-20 are more closely aligned with impairment requirements under FAS 115, and with international accounting standards. This exposure draft was issued with an accelerated due process so as to contemplate anticipated issuance of a final FSP on January 8, 2009, effective for reporting periods ending after December 15, 2008. Similar to commenters concerns about the application of FAS 157 in illiquid markets, the FASB noted the concerns that because EITF Issue No. 99-20 requires entities to use market participant assumptions regarding future cash flows without consideration of the probability that all cash flows will be collected, its application in a dislocated market automatically results in an OTTI any time the fair value is less than cost.

broad range of constituents after adoption of a new rule should be reviewed and considered in a timely manner, and investor information needs should be addressed promptly. The SEC's advisory committee on improvements to financial reporting ("CIFiR") released a report in August 2008 that, among other things, suggested the creation of a financial reporting forum ("FRF").⁴ The FRF would consist of key public and private participants from all user communities (preparer, auditor, investor, etc.) to meet regularly to discuss the current pressures on the financial reporting system and how constituents are meeting these challenges. The SEC agreed with CIFiR's findings and suggested that the FASB create the FRF to more quickly and effectively communicate feedback and coordinate action in a rapidly changing financial landscape.

SEC Guidance

Although the report primarily outlines recommendations for the FASB to consider, the SEC did assign a task to itself and the Public Company Accounting Oversight Board (the "PCAOB"). Recognizing that reasonable judgment in determining valuation is imperative to maintaining investor confidence in financial reporting and proper auditor oversight, the SEC will consider providing further guidance to foster the use of sound judgment in applying FAS 157 and urged the PCAOB to adopt a similar approach with respect to auditing judgments. As an objective-based accounting standard, FAS 157 relies on sound, reasonable judgment in its application for Level 2 and Level 3 assets or liabilities; yet it is often difficult for users of financial statements to determine what factors are used in management's judgment decisions in preparing its models. Less than 10% of financial assets in the study were measured using Level 3 inputs and, 76% of the assets were measured using Level 2 inputs. Although Level 2 inputs rely on some market data, both Levels require management judgment. The SEC acknowledged that CIFiR's recent report urged the SEC to release a statement of policy articulating how it evaluates reasonableness of accounting judgments, including factors it considers when making the evaluation, and the SEC intends to consider releasing such a statement.

Fair Value Accounting Not the Cause of Bank Failures

After reviewing financial statements, call reports, and thrift financial reports, the SEC concluded that fair value accounting does not appear to be the cause of bank and other financial institution failures. Across the sample of financial institutions studied, 70% of issuers reported no impact upon the adoption of FAS 157, and no issuer reported more than a 5% impact in its financial statements. Of total assets held by the issuers, 45% of assets were measured using fair value (an increase of 3% from 2006); however, only 25% of total assets were measured at fair value through the income statement. Although these fair value measurements did significantly affect reported income; growing probable credit losses, concerns about asset quality, and loss of investor and lender confidence appeared to have a greater impact on bank failures.

The decline in overall asset value of the cross-section of issuers studied relative to the related asset portfolios was not a large percentage for any industry. This suggests that the significant impact on equity was a result of the overall leveraged positions of the issuers. The SEC noted that net income was most severely impacted from loan losses, a historical cost concept, not fair value accounting. The substantial increase in impairment charges of approximately \$90 billion from 2006 compared to the first three quarters of 2008 reflected the deteriorating economic conditions which led to a reduction in asset values. Declines in asset values were directionally consistent with the losses on underlying loans and current economic conditions, which impacted the value of trading and available-for-sale securities. Similarly, the SEC noted that increased provisions for credit losses were the most significant reason for the decrease in regulatory capital for banks, not adjustments related to the implementation of FAS 157, or fair value accounting generally.

Conclusion

Finding no clear correlation between recent bank failures and FAS 157, or fair value accounting generally, the SEC concluded that the long-standing accounting measurement should remain in effect because investors believe fair

⁴ The CIFiR study is available on the SEC website at <http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf>.

value accounting is the most useful measurement when valuing a company and they appreciate its transparency. Citing already eroded investor confidence, the SEC concluded suspension or repeal of FAS 157, or fair value accounting generally, would create even greater investor concerns in an already unstable financial market. Instead, the FASB should work with other standard-setting organizations to improve guidance and application of FAS 157 to assist issuers in preparing financial information, auditors in reviewing and certifying such information, and, most importantly, investors in analyzing the financial information.

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