



Mark-to-Market Update: After Congressional Hearing, FASB Proposes New Fair Value Accounting Guidance

On March 17, 2009, the Financial Accounting Standards Board (the “FASB”) issued FSP FAS 157-e, *Determining Whether a Market is Not Active and a Transaction is Not Distressed*, revised guidance on mark-to-market accounting. The new guidance clarifies what constitutes an “inactive market” and a “distressed sale” under current fair value (or “mark-to-market”) accounting standards. The FASB also released FSP FAS 115-a, FAS 124-a, and EITF 99-20-b which revises other-than-temporary impairment (“OTTI”) accounting procedures, in an effort to address many of the concerns that have put mark-to-market accounting in the spotlight as a potential factor contributing to the current financial crisis. The FASB’s action followed a March 12, 2009 hearing of the House Financial Services Subcommittee on Capital Markets, Insurance and Government-Sponsored Entities (the “Committee”) on fair value accounting. Legislators at the hearing urged the FASB to act quickly, indicating that any failure to do so could result in Congressional intervention. The Committee held the hearing after the American Bankers Association (the “ABA”), the U.S. Chamber of Commerce, the Federal Home Loan Banks, and numerous industry groups requested that federal regulators urge the FASB to issue guidance expeditiously.

For additional information on mark-to-market accounting and the financial crisis, please see our Client Alerts and resources at [Financial Crisis Legal Updates and News](#).

Background

Fair value accounting has been the subject of public debate since early 2008 when concerns were raised that it was contributing to the financial crisis. Entities applying fair value accounting and recording the value of their assets based on current market prices have taken a series large write-downs, as prices have fallen and active markets, such as the mortgage-backed securities and auction rate securities markets, have disappeared. Market participants have noted that in some cases, the fair value of these assets, as determined under current accounting guidance, is less than the present value of expected cash flows. These events coincided with the application of Financial Accounting Statement 157, *Fair Value Measurements* (“FAS 157”) by reporting entities and the disparity between perceived value and “fair” or “market” value has called into question FAS 157. Determining whether a market is active and whether a transaction is distressed is critical to assigning an ultimate value to an asset because FAS 157 permits a reporting entity to use a price other than the most recent trading price if the transaction is a distressed sale. However, it has been unclear how broadly the distressed sale exception could be interpreted. As a result of the clamor, the Securities and Exchange Commission (the “SEC”) was mandated by the Emergency Economic Stabilization Act to study and issue a report on mark-to-market accounting. On December 30, 2008, the SEC issued its report¹ on fair value accounting, setting forth recommendations for the FASB to consider and implement. For a more detailed discussion of the SEC’s study, see our client alert “[SEC Study Recommends Keeping Mark-to-Market Accounting](#).”

¹ The study is available on the SEC website at <http://www.sec.gov/news/studies/2008/marktomarket123008.pdf>.

Recent Events

Following publication of the report, the FASB's Valuation Resource Group met, and on February 18, 2009, the FASB agreed to provide additional guidance under fair value standards for determining when a market may be considered "not active" and a transaction "not distressed" under FAS 157. Reporting entities believing that current market prices were indicative of distressed sales disagreed with their auditors who insisted that fair value determinations 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. Prior guidance in this area did not go far enough to comfort auditors.

Although the FASB proposed rulemaking in the second quarter of 2009, industry participants were dissatisfied with the proposed timeframe and sought more immediate remedies. The U.S. Chamber of Commerce asked the Treasury Department to implement the findings in the SEC's report, in conjunction with other efforts under the Troubled Asset Relief Program ("TARP"), citing that the efforts of the TARP program would be undermined by the valuation problems associated with "toxic assets."

On March 6, 2009, the ABA sent a letter to the SEC requesting the FASB issue fair value accounting guidance expeditiously and that the guidance also address issues relating to OTTI. Recent speeches by Federal Reserve Chairman Ben Bernanke and SEC Chairman Mary Schapiro, and recent recommendations issued by the Group of Thirty also called for additional fair value guidance, especially for valuing illiquid assets. On March 9, 2009, the ABA, the Federal Home Loan Banks, and 18 industry groups sent a letter to the Committee urging them to ask difficult questions about fair value accounting and to stimulate immediate action on the part of the FASB. In a March 12, 2009 statement² to the Committee, the ABA recommended that the following action take place:

- The definition of "fair value" be improved to replace current reference to "exit" price with reference to price "between a willing buyer and a willing seller in an arm's length transaction that is not a forced sale";
- OTTI accounting be based on an improved version of international standards set forth in International Accounting Standards 39, *Financial Instruments: Recognition and Measurement* ("IAS 39"), in which OTTI is based on economic loss, not market loss, and is reversed through earnings upon any recovery; and
- Abandonment of efforts underway to expand fair value accounting until a proper review could be performed.

After hearing testimony from industry participants, lawmakers and regulators, Committee members warned that Congress would take action to improve guidance under FAS 157 if the SEC and FASB did not act quickly to improve standards. FASB Chairman Robert Herz agreed to issue additional guidance within three weeks.

FASB Proposals

On March 17, 2009, the FASB issued proposed FSP FAS 157-e (the "Fair Value Proposal"). The Fair Value Proposal provides additional guidance to reporting entities assessing whether a market is not active and whether a transaction is not distressed under FAS 157. The FASB also proposed FSP FAS 115-a, FAS 124-a, and EITF 99-20-b (the "OTTI Proposal," and together with the Fair Value Proposal, the "Proposals") to provide greater clarity regarding the credit and non-credit components of OTTI and to more effectively communicate when an OTTI event has occurred. For a more detailed discussion on FAS 157 and its impact on the financial crisis, including its impact on OTTI, see our client alert "[Fair Value Accounting and the Recent Market Turmoil](#)."

² The statement is available on the ABA website available at <http://www.aba.com/aba/documents/press/FairValueStatementfortheRecordMarch12.pdf>.

FAS 157 Guidance

The Fair Value Proposal does not change existing accounting rules; rather it emphasizes the flexibility that currently exists for determining the fair value of assets in illiquid markets. FASB Chairman Herz stated that he hopes the additional guidance will give comfort to auditors who are reluctant to stray from last trade prices due to liability issues. To achieve this, the Fair Value Proposal switches the focus from prior guidance by creating the presumption that transactions in inactive markets are distressed.

The guidance provides a two-step approach for determining whether a market is not active and a transaction is not distressed. In step one, the reporting entity determines whether there are factors present indicating that the market for the asset is not active at the measurement date. Factors include:

- Few recent transactions (based on volume and level of activity in the market);
- Price quotations not based on current information;
- Price quotations that vary substantially, either over time or among market makers;
- Indices that previously were highly correlated with the fair values of the assets are demonstrably uncorrelated with recent fair values;
- Abnormal (or significant increases in) liquidity risk premiums or implied yields for quoted prices when compared to reasonable estimates of credit and other nonperformance risk for the asset class;
- Abnormally wide bid-ask spread or significant widening of the bid-ask spread; and
- Little publicly released information.

If, after evaluating all the factors and considering the significance and relevance of each, the evidence indicates that the market is not active, the reporting entity proceeds to step two. In step two, the reporting entity evaluates the quoted price to determine whether the quoted price is associated with a distressed transaction. The presumption is that the quoted price is associated with a distressed transaction unless the reporting entity has evidence that indicates that both of the following factors are present for a given quoted price:

- There was sufficient time prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets; and
- There were multiple bidders for the asset.

If both factors are present, then the quoted price is presumed not to be associated with a distressed transaction and is deemed a relevant observable input to be considered in estimating fair value. However, the reporting entity should consider whether any other factors or conditions warrant making an adjustment to the quoted price. For example, if a quoted price that is not associated with a distressed transaction is not current or is a consequence of a trade with insignificant volume relative to the total market for that asset, the reporting entity should consider whether that quoted price is a relevant observable input.

If the reporting entity lacks evidence that both of the step two factors are present for a given quoted price (including because there is insufficient information on which to base a conclusion), then the reporting entity shall consider the quoted price to be associated with a distressed transaction and shall use a Level 3 measurement.³ For example, the reporting entity could use an income approach (that is, a present value technique) to estimate fair value. However, the fair value resulting from the present value technique or an alternate method shall not be derived solely from inputs based on the quoted price associated with a distressed transaction. The inputs should be reflective of an orderly transaction between market participants at the measurement date. An orderly

³ FAS 157 creates a hierarchy of measurements to use when determining fair value. Level 3 measurements are estimates or modeled valuations that are used to determine value 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.

transaction would reflect all risks inherent in the asset, including a reasonable profit margin for bearing uncertainty that would be considered by willing buyers and willing sellers in pricing the asset in a non-distressed transaction at the measurement date.

Changes in fair value resulting from the application of the Fair Value Proposal will apply prospectively with the effective date being interim and annual periods ending after March 15, 2009. A 15-day public comment period will end April 1, 2009, so that the FASB can finalize the Fair Value Proposal at its April 2, 2009 board meeting.

OTTI Guidance

The FASB also voted to revise OTTI accounting. An OTTI event occurs if it is probable that a reporting entity will be unable to collect all amounts due or obtain par value on a sale of an asset or liability, regardless of whether any actual credit loss has been sustained. Currently, a reporting entity is required to assess whether it has the intent and ability to hold a security to recovery of its cost basis in determining whether an impairment of that security is other than temporary. If an impairment is other than temporary, both credit losses and market losses would be recognized in earnings as an OTTI. The OTTI Proposal eliminates the requirement that the reporting entity assess its intent and ability to hold a security to recovery of its cost basis and create a new category in other comprehensive income for non-credit losses as follows:

- If the entity intends to sell the security or it is more likely than not that it will be required to sell the security before recovering its cost basis, the entire impairment loss would be recognized in earnings as an OTTI; but
- If the entity doesn't intend to sell the security and it isn't likely that the entity will be required to sell the security before recovering its cost basis, only the portion of the impairment loss representing credit losses would be recognized in earnings as an OTTI. The balance of the impairment loss would be recognized as a charge to other comprehensive income.

For securities within the scope of FAS 115, *Accounting for Certain Investments in Debt and Equity*, and FAS 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, a reporting entity would determine the impairment charge representing credit losses by using its best estimate of the impairment amount arising from an increase in the credit risk associated with the specific instrument. For a debt security within the scope of EITF 99-20, *Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets*, a reporting entity would estimate the amount of the total impairments charge representing the credit losses in accordance with EITF 99-20.

Subsequent changes in the fair value of an available-for-sale security for which a portion of the OTTI loss was recognized in other comprehensive income would be reflected in other comprehensive income as unrealized gains or losses. However, if there is an indication of additional credit losses, the reporting entity intends to sell the security, or the reporting entity can no longer assert that it is more likely than not that it will not be required to sell the security prior to recovery, subsequent change in the fair value would be recognized in earnings.

This approach creates a new category within other comprehensive income for the portion of the OTTI that is not related to credit losses for held-to-maturity securities. The impairment recognized in other comprehensive income would be amortized over the remaining life of the security in a prospective manner based on the amount and timing of future estimated cash flows unless there is an indication of additional credit losses. That amortization would be recognized in other comprehensive income with an offset to the asset and would not affect earnings.

Changes resulting from the OTTI Proposal will be applied prospectively with the effective date being interim and annual periods ending after March 15, 2009. A 15-day public comment period will end April 1, 2009, so that the FASB can finalize the proposed FSP at its April 2, 2009 board meeting.

Far Enough?

Although the Proposals were just released, skeptics and critics are already questioning whether the guidance goes far enough. Some question whether the guidance is strong enough to provide sufficient comfort to auditors that it is acceptable to value assets without relying on last trade data.⁴ The ABA noted that the Proposals did not go far enough, and it failed to include all of the requests in its March 12, 2009 letter to the Committee.

Although the guidance addresses OTTI accounting, the FASB did not change the standard to permit economic losses to be reversed through earnings. Under the parallel international standard, IAS 39, such reversal is permitted. Although losses can now be treated as credit losses or market losses, market losses are still booked against other comprehensive income. Therefore, reporting entity capital will still be depleted.

Although the comment period remains open through April 1, 2009, we continue to expect incremental changes. And, as with prior guidance issued by the FASB, only time will tell if it will have a positive impact on reporting entity balance sheets.

Contacts

Amy Moorhus Baumgardner
(202) 887-1532
abaumgardner@mofo.com

Melissa D. Beck
(212) 336-4319
mbeck@mofo.com

Anna T. Pinedo
(212) 468-8179
apinedo@mofo.com

About Morrison & Foerster

With more than 1000 lawyers in 17 offices around the world, Morrison & Foerster offers clients comprehensive, global legal services in business and litigation. The firm is distinguished by its unsurpassed expertise in finance, life sciences, and technology, its legendary litigation skills, and an unrivaled reach across the Pacific Rim, particularly in Japan and China. For more information, visit www.mofo.com.

© 2009 Morrison & Foerster LLP. All rights reserved.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

⁴ Steven Sloan and Cheyenne Hopkins, *FASB Bows: Fair Value to Get Overhaul*, American Banker (Mar. 17, 2009).