



Mark-to-Market Update: FASB Issues New Fair Value Accounting Guidance

On April 9, 2009, the Financial Accounting Standards Board (“FASB”) issued guidance further clarifying the FASB’s position on determining fair value in the absence of normal market activity and revising procedures for other-than-temporary impairments in value.¹ As discussed below, the final guidance reflects modifications from the March 17, 2009 proposals.²

The FASB has undertaken significant efforts to respond to industry and Congressional concerns that the fair value accounting standards failed to provide sufficient guidance during periods of extreme market disruption, as has been experienced during the current financial crisis. Despite numerous requests, however, the new guidance will not be available for reporting periods ending before March 15, 2009.

Please see our recent report [Mark-to-Market Update: After Congressional Hearing, FASB Proposes New Fair Value Accounting Guidance](#) and additional coverage of the financial crisis and mark-to-market accounting at [Financial Crisis Legal Updates and News](#).

Overview

The new FASB guidance includes:

- FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, clarifying how to determine fair value when the volume and level of activity for the asset or liability have significantly decreased when compared with normal market activity for the asset or liability, or similar assets or liabilities (“Fair Value Guidance”); and
- FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, revising other-than-temporary impairment (“OTTI”) accounting procedures, in an effort to address the different factors impacting the market value of certain securities, and the way those values are recorded (the “OTTI Guidance,” and together with the “Fair Value Guidance,” the “Guidance”).

The Guidance will be effective for interim and annual reporting periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. If a reporting entity chooses early adoption, the reporting entity must early adopt both the Fair Value Guidance and OTTI Guidance. The Fair Value Guidance must be applied prospectively, while the OTTI Guidance can be applied to existing and new investments held by a reporting entity as of the beginning of the interim period in which the OTTI Guidance is adopted.

¹ FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, and FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (April 9, 2009).

² FSP FAS 157-e, *Determining Whether a Market is Not Active and a Transaction is Not Distressed* (March 17, 2009).

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 of large write-downs, as prices have fallen and active markets for certain securities, such as the mortgage-backed securities and auction rate securities markets, have disappeared. These events coincided with the application of Financial Accounting Statement 157, *Fair Value Measurements* (“FAS 157”), by reporting entities. Financial institutions have noted a disparity between economic value of their assets and liabilities and the “fair” or “market” value, as the latter is determined under FAS 157. FAS 157’s reliance on recent trading prices to determine fair value has called into question the appropriateness of the standard for preparing financial statements that accurately reflect a reporting entity’s current position.

Although FAS 157 permits a reporting entity to use a price other than the most recent trading price if the transaction is a distressed sale, it has been unclear how broadly the distressed sale exception could be interpreted. As a result of the heated debate over FAS 157, the Emergency Economic Stabilization Act mandated a Securities and Exchange Commission (SEC) study on mark-to-market accounting. On December 30, 2008, the SEC issued its report,³ setting forth recommendations for the FASB to consider and implement.

On March 12, 2009, the House Financial Services Subcommittee on Capital Markets, Insurance and Government-Sponsored Entities held a hearing 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. On March 17, 2009, the FASB released proposed guidance addressing two of the SEC’s recommendations: (1) additional guidance for determining whether a transaction is disorderly and whether a market is inactive;⁴ and (2) additional guidance for determining if an asset is other-than-temporarily impaired, and how to book such an impairment.⁵ The Guidance modifies and finalizes FASB’s March proposed releases.

FAS 157 Guidance

The Fair Value Guidance does not change existing fair value accounting rules; rather, it emphasizes the flexibility that currently exists for determining the fair value of assets in illiquid markets. Unlike the proposed release’s creation of a presumption⁶ that transactions occurring in inactive markets are distressed, the Fair Value Guidance does not create such a presumption. Instead, the Fair Value Guidance requires a reporting entity to determine whether market prices reflect an orderly transaction (that is, not a forced liquidation or distressed sale), based on the weight of the evidence available for review. Absent an orderly transaction that reflects the price that would be reached between a willing buyer and seller, the reporting entity is not required to use the market price to set fair value.

The Fair Value Guidance provides a two-step approach for determining whether the volume and level of activity for the asset or liability have significantly decreased when compared with normal market activity for the asset or liability. In step one the reporting entity determines whether there are factors present indicating that the market for the asset has decreased at the measurement date. The factors are meant to distinguish those transactions that normally take place in markets where trade volume is consistent from those transactions that take place in markets where trading is less frequent. Factors include:

- Few recent transactions (based on volume and level of activity in the market);

³ The study is available on the SEC website at <http://www.sec.gov/news/studies/2008/marktomarket123008.pdf>. In addition, please see our Client Alert [SEC Study Recommends Keeping Mark-to-Market Accounting](#).

⁴ FSP FAS 157-e, *Determining Whether a Market is Not Active and a Transaction is Not Distressed* March 17, 2009).

⁵ FSP FAS 115-a, FAS 124-a, and EITF 99-20-b (March 17, 2009).

⁶ FSP FAS 157-e, *Determining Whether a Market is Not Active and a Transaction is Not Distressed* included a presumption that transactions occurred in a disorderly market. Based on comments received, the FASB Board revised this language to require a ‘weight of the evidence’ approach for the final release, FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*.

- 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;
- Significant decline or absence of a market for new issuances (a primary market) for the asset or liability or similar assets or liabilities; and
- Little publicly released information.

If, after evaluating the significance and relevance of the factors and the weight of the available evidence, the reporting entity determines that there has been a significant decrease in the volume and level of activity for the asset or liability, the reporting entity proceeds to step two. As noted above, under the March FASB proposal a quoted price from an inactive market, determined under step one, was presumed to be associated with a distressed transaction. Under the Fair Value Guidance, reporting entities weigh all available evidence to determine whether a transaction is orderly or not. As a result, determining that there has been a significant decrease in volume and activity under step one, will not result in a presumption that a transaction is not orderly. In step two, to determine whether the quoted price is associated with other than an orderly transaction, the reporting entity will consider whether:

- There was sufficient time prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets;
- There was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant;
- The seller is in or near bankruptcy or receivership (that is, distressed), or the seller was required to sell to meet regulatory or legal requirements (that is, forced); and
- The transaction price is an outlier when compared with other recent transactions for the same or similar asset or liability.

Reporting entities must consider the following when preparing asset valuations when there has been a significant decrease in the volume and level of activity for the asset:

- If the weight of the evidence indicates the transaction is not orderly, a reporting entity shall place little, if any, weight (compared with other indications of fair value) on that transaction price when estimating fair value or market risk premiums.
- If the weight of the evidence indicates the transaction is orderly, a reporting entity shall consider that transaction price when estimating fair value or market risk premiums. The weight placed on that transaction price when compared with other indications of fair value will depend on the facts and circumstances.
- If a reporting entity does not have sufficient information to conclude that the transaction is orderly or that the transaction is not orderly, the reporting entity shall consider the transaction price when estimating fair value or market risk premiums. However, the transaction price may not be determinative of fair value (that is, that transaction price may not be the sole or primary basis for estimating fair value or market risk premiums). A reporting entity shall place less weight on transactions on which a reporting entity does not have sufficient information to conclude whether the transaction is orderly when compared with other transactions that are known to be orderly.

In its determinations, a reporting entity cannot ignore information that is available without undue cost and effort. A reporting entity would be expected to have sufficient information to conclude whether a transaction is orderly when the reporting entity is party to the transaction.

If the reporting entity is required to use a Level 3 measurement to determine fair value,⁷ the result from the valuation method should not be derived solely from inputs based on the quoted price associated with a disorderly transaction; instead, the inputs should be reflective of an orderly transaction between market participants at the measurement date. The nature of a price quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighting the available evidence; a reporting entity should place less weight on quotes that do not reflect the result of transactions, such as indicative bids, than those that do. Valuation models based on an orderly transaction should 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 an orderly transaction at the measurement date. Reporting entities must disclose any changes in valuation techniques used (and the related inputs) due to the application of the Fair Value Guidance and to quantify its effects, if practicable.

OTTI Guidance

The FASB also voted to revise OTTI accounting. Application of the OTTI Guidance is limited to debt securities. 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. Prior to the OTTI Guidance, a reporting entity was required to assess whether it had the intent and ability to hold a security to recovery of the security's cost basis in determining whether an impairment of that security is other than temporary. If an impairment were other than temporary, both credit losses and market losses would be recognized in earnings as an OTTI.

The OTTI Guidance eliminates the requirement that the reporting entity assert its intent and ability to hold a debt security to recovery and creates a new category in other comprehensive income for non-credit losses as follows:

- If the entity doesn't intend to sell the debt security and it isn't likely that the entity will be required to sell such security before recovering such security's 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.

There are numerous factors consider when estimating whether a credit loss exists and the period over which the debt security is expected to recover including, but not limited to:

- The length of time, and the extent to which, the fair value has been less than the amortized cost basis;
- Adverse conditions specifically related to the security, an industry, or a geographic area;
- The historical and implied volatility of the fair value of the security;
- The payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future;
- Failure of the issuer of the security to make scheduled interest or principal payments;
- Any changes to the rating of the security by a rating agency; and
- Recoveries or additional declines in fair value subsequent to the balance sheet date.

⁷ FAS 157 creates a hierarchy of measurements to use when determining fair value. Level 3 measurements are estimates or modeled valuations 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.

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 determines 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 estimates the amount of the total impairments charge representing the credit losses in accordance with EITF 99-20.

Unless the security is subsequently sold or there are additional credit losses, subsequent non-credit losses for a held-to-maturity debt security will be recognized in other comprehensive income and amortized over the remaining life of the debt security. The amortization would be recognized in other comprehensive income with an offset to the asset and would not affect earnings.

Subsequent credit losses should be measured on the basis of a reporting entity's estimate of the decrease in expected cash flows. A reporting entity must consider all available information relevant to the collectibility of the security, including information about past events, current conditions, and reasonable and supportable forecasts, when developing the estimate of expected cash flows. A reporting entity should review industry analyst reports and forecasts, sector credit ratings, and other market data for information such as:

- remaining payment terms of the security;
- prepayment speeds;
- the financial condition of the issuer(s);
- expected defaults;
- credit enhancement effects on the performance of the security; and
- the value of any underlying collateral.

A reporting entity will be required to present (where the components of other comprehensive income are reported) amounts recognized in accumulated other comprehensive income related to the non-credit portion of OTTI recognized for available-for-sale and held-to-maturity debt securities. Reporting entities will be required to disclose the cost basis of available-for-sale and held-to-maturity debt securities by major security type, the methodology and key inputs used to measure the portion of an OTTI related to credit losses by major security type, and a rollforward of amounts recognized in earnings for debt securities for which an OTTI has been recognized and the non-credit portion of OTTI that has been recognized in other comprehensive income.

If OTTI was previously recognized for a debt security, the reporting entity does not intend to sell and it is not more likely than not that the reporting entity will be required to sell the security before recovery of the security's amortized cost basis, the reporting entity shall recognize the cumulative effect of initially applying the OTTI Guidance as an adjustment to the opening balance of retained earnings with a corresponding adjustment to accumulated other comprehensive income.

Impact and Reaction

Although just released, some market participants are unsure whether the Guidance goes far enough to address valuation concerns. Some believe the Guidance still does not clearly explain proper asset valuation methods and without more comprehensive guidance, disagreements between reporting entities and their auditors over valuation methods will continue.⁸

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, reversal is permitted.

⁸ Steven Sloan and Cheyenne Hopkins, *FASB Bows: Fair Value to Get Overhaul*, American Banker (Mar. 17, 2009).

Also, the American Bankers Association (“ABA”) had recommended that OTTI be based only on credit losses for securities held-to-maturity, but the FASB declined to make that change in the Guidance. 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. Even though the OTTI Guidance can be applied, and an adjustment made, to assets and liabilities held as of the implementation date, it can only be for debt classified as held-to-maturity. The ABA has expressed its concern that the Guidance may have limited impact on the financial condition of reporting entities that are financial institutions - many of which already have taken write-downs.

Many also had hoped that the Guidance would be retroactively applied so that reporting entities could take advantage of the changes for year-end reporting.

Additionally, market participants are closely watching the potential impact of the Guidance on the ultimate success of the recently announced government-sponsored Private-Public Investment Program (“PPIP”).⁹ The Guidance may encourage reporting entities to hold assets with market losses, but not credit losses, until maturity rather than sell them to the PPIP and face additional write-downs.

The FASB continues to face political pressure to make reforms; on April 2, the same day that the FASB voted to issue the Guidance, Representative Steve Cohen introduced a bill¹⁰ that directs the SEC to suspend the application of fair value accounting for any financial report required to be filed with the SEC after January 1, 2008. While the bill and similar efforts are unlikely to move forward, particularly given FASB’s release of additional guidance, critics continue to call for the suspension of FAS 157.

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.

⁹ On March 23, 2009, the Treasury Department and the FDIC announced the formation of government sponsored public-private investment partnerships that will allow private investors to purchase up to \$1 trillion (or more) of “toxic” loans and asset-backed securities from qualified banks with the Treasury matching investments dollar-for-dollar in joint ventures with hedge funds, private equity funds, insurance funds, and other investors to acquire the loans and securities to be sold.

¹⁰ See H.R. 1909 (2009) available at <http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.1909.IH.>