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REPORT

Impact of Recent Events on Mark-to-Market Accounting

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Fair value, or ''mark-to-market,'' accounting has been a focal point of efforts to identify the causes of and factors contributing to the ongoing financial crisis. Following widespread implementation of Statement of Financial Accounting Standard 157 (FAS 157) at the beginning of 2008, entities noted that financial statements reflected write-downs in asset values based on illiquid and distressed market prices. These ''values,'' determined under FAS 157, failed to reflect the economic value of the assets as evidenced in many cases by current cash flows and continued confidence in asset credit quality. In many cases, the liquidity discount imbedded in market prices was inconsistent with management's views on the value of balance sheet assets.

Several months of media attention on FAS 157 spurred congressional action, first in the fall of 2008, and more recently in March of this year. Recent actions by the Financial Accounting Standards Board (FASB) are still being interpreted, as discussed below. The global nature of the financial crisis, and ongoing efforts to converge international accounting standards, have raised comparisons between FASB guidance and International Accounting Standards that bear review as well.

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FAS 157

FAS 157 establishes guidelines for the consistent reporting and disclosure of the fair value of assets and liabilities covered by the guidance, combining, clarifying and expanding upon years of pre-existing fair value accounting standards. Fair value is defined by FAS 157 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.'' Fair value is derived using a hierarchy of valuation sources. The highest priority, level one, directs preparers of financial statements to ''quoted prices in active markets'' as the source of fair value. The lower priorities in the hierarchy permit less objective inputs, such as management models, to be factored into the fair value determination.

The efforts address the concern "that auditors are requiring rigid adherence to quoted market price without considering the disappearance . . . of an active market"

Critics have alleged that auditors are requiring fair value determination based on quoted prices, even where active or orderly markets are absent. FASB has responded with the following:

- On September 30, 2009, the Securities and Exchange Commission (SEC) Office of the Chief Accountant and staff of FASB issued ''Clarifications on Fair Value Accounting,'' a question and answer release analyzing the impact of inactive markets and distressed transaction prices (4 APPR 856, 10/3/08).
- On October 10, 2008, FASB released FASB Staff Position No. FAS 157-3, ''Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active'' (FSP FAS 157-3), describing how to determine when a market is not active and providing a detailed hypothetical example of a fair value determination upon the loss of a previously active market (4 APPR 900, 10/17/08).
- On April 9, 2009, FASB released FASB Staff Position No. 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'' (FSP FAS 157-4), providing more detailed analysis tools for determining when a market is no longer active and when a transaction is not orderly (5 APPR 349, 4/17/09).
- On May 1, 2009, FASB released Proposed FASB Staff Position No. FAS 157-f, ''Measuring Liabilities under FASB Statement No. 157'', addressing fair value determination for liabilities which are rarely traded in the marketplace, but may, under certain circumstances, trade in the marketplace for assets (5 APPR 438, 5/15/09).

Rather than modify FAS 157, each of these efforts addresses the concern that auditors are requiring rigid adherence to quoted market price without considering the disappearance or absence of an active market or the lack of available orderly transactions.

The factors outlined to assess whether a market is active and whether a transaction is orderly provide additional guidance, but may also impose a roadmap for the documentation necessary to move from a level one measurement to using level two or level three in the hierarchy. Preparers of financial statements will evaluate carefully the procedures and documentation for monitoring markets and transactions prior to and at the time of measurement to demonstrate the relevant inputs for fair value determination.

Related OTTI Efforts

Concerns have similarly been raised with the guidance for determining and reporting other than temporary impairments (OTTI) in fair value. OTTI guidance has previously required an OTTI be recognized in earnings. Concerns have been raised that a significant portion of OTTI, the amount by which amortized cost exceeds current fair value, reflects price declines due to illiquid markets rather than current or anticipated credit losses. In response to these concerns, FASB has recently updated OTTI guidance for debt securities as follows:

- On April 9, 2009, the FASB released FASB Staff Position (FSP) FAS 115-2 and FSP FAS 124-2, ''Recognition and Presentation of Other-Than-Temporary Impairments'' (5 APPR 349, 4/17/09),[1] modifying the circumstances under which an entity must take an OTTI and separating the reporting of credit losses from non-credit losses (*e.g.*, decreased value due to liquidity discounts).

Prior to the updated OTTI guidance, in order to avoid recognizing an OTTI, the reporting entity was required to assert that it has both the intent and ability to hold the security for a period of time sufficient to allow for an anticipated recovery of the amortized cost basis. Under the updated guidance, the determination is based on whether not the entity has a present intent to sell the security, or whether it is more likely than not going to be required to sell the security prior to its anticipated recovery of the cost basis. If there is a present intent to sell or the entity is more likely than not going to be required to sell the security prior to recovery of the amortized cost basis, and the cost basis exceeds fair value, the entity must take an OTTI.

Prior to the updated OTTI guidance, both credit losses and market losses related to the impairment in value would be recognized in earnings. Under the updated guidance, 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.

The amortized cost basis is reduced by the amount of OTTI recognized in earnings, but not the OTTI charged to other comprehensive income.

Many had hoped that the OTTI standards would be revised to permit recovery of previously written-down assets to be reversed through earnings. FASB, however, declined to effect this change.

PCAOB Audit Practice Alert

Following the April 2009 FASB release, on April 21, 2009, the Public Company Accounting Oversight Board (PCAOB) issued a Staff Audit Practice Alert to inform auditors about implications of FSP FAS 157-4 and FSP FAS 115-2 and FAS 124-2 (5 APPR 405, 5/1/09).[2] The alert highlights for auditors their responsibilities in light of the updated standards, addressing reviews of interim and annual financial statements, review of related disclosure and reporting obligations to audit committees. Reporting entities should be aware of the approach and focus of their auditors as they evaluate potential process or policy changes as a result of the FASB releases.

Any resulting changes in a significant accounting policy affecting interim financial information, changes in accounting estimates and management's judgments about such estimates, changes in the processes used by management to formulate sensitive accounting estimates and the auditor's judgment about the quality of

[1] See also FASB Staff Position EITF 99-20-1, Amendments to the Impairment Guidance of EITF Issue No. 99-20, more closely aligning the impairments in EITF 99-20 with the accounting in FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities. See ¶ 5, FSP FAS 115-2 and FAS 124-2 available at http://72.3.243.42/pdf/fsp_fas115-2andfas124-2.pdf.

[2] The PCAOB Staff Audit Practice Alert also discusses FASB Staff Position No. FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments, also released by FASB on April 9, 2009.

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the company's accounting policies are required to be reported by the auditors to the reporting entity's audit committee.

Reporting entities will also be providing auditors, in addition with the information necessary to calculation OTTI, the documentation supporting the allocation of OTTI between credit losses and non-credit losses. Sufficient time to meet with auditors and prepare audit committees must be reserved to implement the updated FASB guidance.

International Standards

Since 2005, European-based corporate and financial institutions have been obliged to prepare their accounts in accordance with International Financial Reporting Standards (IFRS).

Under IFRS, a financial asset must, at the time of its acquisition, be classified into one of the following four categories:

- financial assets at fair value through profit or loss (this includes financial assets held for trading, as well as other financial assets designated as to be measured at fair value);
- available-for-sale;
- loans and receivables; or
- held-to-maturity.

Under International Accounting Standard 39 (IAS 39) the first two categories above must be valued at fair value.

Since 2007, after it became clear that the market had become illiquid for many financial assets, European financial institutions in particular started clamoring to be allowed to reclassify certain of their financial assets. Unlike under U.S. GAAP, reclassification of a financial instrument out of its initial category and into another was originally not permitted under IFRS. However, in order to achieve closer convergence with U.S. GAAP, in October 2008 the International Accounting Standards Board (IASB) published a revision to IFRS permitting reclassification in the same circumstances as are applicable under U.S. rules, subject to requiring new disclosures in respect of any assets so reclassified (4 APPR 901, 10/17/08).

These changes met with a great deal of controversy in Europe in the investor community, due to concerns that they have the effect of decreasing transparency in relation to the value of financial assets. Certainly the balance sheets of many European financial institutions have benefited greatly from this relaxation by IASB, but there are still large volumes of assets held by financial institutions that do not fall into the Loans and Receivables category, nor into the Held-to-maturity category, if the institution still has the intention of selling the asset prior to maturity. Therefore the problems of marking-to-market financial assets in an illiquid market still remain.

The primary principles of IAS 39 in determining fair value are as follows:

- In an active market, quoted market prices are the best evidence of fair market value and should be used where available.
- In an illiquid or inactive market, fair value should be determined by a technique that involves (i) making use of available market inputs, including recent arm's-length market transactions, (ii) referring to the fair value of other substantially similar instruments, and (iii) using discounted cash flow analysis and option pricing models.
- In an inactive market, where the range of reasonable fair values is very broad and there is concern as to the reliability of the estimates of fair value, then the instrument should be valued at cost less impairment.

Following the SEC and FASB's Sept. 30, 2008, release (described above), in response to the continued distressed state of the markets, in October 2008 IASB published a series of press releases stating that it regarded the September 30 press release and FAS 157 to be consistent with IAS 39.

Later the same month, IASB published a report of its expert advisory panel entitled ''Measuring and disclosing the fair value of financial instruments in markets that are no longer active'' which clarified that the objective of fair value measurement in IAS 39 was to arrive at the price at which an orderly transaction would take place between market participants and that a distress sale is not an orderly transaction. However, the report also made clear that when a market becomes inactive it is not appropriate to conclude that all sales are distressed, and transaction prices that do not represent distressed transactions should not be ignored (4 APPR 905, 10/17/08).

In March 2009, IASB announced that it would work to try and achieve further convergence between the fair value measurement provisions of U.S. GAAP and IFRS, a process commenced in 2006 by IASB and FASB setting out a roadmap of convergence. Following increased political pressure emanating from the G-20 meeting in April, IASB published on May 28, 2009, an exposure draft (''May Exposure Draft'') of an IFRS fair value measurement guidance, inviting comments from interested parties before September 28, 2009 (5 APPR 488, 5/29/09).

The stated intentions of their fair value measurement project are:

- to establish a single source of guidance for all fair value measurements required or permitted by existing IFRSs to reduce complexity and improve consistency in their application;
- to clarify the definition of fair value and related guidance to communicate the measurement objective more clearly; and
- to enhance disclosures about fair value to enable users of financial statements to assess the extent to which fair value is used to measure assets and liabilities and to provide them with information about the inputs used to derive those fair values.

It remains unclear whether auditors and reporting entities will modify their practices in light of these pronoucements.

The principle proposals of the draft IFRS proposed in the exposure draft are as follows:

- 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 (an exit price).

- A fair value measurement is for a particular asset or liability. Therefore, the measurement shall consider the characteristics of the asset or liability (*e.g.*, the condition and location of the asset and restrictions, if any, on its sale or use) if market participants would consider those characteristics when determining the price for the asset or liability at the measurement date.
- A fair value measurement shall assume that the transaction to sell the asset or transfer the liability takes place in the most advantageous market to which the entity has access. The most advantageous market is the market that maximizes the amount that would be received to sell the asset or minimizes the amount that would be paid to transfer the liability, after considering transaction costs and transport costs.
- The fair value of the asset or liability shall be measured using the assumptions that market participants would use in pricing the asset or liability. In developing those assumptions, an entity need not identify specific market participants. Rather, the entity shall identify characteristics that distinguish market participants generally, considering factors specific to:
  - o the asset or liability,
  - o the most advantageous market for the asset or liability, and
  - o market participants with whom the reporting entity would enter into a transaction in that market.
- For assets and liabilities measured at fair value, an entity shall disclose information that enables users of its financial statements to assess the methods and inputs used to develop those measurements and, for fair value measurements using significant unobservable inputs, the effect of the measurements on profit or loss or other comprehensive income for the period.

IASB considers that the May Exposure Draft is consistent in principle with the revised FAS 157, and helpfully lists the remaining ways in which the IFRS will still differ from (and, it considers are an improvement on) the provisions of FAS 157. One notable difference that remains is that whereas FAS 157 assumes the transaction to sell the asset or transfer the liability takes place in the principal market (or in the absence of a principal market, the most advantageous market), the May Exposure Draft proposes that an entity should assume that the transaction takes place in the most advantageous market to which the entity has access.

One matter that was not addressed in the May Exposure Draft is the issue of classification of financial instruments under IFRS. IASB has indicated that it intends to publish a separate exposure draft on the classification and measurement of financial instruments by July 2009, with a definitive IFRS being issued for 2009 year-end financial statements, and there is an expectation in the market that this exposure draft should lead to further convergence of IFRS with U.S. GAAP in respect of classification and measurement.

Impact and Reaction

Intense scrutiny on mark-to-market accounting has raised questions regarding the role accounting standards played in causing or intensifying the impact of the financial crisis and the independence of accounting standard setting bodies. International political focus has presented unprecedented focus on the process for accounting standards. Anticipated waves of regulatory reform are likely to result in questions regarding the appropriate role, or lack thereof, of government in the process.

Recent interpretations by FASB clarify and expand on the already lengthy standard without making significant modifications. It remains unclear whether auditors and reporting entities will modify their practices in light of these pronouncements. Additionally, if global efforts to restart markets are even moderately successful, the impacts of any changes may be difficult to detect.

The debate over the impact of FAS 157 and global accounting standards on the financial crisis remains unresolved. A January 2009 SEC study, mandated by Congress in the Emergency Economic Stabilization Act of 2008, concluded that no banking institution failed as a result of FAS 157 and recommended that only modification to, rather than rescission of, the standard was required. Critics, however, contend that the strict reliance on prices from dislocated markets artificially depleted capital levels and confidence in institutions, at a minimum prolonging crisis or its impact on the economy.

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