

Client Alert

Financial Markets Developments

Recommendations for Companies Under New Mark-to-Market FAS 157 Accounting Developments in the Emergency Economic Stabilization Act of 2008 and in Recent Actions by the SEC and FASB

As a result of the current economic environment, new mark-to-market accounting standards have led to substantial mark-downs in the value of many securities, including mortgage-backed securities, due to the lack of a liquid market for such securities. This has been acknowledged by the Securities and Exchange Commission ("SEC") and the Financial Accounting Standards Board ("FASB"), which on September 30, 2008 released clarifications on the use of mark-to-market accounting in the current environment. In addition, the Emergency Economic Stabilization Act of 2008 ("EESA") that was signed into law on October 3, 2008 restates the SEC's authority to suspend the application of mark-to-market accounting under certain circumstances.

The Emergency Economic Stabilization Act of 2008

EESA contains two sections that directly relate to mark-to-market accounting:

- First, EESA restates the SEC's authority to suspend the application of mark-to-market accounting standards in FASB's Statement No. 157 ("FAS 157") if the SEC determines that it is necessary or appropriate in the public interest and consistent with the protection of investors.
- Second, EESA requires the SEC, in consultation with the Board of Governors of the Federal Reserve System (the "Federal Reserve Board") and the Treasury Department, to conduct a study on mark-to-market accounting standards as provided in FAS 157 as such standards are applicable to financial institutions. The study must be completed before January 1, 2009, the date that is 90 days of the enactment of the law, and must cover, among other things, the effects of mark-to-market accounting on a financial institution's balance sheet, the impacts of such accounting on bank failures in 2008 and on the quality of financial information available to investors, as well as the advisability and feasibility of modifications to the mark-to-market accounting standards provided in FAS 157.

What is mark-to-market accounting?

Mark-to-market accounting is a method used to measure the fair value of an asset or liability by using the price that would be received to sell an asset or paid to transfer a liability (the exit price, as opposed to the entry price) in an orderly transaction involving the same or a similar asset or liability between market participants. This method of fair value measurement is set forth in FAS 157, which defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles and expands required disclosures about fair value measurements. FAS 157 states that the determination of fair value often requires significant



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judgment and should be determined based on the assumptions that market participants would use in pricing the asset or liability in question. For this purpose, FAS 157 establishes a hierarchy to rank the quality of evidence relied upon, distinguishing between evidence based on independent market data (observable inputs) and evidence based on the company's own assumptions about market participant assumptions using the best information available for assets or liabilities with little or no market activity (unobservable inputs).

- Level 1 inputs are those based on quoted market prices that are readily and regularly available in an active market, such as stock traded on an exchange, and valuations based on these inputs do not require a significant degree of judgment.
- Level 2 inputs do not have observable prices but have inputs based on them, such as a bond that is not actively traded, but is valued by comparison to the price of another bond with similar terms that is actively traded. Assets and liabilities utilizing Level 2 inputs include exchange-traded equity securities and listed derivatives that are not actively traded, most over-the-counter securities, and certain mortgage-backed securities, asset-backed securities and collateralized debt obligations and retained interest in certain securitization transactions.
- Level 3 inputs, which are the least desirable in measuring fair value, are inputs that do not have observable prices, and are usually assumptions upon which the company bases its internal valuation model. Assets and liabilities utilizing Level 3 inputs include investments in certain high-yield debt, distressed debt (i.e., securities of companies encountering financial difficulties including bankruptcy or insolvency), certain collateralized debt obligations, certain mortgage-backed and asset-backed securities and retained interests in certain securitization transactions. Valuations based on Level 3 inputs require a significant degree of judgment.

During periods of market dislocation, inputs normally used to determine the fair value of assets and liabilities actively traded may be altered and those securities may need to be reclassified from Level 1 to Level 2 or from Level 2 to Level 3. Factors to consider where reclassifications may be needed include the assets and liabilities condition or location, the extent to which the inputs relate to items that are comparable to the assets or liabilities, and the volume and level of activity in the markets where such inputs are observed.

Clarifications on Fair Value Accounting by the SEC Office of the Chief Accountant and FASB Staff

On September 30, 2008, the SEC's Office of the Chief Accountant and the staff of the FASB issued a press release containing certain clarifications on the application of mark-to-market accounting in the current economic environment.

Among other things, the press release stated that the use of unobservable inputs (such as management's internal assumptions regarding expected cash flows) to determine fair value might, in circumstances when relevant market evidence is not available, be more appropriate than using observable inputs that are otherwise normally considered more reliable. The release also stated that market quotes (such as broker quotes or information from a pricing service) are not necessarily determinative if an active market for the security in question does not exist. Further, results of "disorderly" transactions (such as distressed or forced liquidation sales) are not determinative when measuring fair value, and that the fact that a transaction was distressed or forced should be considered when evaluating the available fair value evidence. The clarification release also states that transactions in inactive markets may provide inputs when measuring fair value, but that such transactions would likely not be determinative. If prices in an inactive market do not reflect current prices for the same or similar assets, the release states that adjustments may be necessary to set the fair value.

In addition, the clarification release provides a number of factors that should be considered when determining whether an investment is “other-than-temporarily” impaired. Such impairment may require a security classified as available-for-sale with market value below cost or book value to be permanently written down to its fair value. The factors to consider include (i) the length of the time and the extent to which the market value has been less than cost, (ii) the financial condition and near-term prospects of the company and (iii) the intent and ability of the holder to retain its investment in the company for a period of time sufficient to allow for any anticipated recovery in market value.

The use of unobservable inputs in determining fair value requires judgment and FAS 157 expands disclosures about fair value measurements. It should be noted that the SEC has posted on its website two sample letters sent to chief financial officers in March 2008 and September 2008 regarding disclosure issues for Management’s Discussion and Analysis of Financial Condition and Results of Operations relating to fair value measurements. This guidance emphasizes the need to expand disclosures when the use of unobservable inputs is material and the need to involve a broad team of accountants, auditors, business people and lawyers in fair value discussions.

Recommended Actions for Companies

Companies should consider the following actions to adapt to the new FAS 157 developments:

1. Obtain, evaluate and retain information related to actual purchases and sales of the same or similar assets and liabilities by others and any other information used in valuation of those assets and liabilities. Analyze and document market information and subjective factors related to determinations as to whether or not such sales relate to temporary impairments or “other-than-temporarily” impairments.

2. Contact where appropriate regulators, outside auditors or trade organizations such as the American Bankers Association, to suggest any assets and liabilities that should be considered for special FAS 157 treatment and express views on how mark-to-market accounting and FAS 157 should be interpreted and applied. Note that elimination of FAS 157 would result in a return to the prior lower of cost or market method, which might be disadvantageous in the current environment and which may not be a palatable path for regulators. It also could result in a loss of confidence in the valuations reflected in companies’ financial statements. Some commentators also contend that in the 1990s, banks in Japan did not write down to market value instruments and therefore Japan’s recession was prolonged because recapitalization of the banks did not occur.
3. Limit e-mails on mark-to-market and FAS 157 issues, since even currently healthy back and forth discussions may later result in quotes taken out of context. Consider adopting policies limiting FAS 157 discussions in e-mails. Review and update internal compliance policies related to review of FAS 157 mark-to-market issues. Consider requiring more in-person meetings or telephone calls to review issues and concerns. Ensure that all discussions and internal communications relating to the mark-to-market accounting process be conducted within the framework of the internal working group involved in the process.
4. Ensure that internal working groups involved in the mark-to-market valuation process under FAS 157 and SEC reporting process include, as appropriate, internal accountants, outside auditors, business people and in-house and external lawyers. Update SEC filings after referring to the SEC’s March 2008 and September 2008 sample letters to selected chief financial officers advising when additional FAS 157 disclosures are required in Managements’ Discussion and Analysis of Financial Condition in periodic disclosure documents and in offering documents.

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