

LITIGATION ALERTS

SEC AND FASB ISSUE CLARIFICATIONS ON FAIR VALUE ACCOUNTING

The Securities and Exchange Commission (SEC) and Financial Accounting Standards Board (FASB) yesterday issued interpretative guidance (the “Clarifications”) on fair value accounting that affords greater flexibility to banks and other holders of illiquid securities in estimating asset values under FASB’s fair value measurement rule, Statement of Financial Accounting Standards No. 157 (SFAS 157). These Clarifications have been issued in advance of additional interpretative guidance that the SEC and FASB intend to release by the end of this week.

Under fair value measurement, commonly called “mark-to-market accounting,” a financial institution reports its holdings based on their current market value. SFAS 157 established a single definition for “fair value,” in which asset pricing is determined by the exit price—how much the holder of the asset would receive to sell or transfer it based on current buyer assumptions about benefits or liabilities.

The Clarifications do not actually change or suspend the current mark-to-market rules under SFAS 157, but attempt to clarify the application of fair value accounting principles to illiquid assets in the current market environment. The Clarifications apply to all companies that use generally accepted accounting principles (GAAP) and emphasize that reliance on judgment and principles, as opposed to a strictly prescriptive approach, is appropriate to the application of SFAS 157.

THE CLARIFICATIONS ARE BROKEN INTO FIVE POINTS:

1. Management’s internal assumptions can be used to determine the fair value of securities when an active market for the securities does not exist. The Clarifications explain that a company may use a combination of factors to produce a fair value estimate of illiquid securities, including expectations of future cash flows, as well as other “inputs” from different sources, weighted based on appropriate risk premiums. The SEC and FASB staffs emphasize that “[t]he determination of fair value often requires significant judgment” and that “[i]n some cases, multiple inputs from different sources may collectively provide the best evidence of fair value.”

2. The Clarifications address the use of market quotes from brokers. The SEC and FASB recognize that broker quotes are “not necessarily determinative if an active market does not exist for the security.” In less active markets, **if a broker quote is not based on actual market transactions, but on models and information available only to the broker, then less weight should be placed on those quotes in determining asset values.**
3. The concept of fair value measurement assumes an “orderly transaction” between market participants and, accordingly, “disorderly transactions are not determinative when measuring fair value.” **In particular, distressed or forced sales are not orderly transactions, and thus the fact that a transaction is distressed or forced “should be considered when weighing the available evidence.”** As a threshold matter, the guidance also notes that determining whether a particular transaction is “orderly” requires judgment.
4. The Clarifications also indicate that transactions in inactive markets “may be inputs when measuring fair market value, but would not likely be determinative.” **An inactive market in which there are significant spreads between an asking and a bid price are indicators that should be considered in determining whether a market is inactive.** Again, the guidance emphasizes that the determination of whether a market is active requires reasonable judgment.
5. The Clarifications affirm that determining whether an investment is “other-than-temporarily impaired” requires the exercise of reasonable judgment based upon the specific facts and circumstances of each investment. The SEC and FASB note that, while there are no bright-line tests or safe harbors under GAAP, there are a number of rules of thumb to determine whether an investment’s impairment is long-term (*i.e.*, “other than temporary”). Those rules of thumb, which consider the characteristics of the underlying securities in question, are listed in the SEC’s Staff Accounting Bulletin Topic 5M. **Among the factors that may be considered individually or in combination are: the length of time and the extent to which the market value has been less than cost; the financial condition and near-term prospects of the issuer; and the intent and ability of the holder to retain the investment long enough to anticipate a recovery in market value.**

Overall, the Clarifications underscore the importance of “clear and transparent” disclosures, and state that in addition to requirements already contained in SFAS 157, companies should consider following the guidance provided by the SEC’s Division of Corporate Finance in letters recently issued in March and September 2008 that are available on the SEC’s website.

The Senate passed, in Section 132 and 133 of the Emergency Economic Stabilization Act (H.R. 1424), provisions to allow the SEC to suspend SFAS 157 and to require a study on the effects and impact of these accounting standards on balance sheets, bank failures and investor information. The bill is now before the House for a vote.

Many economists and representatives of financial institutions—including William Isaac, the former Federal Deposit Insurance Corporation (FDIC) chairman—suggest that the mark-to-market accounting rules have exacerbated the credit crisis. In particular, there is currently no active market for mortgage-backed securities, which has driven down fair value prices and caused financial institutions to write down asset values thus incurring massive losses on their balance sheets; this shakes investor confidence in banks’ and other institutions’ solvency and causes further downward pressure on asset holdings. Proponents of suspending the fair value accounting rule say that the vast majority of mortgage-backed assets are still performing, but with a frozen and disorderly market their value is also dragged down.

Supporters of current mark-to-market rules—including large accounting firms, shareholder advocates and backers of traditional liquid equity or fixed-income markets—say that because market opacity and lack of information have caused the build up of “toxic” asset classes and the collapse of the financial system, suspending rules intended to provide straightforward pricing would worsen the situation.

The debate over mark-to-market highlights the significant policy role accounting standards could play in resolving the global financial crisis. Any government intervention in recapitalizing banks will grapple with pricing in a novel way from the savings and loan crisis of the 1980s. At that time, the government purchased liquidated real estate from the bankrupt institutions; now, the price for complex financial derivatives raises questions of market efficiency, behavioral economics, the psychology of investors and the difference between current balance sheets and long-term forecasts.

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