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The SEC's Bid To Save Fair Value Accounting

Law360, New York (October 14, 2008) -- On Sep. 30, 2008, the U.S. Securities and Exchange Commission (SEC) Office of the Chief Accountant and Financial Accounting Standards Board (FASB) staff issued a major joint release providing immediate guidance on "urgent" fair value measurement questions presented in the current market environment.

Noting the challenges facing preparers, auditors, and users of financial statements, the release offers important assistance, clarifying the application of the fair value standard to the many difficult-to-value securities held by financial institutions.

While the release and further guidance anticipated from the FASB will aid those who must make fair value judgments in these unprecedented market conditions, they also play a role in a larger debate about the future of fair value accounting.

Statement Of Financial Accounting Statement (SFAS) No. 157

The essentials of fair value accounting are found in SFAS No. 157, adopted by FASB in 2006 and effective for financial statements issued for fiscal years beginning after Nov. 15, 2007 and for interim periods within those fiscal years.

The changes to current practice resulting from the application of SFAS 157 cover, to the extent relevant here, the definition of fair value and the methods used to measure fair value. The definition of fair value is based upon "exchange price."

SFAS No. 157 asserted that exchange price is the price in an orderly transaction between market participants to sell an asset or transfer a liability in the market in which the reporting entity would transact for the asset or liability.

The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability.

Therefore, the definition focuses on the price that would be received to sell the asset or paid to transfer the liability (an “exit” price), not the price that would be paid to acquire the asset or received to assume the liability (an “entry” price).

SFAS No. 157 emphasized that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based upon the assumptions that market participants would use in pricing the asset or liability.

As a basis for considering market participant assumptions in fair value measurements, SFAS No. 157 established a fair value hierarchy that distinguishes between (1) market participant assumptions developed based upon market data obtained from sources independent of the reporting entity (“observable” inputs) and (2) the reporting entity’s own assumptions about market participant assumptions developed based upon the best information available in the circumstances (“unobservable” inputs).

The concept of unobservable inputs was intended to allow for situations in which there is little, if any, market activity for the asset or liability at the measurement date.

In those situations, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions, and yet the reporting entity could not ignore information about market participant assumptions that is reasonably available without undue cost and effort.

Recent Developments

The subprime meltdown that began last year, the massive write-downs in complicated mortgage-related securities, the recent failures of and threats to financial institutions, and the current credit crisis have focused enormous attention on the methods used to determine asset values reported in financial statements.

When quoted prices in active markets for identical securities are available, fair value accounting is easy to explain and to apply. When financial statement preparers must resort to alternative methods in the second and third levels of the fair value hierarchy established by SFAS No. 157, significantly more difficulties are encountered.

Although the resulting values are intended to provide the same type of information that quoted prices in active markets offer — an exit price — the level of confidence in the outcome is understandably different.

Concerns about the reliability of those values increase when the consequences from large reductions in asset values are enormous. Ratings downgrades, liquidity crises, forced mergers, bankruptcies, and receivership appointments can all follow the write-downs resulting from fair value accounting.

The current environment poses a serious threat to the fair value standards that became effective just last year. Section 133 of the Emergency Economic Stabilization Act of 2008 (Act), enacted last week, requires the SEC, in consultation with the Board of Governors of the Federal Reserve System (Federal Reserve Board) and the secretary of the U.S. Department of the Treasury, to submit a report to U.S. Congress within 90 days on the impact of fair value accounting on financial institutions, specifically addressing whether the standards should be modified or replaced with an alternative approach.

Section 132 of the Act grants the SEC authority to suspend fair value accounting for any issuer or with respect to any class or category of transaction. These provisions, adopted with the support of many constituencies (including some who would ordinarily have little interest in arcane accounting issues), demonstrate the breadth of the assault on fair value accounting.

The arguments for retreat from the fair value standard are still developing, but probably include some common themes reported in the press.

Some seem to place blame for the current financial crisis on the fair value standards and believe that the write-downs in the mortgage-related assets of financial institutions are “artificial” and do not reflect the underlying values of the assets and the cash flows that are still being received on them.

In their view, the fair value standard has made a bad situation worse — leading to chaotic financial reporting that changes from period to period with massive write-downs — all based upon judgment calls that may turn out to be wrong. There is likely to be concern that the information available about the values of these assets is too subjective and unreliable to be useful and is outweighed by the damage that results from asset write-downs.

The response would focus on the role of the fair value standard as an important reform in an area where guidance was lacking. The savings and loan debacle and many intervening financial failures were the backdrop for the new standard.

Learning from the lessons of those events, SFAS No. 157 was adopted to provide more transparent financial reporting. It offers investors enhanced disclosures about the value of a company’s assets and how those values were determined.

The drafters of the joint release have proposed an alternative to eliminating fair values for difficult-to-value assets and simply turning back the clock, leaving investors and users of financial statements on their own when assessing the financial position of affected companies.

The Sep. 30, 2008 Release

Given all of this controversy, the September 30, 2008 joint release is more than just a series of responses to questions posed by the application of fair value accounting.

It tackles some of the most difficult areas of judgment that must be exercised when active market prices are unavailable. It recognizes that the challenges faced by preparers of financial statements and their auditors when weighing level two (observable) and level three (unobservable) inputs for fair value determinations are real and provides assistance in resolving them.

For example, the release clarifies that:

When an active market for a security does not exist, the use of management estimates that incorporate current market participant expectations of future cash flows, and include appropriate risk premiums, is acceptable.

In some cases, using level three (unobservable) inputs might be more appropriate than using level two (observable) inputs. For example, when significant adjustments are required to available observable inputs, it may be appropriate to utilize an estimate based primarily on unobservable inputs.

The determination of fair value often requires significant judgment. In some cases, multiple inputs from different sources may collectively provide the best evidence of fair value. In these cases, expected cash flows would be considered alongside other relevant information.

The weighting of the inputs in the fair value estimate will depend on the extent to which they provide information about the value of an asset or liability and are relevant in developing a reasonable estimate.

Broker quotes may be an input when measuring fair value, but are not necessarily determinative if an active market does not exist for the security. In a liquid market, a broker quote should reflect market information from actual transactions. When markets are less active however, brokers may rely more on models with inputs based upon the information available only to the broker.

In weighing a broker quote as an input to fair value, an entity should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote (e.g., whether the quote is an “indicative” price or a binding offer) should be considered when weighing the available evidence.

The results of disorderly transactions are not determinative when measuring fair value. The concept of a fair value measurement assumes an orderly transaction between market participants. An orderly transaction is one that involves market participants that are willing to transact and allows for adequate exposure to the market.

Distressed or forced liquidation sales are not orderly transactions, and thus the fact that a transaction is distressed or forced should be considered when weighing the available evidence. Determining whether a particular transaction is forced or disorderly requires judgment.

Transactions in inactive markets may be inputs when measuring fair value, but would likely not be determinative. If they are orderly, transactions should be considered in management's estimate of fair value. If prices in an inactive market do not reflect current prices for the same or similar assets, however, then adjustments may be necessary to arrive at fair value.

Indicators such as a significant increase in the spread between the seller "asking" and buyer "bidding" prices and the presence of a relatively small number of bidders should be considered in determining whether a market is inactive. The determination of whether a market is active or not requires judgment.

All of these clarifications further the immediate purpose — to assist those who must make difficult decisions in arriving at fair values for financial statement reporting. They also serve as a defense of the fair value standard, in an effort to show that the current valuation challenges can be addressed reasonably under the fair value hierarchy and other standards established by SFAS No. 157.

Whether these clarifications are sufficient remains to be seen. The debate over fair value accounting has intensified and will not be resolved quickly. The joint statement of the Center for Audit Quality, the Council of Institutional Investors, and the CFA Institute issued on Oct. 1, 2008 strongly opposes any suspension of fair value accounting, noting that it "would deprive investors of critical financial information when it is needed most."

In an Oct. 2, 2008 release, the International Accounting Standards Board (IASB) endorsed the clarifications, noting that they are consistent with the international counterpart to SFAS No. 157 — IAS 39 Financial Instruments: Recognition and Measurement.

IASB Chairman, Sir David Tweedie, recognized the need for additional guidance and committed "to ensure that any IFRS guidance on fair value measurement is consistent with the clarification that has been provided by the US SEC staff and the FASB staff.

The FASB Staff Position FAS 157-d, addressing the determination of fair value in a market that is not active, was approved at a meeting on Oct. 10, 2008 and will reinforce the Sep. 30, 2008 clarifications.

The decisions that must be made under Section 132 and the study to be conducted under Section 133 of the Act will keep these questions at the forefront of the financial crisis controversy. The international impact of these issues is underscored by the CFA Institute's Oct. 2, 2008 letter to French President Sarkozy supporting transparency and warning against "masking financial performance" by suspending fair value accounting.

The level of interest in the fair value debate is also indicated by the more than 100 responses received by the FASB in the one-week period for comments on FAS 157-d, which ended on Oct. 9, 2008.

The SEC's invitation for comments on the subjects of the Section 133 fair value study has already elicited submissions both supporting and opposing fair value accounting. While the debate will continue, the decisive step taken by SEC and FASB staff is an important one in the process, as this is no mere "guidance" but also a bid to save fair value accounting.

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John L. Rogers III and Patrick Daugherty are partners with Foley and are members of the firm's financial crisis response team, which was launched in September to monitor the continuing developments of this historic financial crisis and provide clients with proactive legal and business counsel.