PROSKAUER ROSE LLP

Client Alert

Economic Crisis Response Group

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SEC Holds Roundtable on Mark-to-Market Accounting

The Emergency Economic Stabilization Act of 2008 requires the Securities and Exchange Commission (the "SEC") to conduct a study of mark-to-market accounting – or fair value accounting – in consultation with the Secretary of Treasury and the Board of Governors of the Federal Reserve System. On October 29, 2008, the SEC moderated a roundtable discussion among representatives of issuers, institutional investors, accountants, analysts and standard setters as part of its study. The study, which must be completed by January 2, 2009, will focus on:

- The effects of mark-to-market accounting standards on a financial institution's balance sheet.
- The impact of mark-to-market accounting on bank failures in 2008.
- The impact of mark-to-market accounting standards on the quality of financial information available to investors.
- The process used by the Financial Accounting Standards Board ("FASB") in developing accounting standards.
- The advisability and feasibility of modifications to such standards.
- Alternative accounting standards to those provided in FAS Statement No. 157 ("FAS 157").

What is Mark-to-Market Accounting?

FAS 157 is an accounting standard issued in September 2006 with the objective of defining fair value, establishing a framework for measuring fair value and expanding disclosures about fair value measurements. FAS 157 was intended to achieve greater consistency and comparability in fair value measurements and to provide better information, i.e., more transparency, about the extent to which fair value is used to measure assets and liabilities, the inputs used to develop the measurements, and the effect of certain of the measurements on earnings for the period. FAS 157 defines "Fair Value" 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." In short, the standard requires that assets and liabilities must be valued at a price in a hypothetical market transaction based upon the assumptions of a current market participant who is independent, knowledgeable, able to transact, and willing to transact. To help achieve consistency and comparability in fair value measurements, FAS 157 establishes a hierarchy (Level 1, Level 2 and Level 3) prioritizing those assumptions ("inputs") that a market participant would use in pricing an asset or liability. Generally, Level 1 inputs are current quoted market prices for the identical asset or liability in an active market; Level 2 inputs are quoted current market prices for similar assets or liabilities in an active market, quoted market prices for identical assets or liabilities in markets that are not active; other observable inputs for the asset or liability in question such as interest rates, yield curves, volatilities, prepayment speeds, loss severities and credit risks; and Level 3 inputs are unobservable, meaning they are the reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability "based on the best information available in the circumstances."

The current economic conditions coupled with the implementation FAS 157 have increased the spotlight on fair value or mark-to-market accounting because it has required many financial firms to take enormous losses in connection with illiquid assets, such as investments in collateralized debt obligations, or CDOs, relating to subprime mortgages, for which there no longer is a market. Many claim that FAS 157 is forcing institutions to mark down assets with little or no credit deterioration to values that are unrealistically low, wreaking havoc on the financial system.

In response to the growing concerns over the application of mark-to-market accounting, the SEC and FASB issued on September 30, 2008 a joint clarification regarding the implementation of mark-to-market accounting in cases where a market is disorderly or inactive. Particularly, the SEC clarified that there is no rule requiring a company to mark down assets to the latest transaction prices — especially if the market is distressed. Additionally, the FASB finalized on October 10, 2008 its new FASB Staff Position 157-3, which clarified the application of FAS 157 by providing an illustrative example of how the fair value of a financial asset is to be determined when the market for such asset is inactive. The staff position is available at http://www.fasb.org/pdf/fsp_fas157-3.pdf.

Debating the Merits of Mark-to-Market Accounting

As expected, the roundtable participants presented divergent views as to the benefits and drawbacks of mark-to-market accounting; the different perspectives of investors and regulators responsible for the safety and security of financial institutions; whether mark-to-market accounting caused or had a pro-cyclical effect upon the current economic crisis in general and bank failures in particular; whether financial statement impact (affecting both the balance sheet and the income statement) should be required, as it is under FAS 157, or whether meaningful disclosure should be sufficient; and, the degree of difficulty in the application of FAS 157 to financial instruments with illiquid markets.

Although several participants praised the SEC for its September 30, 2008 release intended to provide immediate additional guidance with respect to the application FAS 157, others expressed concern about the SEC's repeated reference in that release to the utilization of judgment to determine various matters – such as whether a particular transaction is forced or disorderly, whether a market is active or not, and whether an impairment is other-than-temporary. Some were concerned that the SEC was encouraging subjective determinations of fair value rather than determinations being made from the perspective of reasonable participant in the market place. Others were concerned that by exercising their judgment, members of management would expose themselves to civil or even criminal liability if their judgments turned out to be wrong – a proposition not too far fetched given the SEC and the Department of Justice response to financial statement reporting under the Sarbanes-Oxley Act.[1]

An underlying theme in the discussions was exposure to liability as a result of even good faith efforts to comply with FAS 157. Several participants suggested consideration of a "safe harbor" protecting preparers of financial statements from liability for material misstatements of fair value of financial assets.

A similar concern was raised with respect to the expansion of disclosure to include discussions of the risk factors considered and the evaluation of those factors. Indeed, some participants suggested that the disclosure should include allocations of markdowns to credit risks, liquidity risks and other factors as well as disclosure of the range of potential percentage markdowns that were considered. Those concerned with the impact of potential litigation reacted strongly and pointed out that legal challenges to the sufficiency of, and weight given to, the various factors and the selection made within the disclosed range were inevitable.

Although the SEC seemed appreciative of and receptive to the opinions of the participants, its representatives gave no indication of any leaning toward a less restrictive interpretation of FAS 157. Despite the strong polar views of the participants about the wisdom and impact of FAS 157 and mark-to-market accounting generally, there was unanimity (among those who addressed the issue) over the issue of the continued independence of standard setters from government control or intervention. No panelist suggested that any government agency should be formulating the accounting standards in this or any other area.

[1] See SEC Release Nos. 33-8124 and 34-46427 (Aug. 29, 2002) adopting the Section 302 certification which requires that the CEO and CFO certify that the financial statements present fairly in all material respects the financial condition of the company and results of operations. A similar criminal certification has to be supplied by the CEO and CFO in each annual and quarterly report filed with the SEC. This standard was first articulated in a criminal case, *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), in which the Second Circuit upheld a jury verdict finding that the financial statements failed to fairly present the financial condition of a company even though they complied with GAAP.

Conclusion

Although it is unclear whether the SEC will recommend revision or repeal of FAS 157, it is clear that companies must continue to comply with current accounting standards. We expect that financial reporting implications of the credit crisis will continue to be a grave concern and that accounting issues will continue to require heightened focus by management and audit committees. Proskauer Rose professionals are available to assist you in understanding and assessing the relevant legal risks and issues surrounding accounting and financial reporting in this economic environment and are ready to discuss your particular concerns and questions.

If you have any questions regarding the matters discussed in this Client Alert, please contact any of the attorneys listed below:

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