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Client Alert

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SEC SUBMITS REPORT ON FAIR VALUE ACCOUNTING TO CONGRESS

In the months preceding the enactment last October of the Emergency Economic Stabilization Act of 2008 (the “EESA”), critics of fair value accounting asserted that fair value accounting materially contributed to the instability and subsequent decline of the U.S. financial markets. Specifically, critics claimed that the use of fair value accounting standards, particularly in recent illiquid or inactive markets, drastically undervalued assets below their true economic value and subsequently exacerbated the economic crisis. As a result, these critics called for a suspension of fair value accounting to stem further write-downs and subsequent margin and capital calls. Proponents have countered that fair value accounting actually maintained transparency in the market by providing investors with useful information and that suspension would only increase uncertainty.

The EESA mandated that the United States Securities and Exchange Commission (the “SEC”) conduct, in consultation with the Board of

Governors of the Federal Reserve and the Secretary of the Treasury, a study (the “Report”) on the mark-to-market accounting standards as set forth in the Financial Accounting Standards Board’s (“FASB”) Statement on Financial Accounting Standards (“SFAS”) No. 157, *Fair Value Measurements*. The Report was submitted to Congress on December 30, 2008 and concluded that, from an investor’s and from a disclosure perspective, fair value accounting should not be suspended. The Report did recommend certain improvements and changes to fair value accounting. The Report did not address fair value accounting in relation to calculation of capital adequacy ratios.

The Report contains a lengthy background discussion of SFAS No. 157 which defines “fair value”. International Financial Reporting Standards (“IFRS”) also provide a definitional framework for fair value measurements. Despite some differences, under both US GAAP and IFRS, fair value is used to measure financial assets and liabilities and these valuations may affect either

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shareholders' equity or net income. While the SEC's Report focused on US GAAP, consideration of IFRS is relevant given recent efforts to converge the two standards and the SEC's recent roadmap to IFRS adoption in 2014.

The Report includes an empirical study of recent financial statements of 50 financial institutions with a focus on the prevalence of assets measured at fair value on the balance sheet as well as the subset of assets for which mark-to-market changes are made on the income statement. The Report concluded that fair value measurements did not significantly affect financial institutions' reported income. The Report also contains a study of banks by asset size to evaluate the use and impact of fair value measurements on capital over three years. Based on the study, the SEC found that fair value accounting was used in limited circumstances by failed banks and that fair value losses which were recognized had a limited impact on bank capital. Instead, concerns about asset quality and eroding lender and investor confidence appeared to be the principal causes of bank failures. As stated above, the Report did not address the separate question of whether changes to the capital adequacy rules may be warranted in light of the dramatic and sudden effect fair value accounting may have on valuing risk-weighted assets in illiquid markets.

The SEC's focus in the Report was to discern the usefulness of fair value accounting and fair value measurements for investors. The SEC found that investors generally consider fair value measurements as providing more transparent financial information. While investor support for fair value accounting was strong, it was noted that improvements could be made to the existing impairment accounting models, the application of SFAS No. 157 in times of financial stress, the fair value measurement of liabilities and the disclosure requirements of fair value measures.

The Report also compares fair value measures with alternatives, such as historical cost-based measures, to highlight the pros and cons of each method and to possibly elucidate any benefits to suspending SFAS No. 157 and fair value accounting. It concludes that the suspension

of SFAS No. 157 would only result in a reversion to prior practices which were plagued by inconsistency and conflicting guidance and would increase investor uncertainty, erode investor confidence and degrade the transparency of financial information from an investor perspective.

Based on the observations garnered from its Report, the SEC suggested that SFAS No. 157 and the fair value accounting requirements, including mark-to-market accounting, should not be suspended, but improved. The SEC made several suggestions for the improvement of these methodologies including the need to provide additional guidance on:

- how to determine when a market becomes inactive;
- how the impact of a change in credit risk on the value of an asset or liability should be estimated;
- when observable market information should be supplemented with unobservable information in the form of management estimates; and
- how to confirm that assumptions utilized in fair value measurements are those that would be used by market participants generally and not just by a specific entity.

The SEC also recommended that:

- existing disclosure on the effect of fair value in financial statements should be enhanced;
- the FASB should determine whether incorporation of credit risk in the measurement of liabilities is useful to investors and should examine the impact of liquidity on fair value measurements including whether additional disclosure guidance is appropriate;
- educational efforts should be made to highlight the larger role management's judgment plays in the determination of fair value; and
- the FASB should reassess the current impairment accounting models, including the possible reduction in the number of models under US GAAP.

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