



Recent changes to fair-value accounting under US GAAP and IFRS

Enormous losses reported by financial institutions on sub-prime assets have led to vigorous debate over the appropriateness of fair-value or mark-to-market accounting. The banking industry and US lawmakers have pushed to suspend or ease fair-value accounting rules, believing that revising the rules could lower the intensity of the credit squeeze. Critics of the proposed changes argue that any gains from divorcing the value of assets from their true market price would be illusory and simply mask huge losses in asset values.

Changes to fair-value accounting under both International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Principles (US GAAP) have been on two fronts. First, on the fair-value hierarchy, which requires financial instruments to be valued using observable market inputs, where available. Second, on the ability to reclassify financial instruments from trading to holding to avoid the mark-to-market requirement.

Because of these changes, companies will be less tied to market prices, particularly those in inactive markets, and may be able to avoid individual write-downs.

US background

In the wake of Enron's collapse, regulators pushed to make it easier for investors to understand the value of a company's assets and lift the fog on the complexity of structured finance through fair-value accounting rules. The US GAAP mark-to-market accounting standard, known as the Statement of Financial Accounting Standards 157 – Fair Value Measurements (SFAS 157), was issued by the Financial Accounting Standards Board (FASB) in September 2006.

Although financial institutions were already required to report the value of certain assets at market value, SFAS 157 imposed additional requirements and prioritised market pricing information over other methods that seek to identify an asset's market value, including sophisticated valuation modelling. In this financial crisis, the effect of SFAS 157 has been to force balance sheet and income statement write-downs on investments based on market prices that critics argue do not reflect the actual long-term value of these investments.

In reaction to these concerns and as a strong political message, the Emergency Economic Stabilisation Act of 2008 (EESA), enacted on 3 October 2008, affirms that the Securities and Exchange Commission (SEC) has authority to suspend fair-value accounting rules and mandated the SEC to conduct a study of fair-value accounting to determine, among other things, the effects of fair-value accounting on bank failures in 2008 and whether fair-value accounting should be suspended. On 30 December 2008, the SEC released its report on this matter, advising against the suspension of fair-value accounting standards. Instead, the SEC report recommends improvements to existing practice including reconsidering the accounting for impairments and the development of additional guidance for determining fair value of investments in inactive markets. The report also observed that fair-value accounting did not appear to play a meaningful role in the bank failures that occurred in 2008, and noted that such failures seemed to be the result of growing probable credit losses, concerns about asset quality and, in certain cases, eroding lender and investor confidence.

Fair value explained

Fair-value accounting provides a way to measure assets and liabilities that appear on a company's balance sheet and income statement and seeks consistent reporting among comparable institutions. Measuring companies' assets and liabilities at fair value may affect their income, both negatively and positively. SFAS 157 provides a hierarchy of three levels of inputs in applying various valuation techniques. Inputs refer broadly to the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk. The fair-value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (level 1) and the lowest priority to unobservable inputs (level 3).

Level 1 is designated to quoted prices for identical items in active, liquid and visible markets such as stock exchanges. Level 2 indicates observable information for similar items in active or inactive markets, such as prices for two similarly situated buildings in the same downtown real estate market. Level 3 marks unobservable inputs to be used in situations where markets do not exist or are illiquid, such as the market environment in the present credit squeeze. Fair market valuation becomes highly subjective in this market environment.

The equivalent standard to SFAS 157 under IFRS is IAS 39 – Financial Instruments: Recognition and Measurement. IAS 39 provides for a fair-value hierarchy consistent with SFAS 157 as follows: quoted market prices in an active market are the best evidence of fair value and should be used, to the extent possible, to measure the financial instrument. If a market for the financial instrument is inactive or illiquid, an entity establishes fair value by using a valuation technique that makes maximum use of market inputs and includes recent arm's-length market transactions, reference to the fair value of another instrument that is substantially the same, discounted cash flow analysis and option-pricing models. An acceptable valuation technique incorporates all factors that market participants would consider in setting a price and that is consistent with accepted methodologies for pricing financial instruments.

If there is no active market for an equity instrument, the range of reasonable fair values is significant and estimates of fair value cannot be made reliably, then an entity must measure the instrument at cost less impairment.

Recent guidance

On 30 September 2008, the Office of the Chief Accountant of the SEC and FASB jointly issued a press release with immediate clarifications on fair-value accounting rules in light of the financial crisis (recent guidance). On 10 October 2008, the FASB issued a staff position further amplifying that press release. The International Accounting Standards Board (IASB), the EU equivalent of the FASB, quickly responded to the SEC announcement to confirm that IAS 39 was consistent with SFAS 157 and that it will continue to ensure that any IFRS guidance is consistent with SEC and FASB releases to guarantee comparability across borders.

The concept of fair-value measurement under SFAS 157 assumes orderly transactions between market participants. The clarifications issued by the SEC and FASB did not suspend fair-value accounting but rather sought to provide companies and their accountants with added flexibility in making fair-value determinations under present market conditions, in which the sales of many exotic securities are effectively shut down. The clarifications focus on inputs that may be used in applying various valuation techniques and provide that:

- strong judgement is required when determining fair value, and multiple inputs from different sources may collectively provide the best evidence of fair value;
- management's internal assumptions (expected cash flows, for example) may be used to measure fair value when an active market for a security does not exist. In some cases, using level 3 inputs may be more appropriate than using level 2 inputs, such as when significant adjustments are required for available observable inputs;
- market quotes may be an input for the purpose of measuring the fair value of a security but are not necessarily determinative if an active market does not exist for that security (however, transactions in inactive markets may be inputs for the purpose of measuring fair value);
- a significant increase in spread between the amount sellers are asking and the price that buyers are bidding, or the presence of a relatively small number of bidding parities, is an indicator that should be considered when determining whether a market is inactive;
- the results of disorderly transactions, such as distressed or forced liquidation sales, are not determinative; and
- US GAAP does not provide a bright-line test in determining whether there is an asset impairment that is not temporary (however, rules of thumb that consider the nature of the underlying investment can be useful tools for management and auditors when identifying securities that warrant a higher level of evaluation).

A non-comprehensive list of factors provided in the recent guidance to determine whether a non-temporary asset impairment has occurred includes:

- the length of the time and the extent to which the market value has been less than cost;
- the financial condition and near-term prospects of the issuer, including any specific events that may influence the operations of the issuer; and
- the intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.

Additional disclosure

Because fair-value measurements and assessments of impairments may require strong judgements, clear and transparent disclosures are critical to providing investors with an understanding of the judgements made by management. For example, strong judgement must be applied when using unobservable inputs to determine fair value, which may have a material effect on the company's results of operations, liquidity and capital resources. As such, in addition to disclosures required under existing US GAAP, including SFAS 157, the SEC's Division of Corporate Finance recently issued letters in March and September 2008 that provided further guidance (disclosure guidance) regarding information that certain public companies should consider in its *Management's Discussion and Analysis of Financial Condition and Results of Operations* disclosure contained in SEC filings. The disclosure guidance suggestions include, among others:

- if the use of unobservable inputs is material, disclosure of how such inputs were determined and how the resulting fair value of assets and liabilities and possible changes to those values affected or could affect the company's results of operations, liquidity and capital resources;
- a general description of the valuation techniques or models used about material assets and liabilities, including describing the rationale and quantitative effect, to the extent possible, of any material changes made during the reporting period to such techniques or models;
- to the extent material, a discussion of the extent to which, and how, the company used or considered relevant market indices in applying the techniques or models used to value material assets or liabilities;
- a discussion of how the company validates the techniques or models used; and
- a discussion of how sensitive the fair value estimates for material assets or liabilities are to the significant inputs for which the technique or model is used.

Reclassification of investments

Both IFRS and US GAAP require financial instruments to be classified into specific categories at initial acquisition in a similar manner. US GAAP contains three broad categories:

- trading;
- available-for-sale; and
- held-to-maturity.

IFRS contains four categories:

- financial assets at fair value through profit or loss (similar to trading under US GAAP);
- available-for-sale;

- loans and receivables; and
- held-to-maturity.

The additional category under IFRS is not, in effect, significant. The key is that the first two financial asset categories under both US GAAP and IFRS require the following of mark-to-market accounting rules that have been the subject of write-downs during the credit crisis.

Moreover, many financial institutions want to change their classification to held-to-maturity, noting that their intention for these instruments has changed as a result of the market turmoil. Generally, held-to-maturity assets are assets held with no intention to sell in the short term or that are not otherwise part of a trading strategy. Such assets are measured on a cost basis subject to impairment evaluation.

US GAAP permits reclassification of certain securities out of the trading category in rare circumstances, which many are interpreting the present credit squeeze to represent, whereas IFRS did not permit such reclassification. As a result, the IASB reacted swiftly to issue a revision to IAS 39 to provide for a similar ability to reclassify financial instruments as contained in US GAAP. This revision was immediately adopted by the EU. Reclassifications under the revision can be made from 1 July 2008. Moreover, the press release issued by the IASB stated that the deterioration of the world's financial markets that has occurred during the third quarter of 2008 is a possible example of a rare circumstance, thereby providing financial institutions with an opportunity to reclassify their financial assets to held-to-maturity, which exempts them from mark-to-market valuation and allows them to be valued on a basis closer to their discounted cash flows.

It has been reported that Deutsche Bank was the first big EU financial institution to implement this new rule, resulting in a profit instead of a projected loss in its most recent third financial quarter by recategorising €24.9bn (\$31.2bn) of loan exposure. In the third quarter of 2008, it avoided €845m in write-downs because of the accounting change and was able to report a net income of €414m instead of a €122m loss. Deutsche Bank shares rose 18 per cent to €20.20 in Frankfurt. Other financial institutions will also benefit from these changes.

It is unlikely that mark-to-market will literally mean the same going forward. Recent interpretation guidance by the SEC, FASB and IASB will lead more companies and their accountants to attach less significance to market prices, particularly those in inactive markets, when determining the value of securities, which in turn could support the assertion that write-downs are not required in their individual cases. In addition, we expect the SEC to increase scrutiny over disclosures made by reporting companies subject to material fair-value accounting adjustments in their financial statements in light of the recent disclosure guidance.

Furthermore, the study of mark-to-market accounting recently conducted by the SEC will likely change the mark-to-market rules and their application.

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Although the study does not advise suspending existing fair-value standards, it does make various recommendations to improve their application, including that FASB reassess current impairment accounting models for financial instruments and the enhancement of existing disclosure and presentation requirements relating to the effect of fair value in the financial statements.

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