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**SFAS 157: Changes to Market Value Accounting as a result of the
“Credit Crunch”**

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Overview

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- Fair value accounting defined
- Differences from prior practice
- Implementation challenges
- Moving forward
- Profile



Background

Precipitated by the subprime market collapse, the global credit crunch has evolved to unprecedented levels

- Manifested with the failure of the Bear Stearns High-Grade Structured Credit and Structured Credit Enhanced Leveraged hedge funds in July 2007
- Forced the restructuring of much of the financial services industry in the US
 - Bear Stearns, Merrill Lynch, and Wachovia Bank have been sold at bargain basement prices
 - Goldman Sachs and Morgan Stanley, the last of the big independent investment banks, have become bank holding companies
 - Lehman Brothers, unable to find an acquirer, filed for bankruptcy, with assets of \$639 billion, the largest in history
 - American International Group, Fannie Mae and Freddie Mac, among others, were rescued by the government, while Washington Mutual was seized by the FDIC prior to being sold
- Fortis, Hypo Real Estate, Bradford & Bingley, Glitner Bank, and Unitcredito experienced similar fates across Europe
- Has now expanded well beyond subprime markets, with the Big Three automakers now seeking federal assistance

Near the center of the debate as to the underlying cause of the crisis is the use of fair value accounting

- Financial institutions pressed FASB to promulgate fair value as a means to better report their financial position and earnings during the housing bubble
- Since the start of the credit crunch, however, these same institutions have experienced
 - losses on write downs of assets linked to mortgage loans,
 - weakened balance sheets and
 - diminished capital reserves
- Financial institutions have since lobbied to suspend fair value accounting, arguing that it requires losses be taken on instruments that are not held for sale, and for which prices will recover
- Others cite the challenges associated with applying fair value accounting in volatile distressed markets characterized by a lack of liquidity and pricing transparency, along with its pro-cyclical effects
 - i.e., adverse feedback loop



Fair value accounting defined

The current debate regarding fair value accounting is aimed principally at FAS 157, “Fair Value Measurements”

- Though the use of fair value in financial reporting is well established, FAS 157 is relatively new
- FAS 157 was issued in 2006 to take effect for fiscal years beginning after November 15, 2007
- Its purpose was to provide a single, authoritative framework for measuring fair value, and to require additional clarifying disclosures in its use
- As such, FAS 157 applies to financial reporting for
 - publicly traded companies
 - financial assets
 - non-financial assets and liabilities reported at fair value on a recurring basis

FAS 157 does not, however, require fair value any where it was not already required or allowed

- FAS 157's role is in fact that of an interface between pre-existing pronouncements that concern fair value, including
 - SFAS 107, *Disclosures about Fair Value of Financial Instruments*
 - SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*
 - SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*
 - SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*
 - SFAS 156, *Accounting for Servicing of Financial Assets*
 - SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*

Moreover, the use of fair value for financial assets goes back decades

- Financial assets generally fall into three categories depending on type and intended use: trading, available-for-sale, and held-to-maturity
- Held-to-maturity securities are carried at cost; derivatives, trading and available-for-sale securities are reported on the balance sheet at fair value. However,
 - Only changes in the fair value of derivatives and trading securities are reported in earnings
 - Changes in the fair value of available-for-sale securities bypass earnings and are recorded in accumulated comprehensive income
- The use of fair value is also well established for reporting other-than-temporary impairments in the value of financial assets
 - Both available-for-sale and held-to-maturity securities are written down to fair value through earnings if impairment is other than temporary
 - Mortgage loans held for sale are reported at the lower of cost or fair value, while loans held for investment are often written down to reflect the present value of expected future cash flows based on the effective interest rate of the original loan

Fair value accounting is essentially a method of financial reporting based on current exchange prices

- FAS 157 defines fair value as “the *price* that would be *received* to
 - *sell* an asset, or *paid* to transfer a liability,
 - between *market participants*,
 - in an *orderly* transaction,
 - at the *measurement date*”
- Of particular importance to the proper implementation of FAS 157, fair value is
 - an exit, rather than entry price
 - not the price received in a forced liquidation
 - the price in the principal market, or if none, the most advantageous market
 - the value at the measurement date in a hypothetical transaction and not a potential value in the future
 - exclusive of transaction costs; no blockage discount
- Fair value is also different from fair market value
 - i.e., fair value may account for synergies and or characteristics specific to a particular buyer or seller

Transactions between related parties, that are forced, reflect a different unit of account, or in other than the principal/most advantageous market, may not indicate fair value

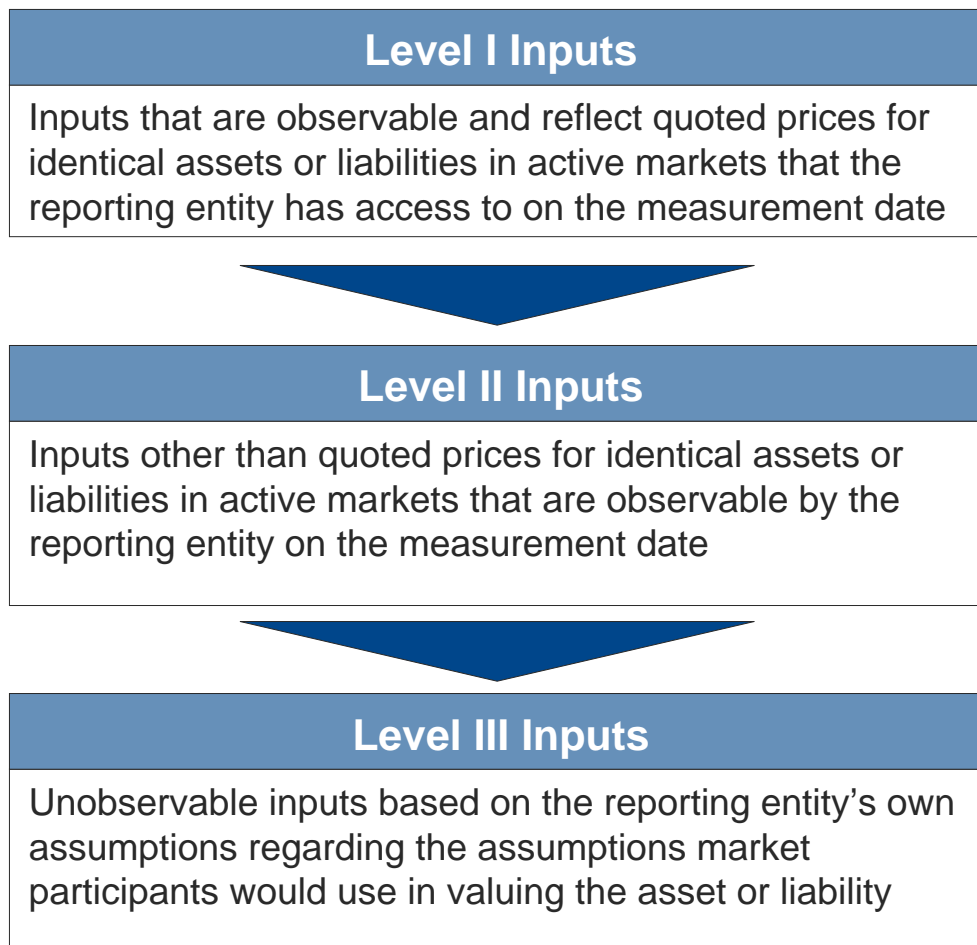


Differences from prior practice

FAS No. 157 differs from prior practice in three key areas

- The main differences between FAS 157 and previous practice center on the
 - definition of fair value,
 - assumptions and methods used to measure fair value, and
 - disclosures regarding how fair value is measured
- Fair value is the price received (exit price) to sell an asset or paid to transfer a liability rather than that paid (entry price) to purchase an asset or received to assume a liability
- In terms of methodology, FAS 157 requires fair value to be determined using
 - market-participant assumptions as opposed to entity-specific
 - a fair value hierarchy to distinguish and prioritize between observable and unobservable inputs
 - valuation methods consistent with the market, income and cost approaches
- Disclosure is also required of the inputs used to measure fair value with unobservable inputs, and the related effect on earnings or changes in net assets

FAS No. 157 prioritizes the inputs used to measure fair value into a three tier hierarchy

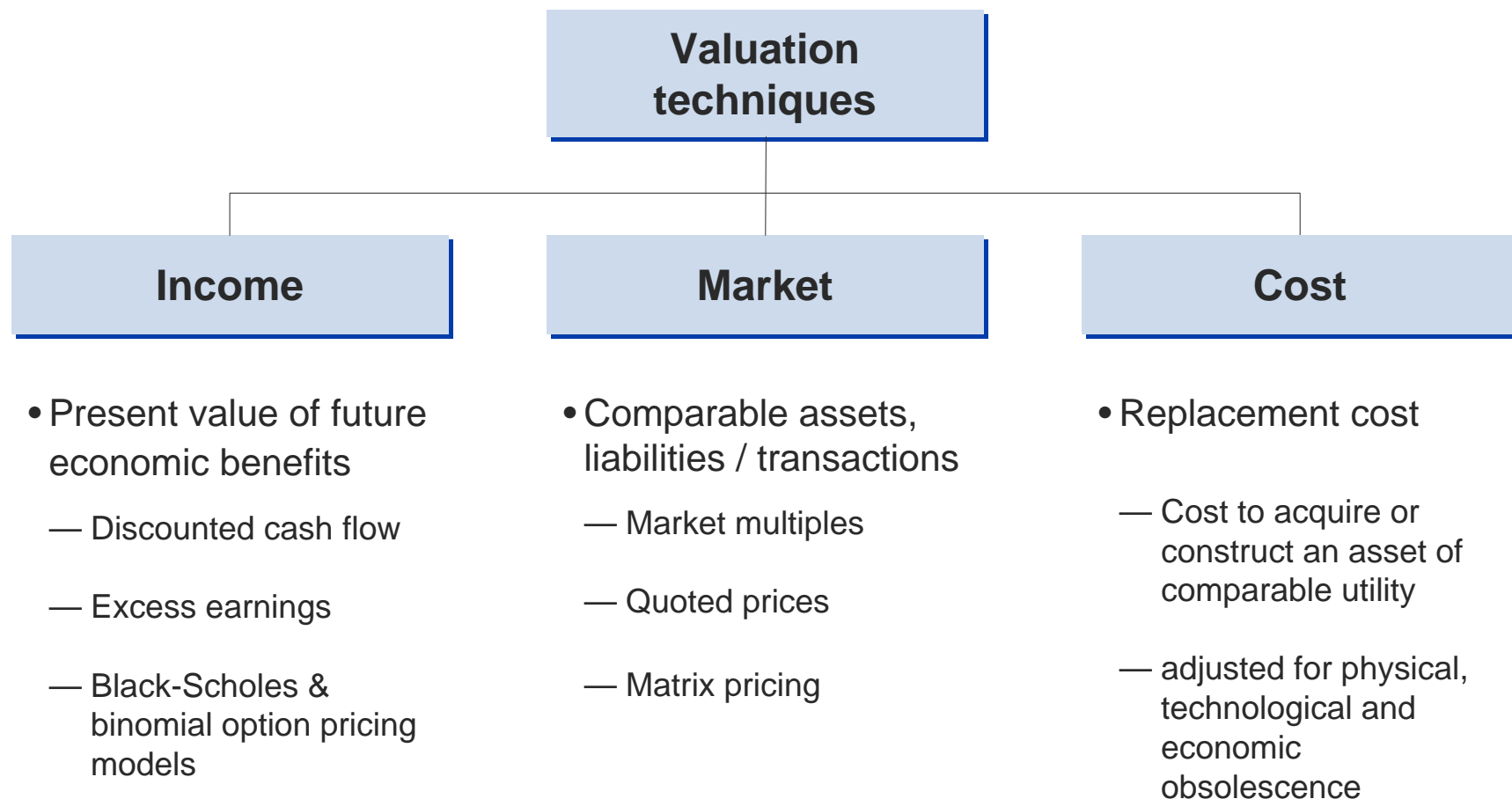


The level of a fair value measurement is determined from the lowest level input that is significant to the measurement in its entirety

The significance of an input depends on its relevance and reliability

- Degree of subjectivity inherent to input adjustments
 - risk of asset, valuation model and inputs
 - restrictions on sale or use of asset
 - non-performance risk for liability
 - transportation costs
 - condition and location
- Extent to which guideline assets and liabilities are comparable
 - Similar or identical
 - Traded in active or inactive, principal or brokered markets
 - credit risks, default rates, volatilities, interest rates, prepayments
- Character of comparable transactions
 - contemporaneous
 - orderly or forced
- Trading characteristics of the markets in which the inputs are observed
 - Liquid or illiquid
 - Volatile, distressed

Valuation methods are required to be consistent with the income, market and cost approaches



Fair value is equal to the point in the range of indications that is most representative

Assets and liabilities are to be valued based on use and transfer characteristics

- The premise of value used in the measurement of the fair value of an asset is that of its highest and best use
 - In-use, if of greatest value employed together with other assets in a group
 - equal to the price in a current sale transaction,
 - where the asset would be used with others in a group, and
 - group would be available to market participants
 - In-exchange, if of greatest value on a standalone basis
 - Equal to the price in a current sale transaction
 - Whether in-use or in-exchange, based on related market participant assumptions
- The assumptions underlying the fair value measurement of a liability posit that
 - The liability to the counter-party continues as-is rather than being settled
 - Non-performance risk is the same before and after the transfer

Disclosure requirements differ for one-time and recurring fair value measurements

- Required disclosures for assets and liabilities measured on a recurring basis consist of
 - Fair value measurements by level within the hierarchy at the reporting date
 - A reconciliation of beginning and ending balances for measurements using Level III inputs, reporting
 - Total realized and unrealized gains and losses included in earnings or changes in net assets, the portions associated with assets and liabilities still held at the reporting date, and where the gains and losses are reported in income
 - Purchases, sales, issuances, and settlements
 - Transfers into or out of Level III
 - The valuation methods used, and changes therein for the period (annual periods only)
- Disclosures for non-recurring fair value measurements differ in that
 - Measurements using Level III inputs require only a description of the inputs and information used in their preparation



Implementation challenges

Applying fair value accounting in volatile and illiquid markets presents significant challenges

- As market participants have continued to suffer losses on subprime and related positions, debt markets have grown increasingly risk adverse, and in turn illiquid, causing fair values to erode further
- Given the speed of the declines, instruments that had been valued using Level 1 inputs have had to be valued using Level III inputs almost instantaneously absent the benefit of established models
- Complicating the equation, risks associated with subprime and related positions have been partitioned through complex securitizations, re-securitizations, and credit derivatives, obscuring their risks
- Buyers have consequently avoided the instruments or bid defensively, while sellers have been willing to sell at most any price to reverse their positions
- Given these conditions, interpreting and applying FAS 157 has become increasingly difficult based on the assumptions and inputs required by the statement

Applying fair value accounting in volatile and illiquid markets presents significant challenges (continued)

- FAS 157's definition of fair value assumes the existence of orderly transactions based on market conditions at the measurement date
 - Since the start of the credit crunch, however, market conditions have not been conducive to informing analyses of what a hypothetical, orderly transaction might entail
- FAS 157's fair value hierarchy favors observable inputs over unobservable inputs, and in inactive markets, management's internal assumptions regarding current market participant expectations with respect to future cash flows and risk-adjusted discount rates
 - The difficulties of identifying poor quality pricing signals and estimating market participant expectations regarding inputs such as cash flows and discount rates, however, are compounded in illiquid markets lacking pricing transparency
- In addressing these issues it is critical to recognize that fair value is not the price that would be received in a fire sale or forced liquidation



Moving forward

How and in what direction fair value accounting evolves will ultimately depend on the needs of the capital markets

- Knowledge of the fair value of a firm's assets and liabilities facilitates informed decisions by improving transparency, aiding in the assessment of risk, and strengthening the efficiency of the capital markets
- Investors made these preferences known to FASB, which took them into account in developing the objectives underlying SFAS 157, which include increased consistency and comparability in fair value measurements as well as expanded disclosures
- While fair value accounting has provided external users of financial statements with real-time insights previously knowable only to insiders, challenges in its application in illiquid markets suggest room for improvement
- Given the need for transparency to facilitate the price adjustments necessary to resolve the credit crunch, FASB might wish to address liquidity concerns directly in the future
- To suspend fair value accounting as some suggest, however, would be untenable and likely prolong the market adjustment



Profile



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- Education

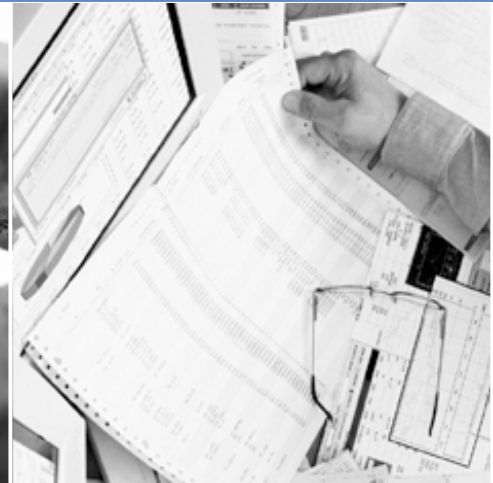
- Master of Management degree, with specializations in accounting and finance, Kellogg School of Management, Northwestern University
- Certified Public Accountant; Certificate in Distressed Business Valuation

- Experience

- Valuation of businesses, debt, equity and derivative securities, tangible and intangible assets
- Antitrust, bankruptcy, contracts, intellectual property, mergers & acquisitions, regulation, securities and international arbitration
- Testifying expert in disputes involving acquisition strategy and structure, merger synergies, competitive effects, enterprise and option valuation, fairness of consideration, lost profits, price fixing, product market definition, solvency, stock market efficiency, and value impairment
- Served in public policy, corporate development, and corporate finance roles with the U.S. Federal Trade Commission, Bureau of Competition, U.S. Generating, Inc., and Inland Steel Industries, Inc.

- Affiliations

- Association of Insolvency and Restructuring Advisors, American Institute of Certified Public Accountants, American Society of Appraisers, American Bankruptcy Institute, Insol International, American Finance Association, American Bar Association



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