SIMPSON THACHER

CLIENT MEMORANDUM

Recent Developments in Mark-to-Market Accounting

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Recent dislocations in the equity and credit markets have precipitated a review of the impact of mark-to-market accounting on the financial condition of U.S. financial institutions. Mark-to-market accounting, which assigns a value to an asset based on its current market price, has come under heavy scrutiny recently, as its critics contend that it has intensified problems in the credit markets by forcing financial institutions to write down billions of dollars worth of mortgage-related securities. However, proponents of mark-to-market accounting, which includes the guidance provided by FAS 157, insist that its suspension would deprive investors of critical financial information.

SEC AND FASB GUIDANCE

On October 3, 2008, the Financial Accounting Standards Board ("FASB") issued a proposed Staff Position on FAS 157 (the "FSP") to clarify the application of FAS 157 in the context of thin or disorderly markets and provide an illustrative example. On September 30, 2008, the Securities and Exchange Commission ("SEC") and FASB jointly issued a press release (the "Release") which also provided guidance on this issue.

In the context of thin or disorderly markets, the FSP and Release permit the use of management estimates, including estimates of future cash flows, to determine fair value while affirming the importance of professional judgment in such determinations. The FSP and Release state that cash flows should be considered alongside other relevant information and in particular, the Release notes that "multiple inputs from different sources may collectively provide the best evidence of fair value." These words provide support for financial institutions to weigh their own expectations of the future cash flows of a security in their determination of that asset's balance sheet value rather than relying strictly on market data from sales of similar securities.

Guidance is also given on the use of "market" quotes (such as from a broker or pricing service). The FSP and Release provide that 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 the illustrative example in the FSP, the interaction between broker quotes and management's estimates is featured prominently. The illustrative example involves the valuation of a mortgage-related security in the context of an inactive market. Rather than using a current market price (which may be inaccurate due to the lack of observable transactions) to calculate fair value, management relies on the present value of future cash flows discounted at an appropriate rate. In determining the appropriate discount rate, management considers its own estimates along with a broker quote, reinforcing the importance of weighing a variety of sources of information when determining fair value.

For further clarity, the Release notes:

- distressed sales are not determinative when measuring fair value;
- the concept of fair value assumes an orderly transaction between market participants; and
- distressed or liquidation sales are not necessarily indicative of the value of an asset.

As such, the circumstances of a sale and whether it is distressed or voluntary is a factor in the weight to be attributed to the actual sales price in determining the underlying value of an asset. This guidance is very timely in light of the distressed sales of mortgage securities which have occurred recently, and those that are expected to occur following the passage of the Emergency Economic Stabilization Act of 2008 (discussed below).

Consideration is also given in the Release to what factors should be weighed in determining whether an impairment in value is not temporary. The Release provides that increases in the following factors suggest that an impairment is not temporary: (1) the magnitude of the decline in value; (2) the period of time until anticipated recovery; and (3) the period of time that a decline has existed.

The FSP along with the Release, address several highly relevant issues and can be expected to be of assistance in valuing assets in current market conditions. However, a great deal of uncertainty still exists in both the relevant accounting rules and market conditions and as such, professional judgment will continue to play a critical role in asset valuation.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008

On October 3, 2008, President George W. Bush signed into law the Emergency Economic Stabilization Act of 2008 (the "Act"), which gives the SEC the authority to suspend mark-to-market accounting.[1] It's unclear, however, if this provision is strictly necessary as the authority to suspend mark-to-market accounting may already be within the SEC's statutory authority. The Act also directs the SEC to conduct a study on mark-to-market accounting in consultation with the Federal Reserve and the Secretary of the Treasury, which will consider the advisability and feasibility of modifying mark-to-market accounting as well as its alternatives. The report must be prepared within 90 days following enactment of the Act.

The Act's provisions regarding mark-to-market accounting have been criticized by the Financial Accounting Foundation ("FAF"), which oversees FASB. In a letter to Congressman Barney Frank, FAF Chair Robert Denham states that suspending mark-to-market accounting would greatly undermine investor confidence and that involvement by Congress in setting accounting standards compromises the integrity of US accounting standard setting by politicizing the process. Denham urged that any changes to accounting standards, including mark-to-market accounting, should be made through FASB.

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[1] Nicolas Sarkozy, the president of France, has also reportedly sent a proposal to the European Commission that recommends suspending mark-to-market accounting.

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