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What Is Fair in This Market?

FASB Issues Guidance on Measuring Fair Value of Financial Assets in an Inactive Market

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Introduction

The recent well-publicized effects of the continuing turbulence in the financial markets, such as tightened credit and a significant reduction in transactional activity in certain markets, have focused much attention on measuring fair value in an inactive market. To address application concerns raised by preparers of financial statements, last week the FASB staff issued Staff Position (FSP) No. FAS 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active." The FSP amends Statement 157[1] by incorporating "an example to illustrate key considerations in determining the fair value of a financial asset" in an inactive market. The FSP is effective upon issuance and should be applied to prior periods for which financial statements have not been issued.

The FSP comes within a short period of the joint press release (hereinafter, the "press release") issued by the SEC's Office of the Chief Accountant and the FASB staff on September 30, 2008 (refer to Deloitte's Financial Reporting Alert 08-11[2]), that addresses similar issues. The FSP specifically states that the guidance in the FSP is consistent with the press release.

The FSP's illustrative example clarifies various application issues raised by preparers of financial statements.

What the FSP Does

The FSP's illustrative example and associated guidance clarifies various application issues raised by preparers of financial statements. With regard to the measurement principles of Statement 157, the FSP emphasizes the following:

- **Objective of Fair Value** — The objective of a fair value measurement is to determine the price that would be received to sell an asset in an orderly transaction that is not a forced liquidation or distressed sale between market participants as of the measurement date. This objective does not change even when there is little, if any, market activity for an asset as of the measurement date.
- **Distressed Transactions** — "Even in times of market dislocation, it is not appropriate to conclude that all market activity represents forced liquidations or distressed sales. However, it is also not appropriate to automatically conclude that any transaction price is determinative of fair value." The evaluation of whether individual transactions are forced (that is, whether one of the parties is forced or otherwise compelled to transact) depends on the facts and circumstances and may require the use of significant judgment.

1 FASB Statement No. 157, *Fair Value Measurements.*
2 Deloitte's *Financial Reporting Alert* 08-11, *SEC and FASB Release Fair Value Clarifications.*

- **Relevance of Observable Data** — Observable market data may require significant adjustment to meet the objective of fair value. "For example, in cases where the volume and level of trading activity in the asset have declined significantly, the available prices vary significantly over time or among market participants, or the prices are not current, the observable inputs might not be relevant and could require significant adjustment." If the adjustment is significant, the measurement would be considered Level 3.
- **Management's Assumptions and Nonperformance and Liquidity Risks** — The use of management's internal "assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable" when relevant observable market data does not exist. In addition, such assumptions or techniques must incorporate adjustments for nonperformance and liquidity risks that market participants would consider in valuing the asset.
- **Third Party Pricing Quotes** — Quotes and information obtained from brokers or pricing services "are not necessarily determinative if an active market does not exist for the financial asset" being measured. In addition, "an entity should place less reliance on quotes that do not reflect [actual] market transactions."
- **Disclosures** — Although new disclosure requirements are not created, emphasis is placed on the disclosure requirements of Statement 157 regarding significant unobservable inputs (Level 3 inputs) and the MD&A fair value considerations addressed in the letters issued by the SEC's Division of Corporation Finance in March and September 2008 to certain financial institutions (see Deloitte's Financial Reporting Alerts 08-7[3] and 08-10[4]).

Assumptions or techniques must incorporate adjustments for nonperformance and liquidity risks that market participants would consider in valuing the asset.

The example in the FSP illustrates how an entity may determine the fair value of an investment in a collateralized debt obligation security that is no longer quoted in an active market. The FSP emphasizes that approaches other than the market value approach to determining fair value also may be appropriate. In the example, the entity has determined that an income approach valuation technique is "equally or more representative of fair value than the market approach valuation technique" that it had previously used because the market is no longer active and the entity would need to make significant adjustments to observable market data (i.e., Level 1 or Level 2 measurements are no longer available). Under its income approach valuation technique, the entity determines the fair value of its investment on the basis of the contractual cash flows of the security, discounted using a risk-adjusted discount rate. The entity determines the discount rate by appropriately weighting (1) its own estimate of a market participant discount rate when "all available market information that could be obtained without undue cost and effort" is taken into account and (2) the discount rates implied by two indicative broker quotes. The discount rate incorporates adjustments for both nonperformance risk (including default risk and collateral value risk) and liquidity risk (i.e., "compensation that a market participant receives for buying an asset that is difficult to sell under current market conditions").

The FSP also clarifies that the illustrative example in the FSP does not apply when assessing an available-for-sale security that is a beneficial interest in a securitized financial asset within the scope of Issue 99-20[5] for an other-than-temporary impairment or change in yield because Issue 99-20 requires an entity to use cash flows expected by market participants rather than contractual cash flows.

[3] Deloitte's *Financial Reporting Alert* 08-7, *SEC Advises Registrants to Further Explain Fair Value in MD&A.*

[4] Deloitte's *Financial Reporting Alert* 08-10, *SEC Advises Registrants to Further Explain Fair Value in MD&A — An Addendum to the March 2008 SEC Letter.*

[5] EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets."

Areas Requiring Significant Judgment

While the FSP addresses various application issues, it stops short of providing detailed guidance in areas requiring significant judgment. Thus, entities will continue to need to apply significant judgment in applying the provisions of Statement 157. The FASB concluded in its October 10, 2008, meeting that providing additional guidance such as rules or bright lines in areas requiring significant judgment would not be in line with principles-based standards. Areas requiring significant judgment include:

- **Active/Inactive Markets** — The determination of what constitutes an active or inactive market requires significant judgment. Although paragraph 28(b) of Statement 157 lists certain characteristics of an inactive market, the existence of one criterion may not necessarily mean the market is inactive. A market is not deemed inactive simply because of insufficient trading volume relative to the size of an entity's position. Therefore, an assessment of whether the market is active or inactive requires analysis and significant judgment.
- **Forced or Distressed Transactions** — In dislocated markets, determining whether a transaction is forced or distressed, thereby allowing an entity to place less or no weight on an observable transaction price in determining fair value, may require significant judgment.
- **Significance Test** — In determining the level of a fair value measurement in the fair value hierarchy, an entity first determines what level in the fair value hierarchy the input falls into. If a measurement includes, for example, inputs from both Level 2 and Level 3, paragraph 22 of Statement 157 requires the level in the fair value hierarchy for the entire measurement to be based on the "lowest level input that is significant to the fair value measurement in its entirety." Accordingly, the determination of significance requires judgment and should take into consideration factors specific to the asset being measured at fair value.
- **Weighting of Valuation Techniques** — When an entity uses multiple valuation techniques in the absence of valuations that constitute Level 1 or Level 2 measurements, significant judgment is required in allocating weights between those techniques. For example, an entity may employ both a market approach and an income approach in determining fair value and will need to apply judgment in designing a method of weighing the two approaches.

Entities will continue to need to apply significant judgment in applying the provisions of Statement 157.

Since the above areas require significant judgment, it may be appropriate for entities to consult with independent accountants and consider involvement of specialists with appropriate market knowledge and qualifications.

Effective Date and Transition

The FSP is effective as of the date of issuance (October 10, 2008) and applicable to prior periods for which financial statements have not yet been issued (e.g., September 30, 2008). Revisions to fair value estimates resulting from the adoption of the FSP must be accounted for as a change in accounting estimate under Statement 154,[6] but entities need not provide the required disclosures.

[6] FASB Statement No. 154, *Accounting Changes and Error Corrections.*

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