Deloitte.

Heads Up

April 14, 2009
Volume 16, Issue 18

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Three's a Charm

FASB Issues Guidance on Measuring Fair Value When Market Activity Declines, Other-Than-Temporary Impairments, and Interim Fair Value Disclosures

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Background

Late last week, the FASB issued a trio of Staff Positions (FSPs): (1) FSP FAS 157-4,[1] which provides guidance on determining fair value when market activity has decreased; (2) FSP FAS 115-2 and FAS 124-2 (FSP FAS 115-2),[2] which addresses other-than-temporary impairments (OTTIs) for debt securities; and (3) FSP FAS 107-1 and APB 28-1 (FSP FAS 107-1),[3] which discusses fair value disclosures for financial instruments in interim periods. The FSPs are effective for interim and annual periods ending after June 15, 2009, with early adoption permitted (see Effective Dates section). Each of these FSPs is discussed in more detail below.

Determining Fair Value When Market Activity Declines

FSP FAS 157-4 does not change the objective of fair value measurements when market activity declines.

FSP FAS 157-4 provides guidance on (1) estimating the fair value of an **asset or liability** (financial and nonfinancial) when the volume and level of activity for the asset or liability have significantly decreased and (2) identifying transactions that are not orderly. What may be more interesting is what the FSP does not do. Despite early press reports, the FSP does not change the objective of fair value measurements when market activity declines. To the contrary, the FSP emphasizes that "[f]air value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under **current** market conditions" (emphasis added). This emphasis reinforces that fair value is a current market-based measurement and not an entity-specific or hypothetical future market-based measurement.

Why did the FASB issue FSP FAS 157-4? In addition to responding to feedback from constituents trying to apply fair value principles in the current financial turmoil and indicating that Statement 157[4] and FSP FAS 157-3[5] did not provide sufficient guidance on

[1] FASB Staff Position No. FAS 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly."
[2] FASB Staff Position No. FAS 115-2 and FAS 124-2, "Recognition and Presentation of Other-Than-Temporary Impairments."
[3] FASB Staff Position No. FAS 107-1 and APB 28-1, "Interim Disclosures About Fair Value of Financial Instruments."
[4] FASB Statement No. 157, *Fair Value Measurements.*
[5] FASB Staff Position No. FAS 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active."

how to determine whether a market for a financial asset that was historically active is no longer active and whether a transaction is not orderly, the guidance is in response to the SEC's study of mark-to-market accounting and requests from members of Congress to address issues associated with fair value accounting.

Application Guidance

What are the considerations related to estimating fair value in the current market? FSP FAS 157-4 indicates that when determining the fair value of an asset or liability that is not a Level 1 fair value measurement, an entity should assess whether the volume and level of activity for the asset or liability have significantly decreased when compared with normal market conditions. If the entity concludes that there has been a significant decrease in the volume and level of activity, a quoted price (e.g., observed transaction) may not be determinative of fair value and may require a significant adjustment. Statement 157 does not prescribe a specific approach for calculating the adjustment and indicates that significant judgment is involved. However, the FSP clarifies that as part of this judgment, an entity may deem it necessary to change the valuation technique (e.g., move from a market approach, such as a quoted price, to an income approach, such as a present value technique) or use multiple valuation techniques (e.g., a combination of market and income approaches) in determining fair value when there has been a significant decline in the volume and level of activity. Further, the FSP clarifies that when using multiple valuation techniques, an entity needs to consider the reasonableness of the range of results provided by the valuation techniques and use the point within that range that is "most representative" of fair value under current market conditions. In addition, a wide range of results provided by multiple valuation techniques may indicate that further analysis is required. Regardless of the approach taken (i.e., either a single valuation technique or multiple valuation techniques), the FSP emphasizes that the objective of fair value remains unchanged (i.e., an **exit price** notion in an orderly transaction between market participants as of the measurement date under **current** market conditions).

FSP FAS 157-4 highlights that a fair value measurement is not an entity-specific measurement but a market-based measurement.

The FSP also emphasizes that entities need to include an adequate risk adjustment in the fair value measurement, since a market participant would demand a higher return if there is uncertainty in the cash flows. However, such a risk premium must be representative of an orderly transaction under current market conditions. The FSP further highlights that a fair value measurement is not an entity-specific measurement but a market-based measurement. Thus, for example, an entity's intent to hold an asset or liability is not relevant to an estimation of fair value.

The FSP emphasizes that in identifying transactions that are not orderly, an entity cannot assume that the observable transaction price is not orderly when the volume and level of activity for the asset or liability have significantly declined. Instead, an entity must perform an analysis to determine whether the observable price is representative of a transaction that is not orderly. In making this determination, an entity cannot ignore information that is "available without undue cost and effort"; however, the entity is not required to undertake **all** possible efforts.

In addition, the FSP provides the following guidance:

- If the weight of the evidence indicates the transaction price is not representative of an orderly transaction, the entity should place "little, if any," weight on that transaction price when estimating fair value.
- If the weight of the evidence indicates the transaction price represents an orderly transaction, an entity needs to consider the transaction price as an observable input in determining fair value. The FSP highlights that the weight an entity would place on a transaction price that represents an orderly transaction depends on facts and circumstances, such as the volume of the transaction and whether the input is representative of an identical or similar transaction.
- If an entity determines that it does not have enough information to determine whether the transaction price reflects an orderly transaction, it needs to consider

that transaction price as an observable input in determining fair value. However, the transaction price may not be the "sole or primary" basis for estimating fair value and the entity may assign less weight to the transaction price.

Finally, the FSP clarifies that entities may continue to use quoted prices provided by third parties (such as brokers or pricing services) when there has been a significant decrease in the volume and level of activity for a particular item, as long as the entity has determined that the quoted price is based on current information that reflects orderly transactions or a valuation technique that reflects market participant assumptions.

As to transition, changes resulting from application of the provisions of this FSP should be accounted for as a change in estimate.

Disclosure

The FSP amends the disclosure provisions of Statement 157 to require entities to disclose in interim and annual periods the inputs and valuation technique(s) used to measure fair value. Note that this requirement was previously limited to annual periods under Statement 157. Further, if an entity changes the valuation technique or related assumptions in measuring fair value, the entity is required to qualitatively discuss the changes in valuation techniques and related assumptions in both interim and annual financial statements. The FSP also requires an entity to provide, by major categories of debt and equity securities identified in accordance with Statement 115,[6] the Statement 157 hierarchy and Level 3 rollforward disclosures.

OTTI for Debt Securities

FSP FAS 115-2 only modifies the existing OTTI model for investments in debt securities.

FSP FAS 115-2 only modifies the existing OTTI model for investments in debt securities. Note that in a change from the Exposure Draft, the FSP does not address equity securities; thus, entities with equity securities should continue to follow other OTTI guidance, including SAB Topic 5.M.[7]

Under the FSP, the primary change to the OTTI model for debt securities is the change in focus from an entity's intent and ability to hold a security until recovery. Instead, an OTTI is triggered if (1) an entity has the intent to sell the security, (2) it is more likely than not that it will be required to sell the security before recovery, or (3) it does not expect to recover the entire amortized cost basis of the security. In addition, the FSP changes the presentation of an OTTI in the income statement if the only reason for recognition is a credit loss (i.e., the entity does not expect to recover its entire amortized cost basis (see further discussion in Determination of Whether an Impairment Loss Has Occurred section below)). That is, if the entity has the intent to sell the security or it is more likely than not that it will be required to sell the security, the entire impairment (amortized cost basis over fair value) will be recognized in earnings. However, if the entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security, but the security has suffered a credit loss, the impairment charge will be separated into the credit loss component, which is recorded in earnings, and the remainder of the impairment charge, which is recorded in other comprehensive income (OCI). See the Presentation of OTTI section for a more detailed discussion.

Determination of Whether an Impairment Loss Has Occurred

The new OTTI model for debt securities can be broken down into a few steps. First, an entity must determine whether an impairment has occurred. A security is considered impaired if its fair value is less than its amortized cost basis. If a debt security is impaired, the holder must assess whether it intends to sell the security (i.e., whether a decision to sell the security has been made). If an entity intends to sell the security, an OTTI is considered to have occurred.

[6] FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

[7] SEC Staff Accounting Bulletin Topic 5.M, "Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities."

If an entity does not intend to sell the security (i.e., a decision to sell the security has not been made), it must assess whether it is more likely than not that it will be required to sell the security before recovery of the amortized cost basis of the security. For example, an entity should consider whether its cash flow and working capital requirements or contractual or regulatory obligations will require it to sell the security before recovery of its amortized cost basis. If, after considering the relevant factors, an entity determines it is more likely than not that it will be required to sell the security before recovery of the amortized cost basis, an OTTI is considered to have occurred.

Even if an entity does not intend to sell the security, an OTTI has occurred if the entity does not expect to recover the entire amortized cost basis (i.e., there is a credit loss). Under this analysis, the entity compares the present value of the cash flows expected to be collected to the amortized cost basis of the security (see further discussion in the Determination of the Amount of the OTTI Loss section below). If the present value of the cash flows expected to be collected is less than the security's amortized cost, an OTTI exists, irrespective of whether the entity will be required to sell the security.

Determination of the Amount of the OTTI Loss

If an OTTI has occurred, an entity must then determine the amount of the loss to be recorded in earnings. If the entity intends to sell the security or it is more likely than not that it will be required to sell the security, the entire impairment loss is recorded in earnings. The impairment loss is the difference between the debt security's amortized cost basis and its fair value as of the measurement date.

FSP FAS 115-2 states that one way of determining the credit loss is to consider the methodology in paragraphs 12–16 of Statement 114.

In contrast, if the entity (1) **does not** intend to sell the security and it **is not** more likely than not that it will be required to sell the security and (2) **does not** expect to recover the amortized cost basis of the security, the impairment loss is separated into the amount representing the credit loss and the amount related to other factors. The amount of the impairment loss representing the credit loss is recognized in earnings and the amount due to other factors is recognized in OCI. See the Presentation of OTTI section for a more detailed discussion.

So how does one determine the amount of the credit loss? The FSP states that one way of determining the credit loss is to consider the methodology in paragraphs 12–16 of Statement 114.[8] That is, the entity would discount the expected cash flows of the security by using the effective interest rate of the security as of the date it was acquired. The FSP also notes that for beneficial interests in securitized financial assets within the scope of Issue 99-20,[9] an entity applies the guidance in paragraph 12(b) of Issue 99-20 to determine the present value of the expected cash flows to be collected. That is, the entity would discount the estimated cash flows at a rate equal to the current yield used to accrete the beneficial interest.

Presentation of OTTI

If an OTTI has occurred, the entire OTTI is presented in an entity's income statement. As noted above, if the entity recognizes an OTTI on a debt security because it intends to sell the security or it is more likely than not that it will be required to sell the security before recovery, the whole impairment is presented in earnings and no amount (i.e., not even any amount due to other than credit) is reclassified to OCI. However, if, as discussed above, an entity recognizes an OTTI only because of a credit loss (i.e., the entity does not intend to sell the security and it is not more likely than not that it will be required to sell

[8] FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* — an amendment of FASB Statements No. 5 and 15.

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

the security), the amount of the impairment loss related to other factors is reclassified to OCI. The following is a sample presentation in an entity's income statement of an OTTI loss triggered solely by a credit loss:

Total other-than-temporary impairment losses on securities	$ 10,000
Portion of loss recognized in other comprehensive income	(7,000)
Net impairment losses recognized in earnings	$ 3,000

Note that the requirement to present the noncredit portion of the loss in OCI also applies to held-to-maturity (HTM) debt securities. An entity should also be mindful that when presenting the components of accumulated other comprehensive income (AOCI), it must separately present the amount of impairment losses of debt securities related to other factors. That is, the portion of the impairment loss reclassified to OCI is presented apart from unrealized gains and losses on available-for-sale (AFS) debt securities.

Subsequent Accounting for Debt Securities After an OTTI

For AFS debt securities, any subsequent unrealized changes in the fair value of the security (other than further OTTIs) is recorded in OCI. For HTM debt securities, the amount of OTTI recorded in OCI for the noncredit portion of a previous OTTI should be amortized prospectively over the remaining life of the security on the basis of the timing of future estimated cash flows of the security. That is, a portion of the OTTI recorded in OCI will be amortized out of OCI and will increase the carrying value of the asset until the security matures or is sold or a subsequent OTTI is recognized in earnings.

Transition: Cumulative-Effect Adjustment Upon Initial Adoption

FSP FAS 115-2 amends the disclosure provisions of Statement 115 for both debt and equity securities.

FSP FAS 115-2 requires entities to initially apply the provisions of the standard to previously other-than-temporarily impaired debt securities (i.e., debt securities that the entity does not intend to sell and that the entity is not more likely than not required to sell before recovery), existing as of the date of initial adoption, by making a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. The cumulative-effect adjustment reclassifies the noncredit portion of a previously other-than-temporarily impaired debt security held as of the date of initial adoption from retained earnings to AOCI.

Disclosure

The FSP amends the disclosure provisions of Statement 115 for both **debt** and **equity** securities. The FSP requires disclosures in interim and annual periods for major security types identified on the basis of how an entity manages, monitors, and measures its securities and the nature and risks of the security. Financial institutions[10] should include various major types of securities, such as equity securities (segregated by industry type, company size, or investment objective), debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies, corporate debt securities, residential mortgage-backed securities, collateralized debt obligations, and other debt obligations. Entities should disclose the amortized cost basis by major security type for AFS and HTM securities.

In addition, for periods in which an entity recognizes an OTTI of a debt security and only the credit loss portion is recognized in earnings, the entity must disclose, for each major security type, the method and significant inputs used to measure the amount related to the credit loss. The entity shall also include a tabular rollforward for interim and annual reporting periods that discloses the amount related to credit losses for debt securities held with a portion of OTTI recognized in OCI. The tabular rollforward includes, at a minimum, the beginning balance of the OTTI amount related to credit losses previously recognized in earnings for debt securities held as of the beginning of the period, any additions and reductions (e.g., sales of debt securities, recognition of OTTI amount recorded because an entity now has the intention to sell a debt security), and the ending balance of credit

[10] Financial Institutions as defined in paragraph 39 of FSP FAS 115-2.

losses recognized in earnings on debt securities that continue to be held at the end of the period.

Interim Disclosures of Fair Values

FSP FAS 107-1 expands the fair value disclosures required for all financial instruments within the scope of Statement 107[11] to interim periods for publicly traded entities. The FSP also requires entities to disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments in financial statements on an interim basis and to highlight any changes of the methods and significant assumptions from prior periods. It does not require interim disclosures of credit or market risks also discussed in Statement 107.

Effective Dates

All three FSPs are effective for interim and annual periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. However, FSP FAS 157-4 and FSP FAS 115-2 must be adopted concurrently. Therefore, an entity that early adopts FSP FAS 157-4 (for periods ending after March 15, 2009) must also early adopt FSP FAS 115-2, and vice versa. An entity that chooses to early adopt FSP FAS 107-1 (for periods ending after March 15, 2009) must also early adopt the other two FSPs.

FASB's Recent Fair Value Guidance — What's the Impact?

Deloitte will host a 90-minute webcast on Friday, April 24, at 2:00 p.m. (EDT) on the FSPs. This special webcast will focus on (1) the changes resulting from the FSPs, (2) when the changes will become effective, and (3) how the recent FASB actions on fair value may affect organizations. Registration will be available soon on the Dbriefs Web site.

[11] FASB Statement No. 107, *Disclosures About Fair Value of Financial Instruments.*

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