

On March 12, 2009, Congress asked FASB to review current US GAAP accounting rules, specifically “mark-to-market” and “other-than-temporary impairment” rules, and make necessary changes to better align the accounting and economics of financial assets associated with inactive markets to provide investors with information necessary to make more informed decisions.

Congress recognized the strict application of existing GAAP rules in the current environment was, in too many instances, distorting rather than clarifying, the financial picture of participants in the financial services industry. They asked FASB to quickly review and modify existing rules to ensure they are interpreted and applied in a manner that better conforms the accounting and economics of the affected financial instruments while considering the currently dysfunctional state of some markets. On March 17, 2009, FASB issued draft proposals concerning the determination of when a market is inactive and transactions are distressed (i.e., Proposed FSP FAS 157-e) and the recognition and presentation of other-than-temporary impairments (OTTI); that is, Proposed FSP FAS 115-a, FAS 124-a, and EITF 99-20-b. While not perfect, reporting entities believed the Proposed FSP’s, with relatively minor modifications, could meet the objectives set by Congress.

On April 2, 2009, FASB approved dissemination of two Final FSP’s (i.e., FSP FAS 157-4 and FSP FAS 115-2 and FAS 124-2). Discussion at the Board meeting concerning confirmation of the measurement objective (i.e., exit value at the reporting date under current market conditions) indicated that substantial changes to the Final FSP would be likely. In contrast, the Board discussion of the recognition and presentation of OTTI suggested modifications to the Final FSP would be less significant, except in the area of disclosure.

On April 9, 2009, the FASB approved the release of three final FSP’s (FAS 157-4, FAS 115-2 and FAS 124-2, and FAS 107-1). FSP FAS 157-4 represented an about face as compared to Proposed FSP FAS 157-e and, in the opinion of reporting entities, was a setback to the achievement of the key goals established during the March 12, 2009 Congressional hearing. Similarly, FSP 115-2 introduced concepts and interpretations not previously discussed into the final FSP that may prove problematic in their application despite a significant improvement in the recognition of credit losses in the earnings statement and non-credit related losses in other comprehensive income (OCI).

Many reporting entities have taken time to thoroughly review and understand the final FSPs released on April 9, 2009 and believe it is important for you to know and understand some of the significant concerns/issues that remain after the dissemination of the FSPs.

- ⇒ **FSP 157-4 does not materially change the measurement of fair value in situations where markets that were previously active become inactive.**
- FSP 157-4 reaffirms that regardless of whether a market is active or inactive, the fair value measurement objective is an “exit price”—*even* in inactive markets.
  - When markets are inactive, exit price is commonly a last transaction or liquidation price which we believe overstates losses in situations where assets continue to perform and there is a low level of likelihood that losses of contractual principal will occur.
  - FSP 157-4 identifies four circumstances that a reporting entity shall evaluate to determine whether a transaction is not orderly. We believe the circumstances enumerated are overly restrictive and not effective in identifying disorderly transactions.
  - The changes in FSP 157-4, while they do not respond to the issues identified by Congress or reporting entities, as evidenced by comments from early adopters, will substantially increase the cost of compliance associated with applying the new guidance to produce substantially the same result.

Solution:

- In paragraph 2 of the FSP, amend the end of the second sentence to read “between market participants *in a functioning or active market.*” Amend the end of the second sentence in paragraph 15 to read “between market participants *in a functioning or active market.*”
- In paragraph 12 of the FSP, amend example “e” to remove “implied liquidity risk premiums.”
- The SEC or FASB should reconsider the “exit price” objective and, when a market has been determined to be “inactive,” allow for other observable and non-observable inputs in valuations of assets.

⇒ **FSP FAS 115-2 and FAS 124-2, paragraph 25 provides examples that “shall be considered” by reporting entities and auditors when “estimating if a credit loss exists.” Many of the factors listed have no relevance to credit losses, but rather, are more reflective of the period over which the debt security is expected to recover.**

- While some of the factors listed in paragraph 25 are relevant in estimating quantitative credit losses, other factors are reflective of determining the period over which the debt security is expected to recover or other non-credit risk related factors. As issued, the FSP may create confusion among filers and auditors regarding which factors relate specifically to the estimation of credit losses and which relate to the recovery period. The issued FSP may create operational problems resulting in greater “non-credit” related losses being recognized by companies through their earnings rather than OCI.

Solution:

- In paragraph 8, change the third sentence as follows: “The Board intends the term *cash flows expected to be collected* should represent the cash flows that the entity is likely to collect after a careful assessment of all available information, including the **issues** described in paragraphs **23, 25 and 26** of this FSP.” Paragraph 25 should be changed to identify which factors are to be considered in the credit loss analysis and which are to be considered in estimation of the recovery period.

⇒ **FASB voted on and approved the proposed FSPs on April 2, 2009. Significant changes that were neither concepts approved by the Board in the April 2, 2009 Board meeting nor reflective of a majority of comment letters sent in by preparers of financial statements were made to the final FSPs released on April 9, 2009. The changes merit re-exposure of the final FSPs for comments.**

- Significant changes were made to the FSP’s subsequent to the dissemination of the original proposals, including the deletion of a presumption of distressed transactions in an inactive market. While some of these alterations were discussed at the April 2, 2009 meeting, they were not circulated for comment, despite the fact that they dramatically changed the FSP’s and were not representative of a majority of comment letters submitted by preparers. By not circulating these significant changes for public comment, an opportunity was missed to allow reporting entities to express concerns and indicate challenges in complying with the new rules.

Solution:

- Without delaying implementation of the FSPs, FASB should reopen for comment the final FSPs for 15 days and consider changes that not only provide for financial reporting that more accurately presents the financial conditions of companies and

performance of assets, but that also is less burdensome and operationally more feasible for reporting entities.

⇒ **The Final FSP, FAS-115-2, is effective for the interim and annual reporting periods ending after June 15, 2009. Early adoption is permitted for periods ending after March 15, 2009. The FSP is to be applied to existing and new investments held as of the beginning of the interim period in which it is adopted; April 1, 2009 if the FSP is adopted for periods ending after June 15, 2009.**

The issues/concerns with the aforementioned are

- Comparability between reporting entities that early adopt and those that do not early adopt the FSP. That is, reporting entities who choose not to early adopt the FSP will have OTTI's recognized and presented on two different bases in a single set of financial statements in the year of adopting the FSP. (*New accounting standards are typically applied at the beginning of the annual period and not the beginning of an interim period other than the first interim period in an annual period*).
- For debt securities held at the beginning of the interim period of adoption for which an OTTI was previously recognized, if the reporting entity does not intend to sell and it is more likely than not that the entity will not be required to sell the security before recovery of its amortized costs basis, the reporting entity will recognize the cumulative effect of initially applying the FSP as an adjustment to opening retained earnings with a corresponding adjustment to accumulated other comprehensive income.

Solution:

- The FSP should be modified to permit second quarter adopters to take the cumulative adjustment effective as of the beginning of the fiscal year. Since this only affects second quarter adopters, it can be part of the recommendations made to the FASB in May by the staff as part of its review of the balance of the comment letters and feedback from first quarter adopters.