

**Notice for Recipients of
This Proposed FASB Staff Position**

This proposed FASB Staff Position (FSP) would amend FASB Statement No. 157, *Fair Value Measurements*, to clarify its application in an inactive market by providing an illustrative example to demonstrate how the fair value of a financial asset is determined when the market for that financial asset is inactive. Application issues addressed by the proposed FSP include:

- a. How management's internal assumptions (that is, expected cash flows and appropriately risk-adjusted discount rates) should be considered when measuring fair value when relevant observable data do not exist
- b. How observable market information in a market that is not active should be considered when measuring fair value
- c. How the use of market quotes (for example, broker quotes or pricing services for the same or similar financial assets) should be considered when assessing the relevance of observable and unobservable data available to measure fair value.

The Board invites individuals and organizations to send written comments on all matters in this proposed FSP. Comments are requested from those who agree with the provisions of this proposed FSP as well as from those who do not. Comments are most helpful if they identify the issues to which they relate and clearly explain the issue or question. Those who disagree with provisions of this proposed FSP are asked to describe their suggested alternatives, supported by specific reasoning.

Responses must be received in writing by October 9, 2008. Interested parties should submit their comments by email to director@fasb.org, File Reference: Proposed FSP FAS 157-d. Those without email may send their comments to "Russell G. Golden, FASB Technical Director, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116, File Reference: Proposed FSP FAS 157-d." Responses should not be sent by fax.

All comments received by the FASB are considered public information. Those comments will be posted to the FASB's website and included as part of the public record with other project materials.

PROPOSED FASB STAFF POSITION

No. FAS 157-d

Title: Determining the Fair Value of a Financial Asset in a Market That Is Not Active

Comment Deadline: October 9, 2008

Objective

1. This FASB Staff Position (FSP) clarifies the application of FASB Statement No. 157, *Fair Value Measurements*, in an inactive market and provides an illustrative example to demonstrate how the fair value of a financial asset is determined when the market for that financial asset is inactive.

Background

2. Statement 157 was issued in September 2006, and is effective for financial assets and financial liabilities for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early application was encouraged. FSP FAS 157-2, *Effective Date of FASB Statement No. 157*, amended Statement 157 to delay the effective date of Statement 157 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years.

3. Statement 157 establishes a single definition of fair value and a framework for measuring fair value in generally accepted accounting principles (GAAP) that result in increased consistency and comparability in fair value measurements. Statement 157 also expands disclosures about fair value measurements, thereby improving the quality of information provided to users of financial statements. Statement 157 does not require any new fair value measurements.

4. The FASB staff has obtained extensive input from various constituents, including financial statement users, preparers, and auditors, on determining fair value in accordance

with Statement 157. Many of those constituents have indicated that the fair value measurement framework in Statement 157 and related disclosures have improved the quality and transparency of financial information.

5. However, certain constituents have expressed concerns that Statement 157 does not provide sufficient guidance on how to determine the fair value of financial assets in markets that are not active. Application issues include:

- a. How management's internal assumptions (that is, expected cash flows and appropriately risk-adjusted discount rates) should be considered when measuring fair value when relevant observable data do not exist
- b. How observable market information in a market that is not active should be considered when measuring fair value
- c. How the use of market quotes (for example, broker quotes or pricing services for the same or similar financial assets) should be considered when assessing the relevance of observable and unobservable data available to measure fair value.

6. The Office of the Chief Accountant of the Securities and Exchange Commission and the FASB staff jointly issued a press release on September 30, 2008, that addresses similar Statement 157 application issues. That press release provides financial statement users, preparers, and auditors with additional guidance useful in dealing with those issues. The guidance included in this FSP is consistent with and amplifies the guidance contained in that press release.

<p>All paragraphs in this FSP have equal authority. Paragraphs in bold set out the main principles.</p>

FASB Staff Position

Scope

7. **This FSP applies to financial assets within the scope of Statement 157 for which other accounting pronouncements require or permit fair value measurements.**

Amendment to Statement 157

8. This FSP clarifies the application of Statement 157 in an inactive market and provides an illustrative example to demonstrate how the fair value of a financial asset is determined when the market for that financial asset is not active.

9. Key existing principles of Statement 157 illustrated in the example include:

- a. A fair value measurement represents the price at which a transaction would occur between market participants at the measurement date. As discussed in paragraph 30 of Statement 157, in situations in which there is little, if any, market activity for an asset at the measurement date, the fair value measurement objective remains the same; that is, the price that would be received by the holder of the financial asset in an orderly transaction that is not a forced liquidation or distress sale at the measurement date.¹
- b. In determining fair value for a financial asset, the use of management's internal assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable market data do not exist. Statement 157 discusses a range of information and valuation techniques that a reporting entity might use to estimate fair value when relevant observable market data are unavailable.² In some cases an entity may determine that observable market data (Level 2) require significant adjustment based on unobservable data and thus would be considered a Level 3 fair value measurement. Regardless of the valuation technique, an entity must include appropriate risk adjustments that market participants would make for nonperformance and liquidity risks.
- c. Broker quotes may be an input when measuring fair value, but they are not necessarily determinative if an active market does not exist for the financial asset. In a liquid market, a broker quote should reflect market information from actual transactions. However, when markets are less active, brokers may rely more on models with inputs based on the information available only to the broker. In weighing a broker quote as an input to fair value, an entity should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighing the available evidence.

10. For recurring fair value measurements using significant unobservable inputs (Level 3), paragraph 32 of Statement 157 requires an entity to reconcile the beginning and ending balances, including separately presenting changes that occurred during the period

¹See paragraph 7 of Statement 157.

²Paragraph B6 of Statement 157 describes two present value techniques for determining fair value. The present value techniques differ in how they adjust for risk and in the type of cash flows they use.

that are attributable to transfers in and/or out of Level 3. For nonrecurring fair value measurements using significant unobservable inputs (Level 3), paragraph 33 of Statement 157 requires an entity to disclose a description of the inputs and the information used to develop those inputs. The staff strongly encourages a similar disclosure for recurring fair value measurements affected by this FSP.

11. Statement 157 is amended as follows: [Added text is underlined.]

a. Paragraphs A32A–A32F and the heading preceding them are added as follows:

Example 11—Determining Fair Value in a Market That Is Not Active

Note: The conclusions reached in this example are based on the assumed facts and circumstances presented. Other approaches to determining fair value may be appropriate.

A32A. On January 1, 2008, Entity A invests in a BBB-rated tranche of a collateralized debt obligation security. The underlying collateral for the collateralized debt obligation security is unguaranteed nonconforming residential mortgage loans. Prior to June 30, 2008, Entity A was able to determine the fair value of the collateralized debt obligation security using a market approach valuation technique based on either (a) quoted prices in active markets for identical collateralized debt obligation securities without any adjustment (Level 1) or (b) quoted prices in active markets for similar collateralized debt obligation securities with insignificant adjustments for differences between the collateralized debt obligation security that Entity A holds and the similar collateralized debt obligation securities (Level 2).

A32B. Since June 30, 2008, the market for collateralized debt obligation securities has become increasingly inactive. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which collateralized debt obligation securities trade and then by a significant decrease in the volume of trades relative to historical levels as well as other relevant factors. At September 30, 2008 (the measurement date), Entity A determined that the market for its collateralized debt obligation security is inactive and that markets for similar collateralized debt obligation securities (such as higher-rated tranches within the same collateralized debt obligation security vehicle) also are inactive. That determination was made considering that there are few observable transactions for the collateralized debt obligation security or similar collateralized debt obligation securities, the prices for transactions that have occurred are not current, and the observable prices for those transactions—to the extent they exist—vary substantially either over time or among market makers, thus reducing the potential usefulness of those observations. Consequently, while Entity A appropriately considers those observable inputs,

ultimately, Entity A's collateralized debt obligation security will be classified within Level 3 of the fair value hierarchy because significant adjustments are required to determine fair value at the measurement date.

A32C. Entity A determines that an income approach (present value technique) that maximizes the use of observable inputs and minimizes the use of unobservable inputs will be equally or more representative of fair value than the market approach used at prior measurement dates. Specifically, Entity A uses the discount rate adjustment technique described in Appendix B of Statement 157 to determine an indication of fair value.

A32D. Entity A determines that the appropriate discount rate^{21a} used to discount the contractual cash flows of its collateralized debt obligation security is 22 percent after considering the following:

- The implied rate of return at the last date on which the market was considered active for the collateralized debt obligation security was 15 percent. Based on an analysis of available market data for mortgage-related debt securities, Entity A determines that market rates of return generally have increased in the marketplace since the last date on which the market was considered active for the collateralized debt obligation security. Entity A determines that credit spreads have widened (100 basis points) and liquidity risk premiums have increased during that period (400 basis points). Other risks (for example, interest rate risk) have not changed. Thus, Entity A estimates that an appropriate rate of return is 20 percent. In making that determination, Entity A considered all available market information that could be obtained without undue cost and effort. For this collateralized debt obligation security, the available market information used in assessing the risks in the security (including nonperformance risk [for example, default risk and collateral value risk] and liquidity risk) included (a) quoted prices that are not current that represent orderly transactions for the same or similar collateralized debt obligation securities, (b) relevant reports issued by analysts and ratings agencies, (c) any directional movements in relevant indexes, for example, interest rate and credit risk indexes, and (d) other relevant market data.
- Indicative quotes (that is, nonbinding quotes) for the collateralized debt obligation security from brokers or independent pricing services based on proprietary pricing models (that is, Level 3 inputs) imply a rate of return of 25 percent.

A32E. Because Entity A has two indications of the appropriate rate of return that it determines market participants would consider relevant in estimating fair value, it evaluates and weighs, as appropriate, the respective indications of the appropriate rate of return, considering the reasonableness of the range indicated by the results. Entity A concludes that 22 percent is the point within the range that is most representative of fair value in the circumstances. Entity A's

conclusion is based in part on the fact that the relative indications of the appropriate rate of return are reasonable in relation to each other given the nature of the asset and current market conditions.

A32F. In accordance with the requirements of Statement 157, Entity A has determined that the risk-adjusted discount rate appropriately reflects the reporting entity's best estimate of the assumptions that market participants would use in pricing the asset in a current transaction to sell the asset at the measurement date. Risks include nonperformance risk (that is, default risk and collateral value risk) and liquidity risk (that is, the compensation that a market participant receives for buying an asset that is difficult to sell under current market conditions).

^{21a}See paragraphs B7–B11 of Statement 157.

Effective Date and Transition

12. This FSP shall be effective upon issuance, including prior periods for which financial statements have not been issued. Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate (FASB Statement No. 154, *Accounting Changes and Error Corrections*, paragraph 19). The disclosure provisions of Statement 154 for a change in accounting estimate are not required for revisions resulting from a change in valuation technique or its application.

The provisions of this FSP need not be applied to immaterial items.
