



Financial Accounting Standards Board

Board Meeting Handout¹

Proposed FSP FAS 157-x, *Determining Whether a Market is Not Active and a Transaction is*

Not Distressed

March 16, 2009

PURPOSE OF MEETING

1. The staff seeks a decision from the Board regarding whether to issue an FSP to provide application guidance to assist practitioners in determining whether (1) a market for an asset or a liability is not active and (2) a transaction is not distressed.

BACKGROUND

2. FASB Statement No. 157, *Fair Value Measurements*, was issued in September 2006. Statement 157 establishes a single definition of fair value and a framework for measuring fair value in generally accepted accounting principles (GAAP) to promote increased consistency and comparability in fair value measurements. The Statement also expands disclosures about fair value measurements, improving the quality of information provided to users of financial statements.
3. In light of the current economic crisis, many constituents have requested additional authoritative guidance related to the application of Statement 157. Some constituents believe that the fair value hierarchy within Statement 157 creates a bias to use an

¹ The staff prepares Board meeting handouts to facilitate the audience's understanding of the issues to be addressed at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

observable market transaction even when that transaction may be “distressed” or the market for that transaction may not be active. Constituents have indicated that this emphasis on the use of the so-called “last transaction price” as the sole or primary basis of fair value even when significant adjustments may be required to the transaction price or when other valuation techniques should be considered, has resulted in the significant write downs in asset values that are not grounded in economic reality.

4. On October 3, 2008, the Emergency Economic Stabilization Act of 2008 was signed into law. Section 133 of the Act mandated that the SEC conduct a study on mark-to-market accounting standards. One of the recommendations in the study stated that “additional measures should be taken to improve the application and practice related to existing fair value requirements (particularly as they relate to both Level 2 and Level 3 estimates).” This recommendation further notes that “Fair value requirements should be improved through development of application and best practices guidance for determining fair value in illiquid or inactive markets.” The SEC Staff’s suggestions for additional guidance included (1) How to determine when markets become inactive; and (2) How to determine if a transaction or group of transactions is forced or distressed.
5. At the FASB’s meeting on February 5, 2009 with the Valuation Resource Group, VRG members provided the Board with their views on practice issues related to active and inactive markets and distressed transactions. VRG members agreed that additional guidance in both areas is warranted. With respect to distressed transactions, members noted that the current bias is that a transaction price is not distressed unless the reporting entity has evidence that it is distressed. Due to the lack of transparency in many

transactions, VRG members stated that it is difficult to obtain evidence that a transaction is not distressed.

6. The FASB issued FSP FAS 157-3 “Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active” on October 10, 2008. The primary intent of the FSP was to reinforce the existing principles in Statement 157 and emphasize that those principles allow an entity to use its own assumptions when relevant observable inputs are not available.
7. Some constituents have indicated that FSP FAS 157-3 provides useful application guidance, since it permits entities to exercise professional judgment and utilize an entity’s own assumptions when relevant observable inputs are not available. Other constituents have indicated that while judgment is permitted the end result is no different than using the last transaction price, which may have been a distressed transaction. This is because the FSP indicates that market participant liquidity risk must be considered. They point out that many have interpreted that to mean that entities must use the liquidity risk implied in the last transaction price, since it is argued that there is no better indicator of market participant liquidity risk. These constituents would like better guidance on how to include a liquidity risk premium in a fair value measurement.
8. At the February 18, 2009 Board meeting the Chairman announced that he added a project to the Board’s agenda to develop additional application guidance to address concerns raised by constituents regarding active and inactive markets and distressed transactions.

OBJECTIVE OF THE PROPOSED GUIDANCE

9. The objective of the proposed FSP 157-x is to provide additional guidance to aid practitioners in determining whether a market is not active and a transaction is not distressed. The staff has developed a two-step model to address these issues.

PROPOSED MODEL

10. When evaluating whether it is necessary to make a significant adjustment to quoted prices for identical or similar assets or liabilities in markets that are not active, reporting entities shall apply the following two-step approach (this approach requires significant judgment):

Step 1: Determine whether there are factors present that indicate that the market for the asset is not active at the measurement date. Factors include:

- a. Few recent transactions (based on volume and level of activity in the market).
Thus, there is not sufficient frequency and volume to provide pricing information on an ongoing basis.
- b. Price quotations are not based on current information.
- c. Price quotations vary substantially either over time or among market makers (for example, some brokered markets).
- d. Indices that previously were highly correlated with the fair values of the asset are demonstrably uncorrelated with recent fair values.

- e. Abnormal (or significant increases in) liquidity risk premiums or implied yields for quoted prices when compared to reasonable estimates of credit and other nonperformance risk for the asset class.
- f. Significant widening of the bid-ask spread.
- g. Little information is released publicly (for example, a principal-to-principal market).

If after evaluating all the factors the sum of the evidence indicates that the market is not active, the reporting entity shall apply step 2.

Step 2: Evaluate the quoted price (that is, a recent transaction or broker price quotation) to determine whether the quoted price is not associated with a distressed transaction. The reporting entity shall presume that the quoted price is associated with a distressed transaction unless the reporting entity has evidence that indicates that both of the following factors are present for a given quoted price:

- a. There was a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities (for example, there was not a regulatory requirement to sell).
 - b. There were multiple bidders for the asset.
11. If the reporting entity has evidence that both of the factors are present for a given quoted price, then that quoted price is presumed not to be associated with a distressed transaction. In that case, the quoted price may be a relevant observable input that shall be considered in estimating fair value. However, the reporting entity should consider

whether any other factors or conditions warrant making an adjustment to the quoted price (see paragraph 29). For example, if a quoted price that is not associated with a distressed transaction is not current or is a consequence of a trade with an insignificant volume relative to the total market for that asset, the reporting entity should consider whether that quoted price is a relevant observable input (that is, whether the quoted price requires adjustment).

12. If the reporting entity does not have evidence that both of these factors are present for a given quoted price (including because there is insufficient information on which to base a conclusion), then the reporting entity shall consider the quoted price to be associated with a distressed transaction and shall use a valuation technique other than one that uses the quoted price without significant adjustment (that is, a significant adjustment is required, resulting in a Level 3 measurement). For example, the reporting entity could use an income approach (that is, a present value technique) to estimate fair value. However, the fair value resulting from the present value technique shall not be derived solely from inputs based on the quoted price associated with a distressed transaction. The inputs should be reflective of an orderly (that is, not distressed or forced) transaction between market participants at the measurement date. An orderly transaction would reflect all risks inherent in the asset, including a reasonable profit margin for bearing uncertainty that would be considered by market participants (that is, willing buyers and willing sellers) in pricing the asset in a non-distressed transaction.

TRANSITION AND EFFECTIVE DATE

13. The staff proposes prospective transition. Changes in fair value resulting from the application of the FSP are considered changes in estimate and affect results in the period of adoption. The staff believes there are two effective date alternatives:

- a. Effective for interim and annual periods ending after March 15, 2009.
- b. Effective for interim and annual periods ending after June 15, 2009. Early adoption would be permitted.

14. The staff recommends that a final FSP be effective for interim and annual periods ending after March 15, 2009.

COMMENT PERIOD

15. The staff recommends a comment period of 15 days ending April 1 so that the Board can finalize the proposed FSP at its Board meeting on April 2.

QUESTIONS FOR THE BOARD

16. The staff has the following questions for the Board to be addressed at this meeting:

- 1) Does the Board agree with the factors that indicate that a market is not active and the principle for concluding on whether the market is not active?
- 2) Does the Board agree with the staff's proposed model for determining whether a transaction is not distressed and the fair value measurement guidance when the transaction is not distressed?

- 3) Does the Board agree with the staff's proposed fair value measurement guidance when the reporting entity does not have evidence to support the transaction is not distressed?
- 4) Does the Board agree with the staff's recommendation on the proposed transition and effective date?
- 5) Does the Board agree with the staff's recommendation on the proposed comment period?
- 6) Does the Board give the staff permission to ballot a proposed FSP for public comment?



Board Meeting Handout

OTHER-THAN-TEMPORARY IMPAIRMENTS

March 16, 2009

PURPOSE

1. At the March 16, 2009 Board meeting, the Board will discuss proposed changes to the guidance for other-than-temporary impairments.

BACKGROUND

2. On October 3, 2008, the Emergency Economic Stabilization Act of 2008 (EESA) was signed into law. Section 133 of the EESA mandated that the U.S. Securities and Exchange Commission (SEC) conduct a study on mark-to-market accounting standards. The SEC submitted its study to Congress on December 30, 2008. One of the recommendations in the study was that the FASB reassess current impairment accounting models for financial instruments. The SEC recommended that the FASB “evaluate the need for modifications (or the elimination) of current other-than-temporary impairment guidance to provide for a more uniform system of impairment testing standards for financial instruments.”
3. On January 12, 2009, FASB Staff Position (FSP) No. EITF 99-20-1, *Amendments to the Impairment Guidance of EITF Issue No. 99-20*, was issued to achieve more consistency between FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and 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,” in the accounting for other-than-temporary impairments. However, constituents continue to express concerns that the requirements for measurement and recognition of impairment losses are different for loans than for investments in debt securities and that financial statements do not provide users with information about an entity’s credit losses. Constituents have also expressed concerns that it is extremely difficult for entities to assess the likelihood a security will recover in value and

to make a positive assertion that it has the intent and ability to hold the investment long enough for it to recover.

PROPOSALS FOR THE BOARD'S CONSIDERATION

Issue 1: Potential Approaches to Address Other-Than-Temporary Impairments

Approach A

4. Approach A would only apply to debt securities. Under Approach A, the reporting entity would separately report on the face of the statement of earnings (or statement of activities for not-for-profit entities) other-than-temporary-impairments recorded during the reporting period related to debt securities reported under Statement 115 or FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*. An other-than-temporary impairment would continue to be measured as the difference between the fair value and the cost basis of the security. The amount reported on the face of the statement of earnings would be separated into two components:
 - (1) The amount of the total impairment charge related to credit losses. One way of estimating that amount would be to consider the measurement methodology described in FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*.
 - (2) The amount of the total impairment charge related to all other factors. This amount is the total impairment charge reported during the reporting period less the amount related to credit losses (as described in (1) above).
5. For debt securities reported under Issue 99-20, the methodology described above for securities reported under Statement 115 or Statement 124 would be applied, except that the amount of the total impairment charge related to credit losses would be estimated in accordance with Issue 99-20.
6. This approach represents a change in the presentation of an other-than-temporary impairment and not a change to the method for determining when an other-than-temporary impairment exists, the measurement of the total impairment, or the subsequent accounting for such an impairment.

Approach B

7. Approach B would only apply to debt securities. Under Approach B, the reporting entity would continue to apply existing U.S. GAAP to determine and measure other-than-temporary impairment losses for debt securities accounted for in accordance with Statement 115, Issue 99-20, and Statement 124—that is, an other-than-temporary impairment would be measured as the difference between the fair value and the cost basis of the security. However, when an other-than-temporary impairment is identified and measured, the entire impairment loss would not be recognized in earnings. Only the amount of the total impairment charge related to credit losses as previously described in Approach A would be recognized in earnings. The remainder of the impairment loss would be recognized as part of other comprehensive income (or would be excluded from an operating measure within the statement of activities for not-for-profit entities). Under Approach B, a reporting entity would be required to separately present the total amount of the impairment loss in the statement of earnings and present the amount recognized in other comprehensive income as a deduction from the total impairment loss.
8. Under Approach B, once an entity determines that it has an other-than-temporary impairment, the entity's intent and ability to hold the security until recovery is not considered in determining the portion of the impairment to be recorded in earnings versus other comprehensive income. Therefore, if the only reason for an other-than-temporary impairment of a debt security is that the entity does not have the intent and ability to hold the security until recovery (that is, there is no credit loss), the entire impairment would be recognized in other comprehensive income. However, because the entity determined that there was an other-than-temporary impairment, that amount would be required to be displayed as part of the total impairment loss on the face of the statement of earnings and deducted as a non-credit loss.
9. For available-for-sale securities, the portion of the impairment that does not relate to credit losses would continue to be accounted for as an unrealized loss in other comprehensive income and the disclosures required by FSP FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, would apply.

Subsequent changes in the fair value of an available-for-sale security for which a portion of the other-than-temporary impairment loss was recognized in other comprehensive income would be reflected in other comprehensive income as unrealized gains or losses unless there is an indication of additional credit losses or the security is sold. However, reversal of the impairment recorded in earnings related to credit losses would not be permitted.

10. This approach would result in a new category within other comprehensive income for the portion of the other-than-temporary impairment that is not related to credit losses for held-to-maturity securities. The impairment recognized in other comprehensive income would be amortized over the remaining life of the debt security in a prospective manner based on the amount and timing of future estimated cash flows unless there is an indication of additional credit losses. That amortization would be recognized in other comprehensive income with an offset to the asset and would not affect earnings.

Approach B1

11. Approach B1 would only apply to debt securities. Approach B1 is the same as Approach B except that Approach B1 requires a continued assertion that the entity has the intent and ability to hold the security to recovery for the portion of the loss recorded in other comprehensive income. If the reporting entity is not able to assert it has the intent and ability to hold the security to recovery (at the date of the other-than-temporary impairment or at a later date), the entire other-than-temporary impairment would be recognized in earnings.
12. Under Approach B1, subsequent changes in the fair value of an available-for-sale security for which a portion of the other-than-temporary impairment loss was recognized in other comprehensive income would be reflected in other comprehensive income as unrealized gains or losses unless there is an indication of additional credit losses, the entity can no longer assert that it has the intent and ability to hold the security to recovery, or the security is sold.
13. Approach B1 is the same as Approach B for held-to-maturity debt securities.

Approach B2

14. Approach B2 would only apply to debt securities. Approach B2 is similar to Approach B1, except that Approach B2 would require an entity to recognize the non-credit portion of an other-than-temporary impairment in other comprehensive income even if it cannot assert intent and ability to hold to recovery if it is able to assert that it has the intent and ability to hold the security for the foreseeable future.
15. Under Approach B2, subsequent changes in the fair value of an available-for-sale security for which a portion of the other-than-temporary impairment loss was recognized in other comprehensive income would be reflected in other comprehensive income as unrealized gains or losses unless there is an indication of additional credit losses, the entity can no longer assert that it has the intent and ability to hold the security for the foreseeable future, or the security is sold.
16. Approach B2 is the same as Approach B for held-to-maturity debt securities.

Approach C

17. Approach C would apply to both debt and equity securities. Approach C would change the method for determining whether an other-than-temporary impairment exists. Instead of assessing whether an entity has the ability and intent to hold a security to recovery, the entity would be required to assess whether it intends to sell the security or whether it is more-likely-than-not that it will be required to sell the security prior to recovery of its cost basis. If the entity intends to sell the security or it is more-likely-than-not that the entity will be required to sell the security prior to recovery of its cost basis, the entire impairment would be recognized as an other-than-temporary impairment in earnings, regardless of the amount of the impairment that relates to credit losses (for a debt security). If the entity does not intend to sell the security and it is not likely that the entity will be required to sell the security prior to recovery, the security would not be considered other than temporarily impaired unless there are credit losses associated with the debt security. If such credit losses exist, only the amount of the total impairment charge related to credit losses would be recognized in earnings. The remainder of the impairment would be recognized as part of other

comprehensive income. Other aspects of determining whether a security is other than temporarily impaired would remain unchanged.

18. Under Approach C, subsequent changes in the fair value of an available-for-sale security for which a portion of the other-than-temporary impairment loss was recognized in other comprehensive income would be reflected in other comprehensive income as unrealized gains or losses unless there is an indication of additional credit losses, the entity intends to sell the security, or the entity can no longer assert that it is more-likely-than-not that the entity will not be required to sell the security prior to recovery.
19. Approach C is the same as Approach B for held-to-maturity debt securities for subsequent recognition.

Staff Recommendation

20. The staff recommends Approach B.
21. Under any of the approaches, the staff recommends the Board consider requiring entities to disclose the methodology and key inputs used to measure the credit loss amount.

Q1: Does the Board agree with the staff’s recommendation to only require entities to recognize the portion of an other-than-temporary impairment related to credit losses on debt securities in earnings and to recognize the remainder in other comprehensive income (Approach B)?

Q2: Does the Board wish to require that entities disclose the methodology and key inputs used to measure the incurred loss amount?

Issue 2: Insignificant Amount of Loss

22. In prior projects the staff has received requests from constituents to consider whether paragraph 16 of Statement 115 (and Issue 99-20) should be amended. These constituents believe that paragraph 16 (and Issue 99-20) creates an unintended cliff-effect when it is probable that the reporting entity will not collect “all” of the cash flows. The cliff-effect occurs because it has been interpreted to mean an insignificant amount of loss (or delay in the case of securities within the scope of Issue 99-20) triggers recognition in earnings of the

entire difference between the cost basis of the debt security and its fair value. When markets are dislocated, that difference could include liquidity risk that will ultimately not be realized. These constituents recommend that the Board consider adding language similar to that contained in paragraph 8 of Statement 114, which states in part, “An insignificant delay or insignificant shortfall in amount of payments does not require application of this Statement.”

Staff Recommendation

23. The staff does not recommend the Board add language similar to that contained in paragraph 8 of Statement 114.

Q3: Does the Board agree with the staff’s recommendation?

Effective Date and Transition

24. If the Board chooses Approach A, the staff recommends retroactive application. If the Board selects any other approach, the staff recommends prospective application.

25. The staff believes there are two options for effective date:

- a. Effective for interim and annual periods ending after March 15, 2009.
- b. Effective for interim and annual periods ending after June 15, 2009. Early adoption would be permitted.

26. The staff recommends that the FSP be effective for interim and annual periods ending after March 15, 2009.

Q4: Does the Board agree that under Approach A the application should be retroactive but under any other approach application should be prospective?

Q5: Does the Board agree that the effective date should be for interim and annual periods ending after March 15, 2009?

Comment Period

27. The staff recommends a comment period of 15 days ending April 1 so that the Board can finalize the proposed FSP at its Board meeting on April 2.

Q6: Does the Board agree with a 15-day comment period for the proposed FSP?

Example of OTTI Approaches

Bank A holds 3 debt securities (securities X, Y, and Z). Securities X and Y are available-for-sale and Security Z is held-to-maturity. The cost basis of each security at 12/31/x1 is \$9,800,000 (\$29,400,000 total) and the fair value is estimated to be \$8,700,000 (\$26,100,000 total). The entity determines that the impairment of Securities Y and Z is other than temporary because the entity believes it is probable that it will be unable to collect all amounts due according to the contractual terms of the securities. The entity is not able to assert that it has the intent and ability to hold Securities X or Y until recovery. However, the entity does intend to hold Security X for the foreseeable future and it is not likely it will have to sell Security X prior to its recovery. The entity believes it is more-likely-than-not that it will have to sell Security Y prior to its recovery. For Securities Y and Z, the entity estimates that \$600,000 of the OTTI loss is related to credit losses, and the remainder of the loss, \$500,000, is due to other factors. The entity does not anticipate any credit losses for Security X.

Income Statement Presentation:

Approach A

Credit-related impairment losses	\$1,200,000
Non-credit impairment losses	2,100,000
Total impairment loss	<u>\$3,300,000</u>

Approach B

Total impairment loss	\$3,300,000
Less: Noncredit losses	2,100,000
Net impairment loss	<u>\$1,200,000</u>

Approach B1

Total impairment loss	\$3,300,000
Less: Noncredit losses on securities that will be held until recovery (Security Z)	500,000
Net impairment loss	<u>\$2,800,000</u>

Approach B2

Total impairment loss	\$3,300,000
Less: Noncredit losses on securities that will be held for the foreseeable future (X & Z)	1,600,000
Net impairment loss	<u>\$1,700,000</u>

Approach C

Total impairment loss	\$2,200,000
Less: Noncredit losses on securities more-likely-than-not to be held to recovery (Security Z)	500,000
Net impairment loss	<u>\$1,700,000</u>