FASB Issues Three Staff Positions to Improve Guidance and Disclosures Related to Fair Value Measurements and Impairments

On April 9, 2009, the Financial Accounting Standards Board ("FASB") issued three final Staff Positions ("FSPs") to provide additional application guidance and enhance disclosures regarding fair value measurements and impairments of securities. The FSPs issued were:

- FSP FAS 157-4 ("FAS 157-4"), which provides additional guidance for estimating fair value in accordance with FASB Statement of Financial Accounting Standards No. 157 ("SFAS 157"), *Fair Value Measurements*, when the volume and level of activity for an asset or liability have significantly decreased.[1] This FSP also provides guidance on identifying circumstances which may indicate that a transaction is not orderly.

- FSP FAS 115-2 and FAS 124-2 (collectively, "FAS 115-2"), which amends the other-than-temporary impairment ("OTTI") guidance under U.S. generally accepted accounting principles ("U.S. GAAP") for debt securities to make the guidance more operational and to improve the presentation and disclosure of OTTIs in financial statements.[2]

- FSP FAS 107-1 and APB 28-1 (collectively, "FAS 107-1"), which requires more frequent and extensive disclosures by publicly traded companies about the fair value of financial instruments.[3]

I. Background

The FASB promulgated SFAS 157 in September 2006, and it became effective for financial statements issued for fiscal years that began after November 15, 2007.[4] SFAS 157 provides a framework for measuring and evaluating the fair value of assets and liabilities for purposes of complying with U.S. GAAP. A central concept of SFAS 157 is the "fair value hierarchy," which categorizes the inputs used to determine fair value. Level 1 inputs are those with readily verifiable prices, such as stock quotes. Level 2 inputs are those for which there is a market, albeit one with imperfect pricing. Examples of Level 2 inputs include inventory prices and real estate. Level 3 inputs, in contrast, are those that reflect the company's "own assumptions about the assumptions market participants would use in pricing the asset or liability...developed based on the best information available in the circumstances."

Although SFAS 157 states that assets and liabilities should be valued using Level 1 and 2 inputs where possible, it acknowledges that when a market for a financial asset is inactive, current prices may be determined as

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1 *See* FASB Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, *available at* http://www.fasb.org/pdf/fas157.pdf. *See also* 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*, *available at* http://www.fasb.org/pdf/fsp_fas157-4.pdf.

2 *See* FASB Staff Position No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, *available at* http://www.fasb.org/pdf/fsp_fas115-2andfas124-2.pdf.

3 *See* FASB Staff Position No. FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*, *available at* http://www.fasb.org/pdf/fsp_fas107-1andapb28-1.pdf.

4 *See* FASB Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, *available at* http://www.fasb.org/pdf/fas157.pdf.

a result of “a forced liquidation or distress sale” and may not be appropriate inputs because they would not be determinative of fair value. Consequently, unobservable inputs may be more appropriate to use in determining the fair value of assets and liabilities. In such circumstances, SFAS 157 permits reporting entities to value their assets and liabilities using Level 3 inputs. Since issuing SFAS 157, the FASB has attempted several times to provide guidance to clarify what constitutes an inactive market and a distressed transaction.[5] This guidance has not sufficiently addressed the concerns of reporting entities as to when they could appropriately value their assets and liabilities using Level 3 inputs.

As a result, companies relied predominantly on observable inputs to value their assets and liabilities. Specifically, emphasis was often placed on the use of the so-called last transaction price (or quoted price) as the sole or primary basis of fair value even when a significant adjustment to the transaction price (or quoted price) may have been required or when other valuation techniques could have been considered. Critics asserted that the resulting write-downs in the value of investments held by companies, including financial institutions, did not accurately reflect the underlying economics of the securities. In fact, a number of parties blamed fair value accounting, also known as “mark-to-market” accounting, for the instability in the financial markets experienced in the United States and much of the world beginning in 2008 and continuing into 2009.[6]

In part to ascertain whether this perspective had merit, Section 133 of the Emergency Economic Stabilization Act of 2008 mandated that the SEC, in consultation with the Board of Governors of the Federal Reserve System and the Secretary of the Treasury, conduct a study of SFAS 157 mark-to-market accounting standards as they applied to financial institutions, including depository institutions.[7] On December 30, 2008, the SEC delivered a report to Congress regarding the results of the study.[8] One key recommendation of the study was that “additional measures...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).” As part of this recommendation, the study further noted 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 suggested that additional guidance include (1) how to determine when markets become inactive and thus potentially require significant adjustment to transactions or quoted prices and (2) how to determine if a transaction or group of transactions is forced or distressed (that is, not orderly). Another recommendation of 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.”

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5 *See*, *e.g.*, FASB Staff Position No. FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* (Oct. 10, 2008), *available at* http://www.fasb.org/pdf/fsp_fas157-3.pdf. *See also SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting, available at* http://www.sec.gov/news/press/2008/2008-234.htm.

6 *See, e.g.,* House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, *Mark-to-Market Accounting: Practices and Implications, Kanjorski Convenes Hearing to Address Problems Facing Mark-to-Market Accounting* (“[M]any contend [that mark-to-market accounting rules] have exacerbated the current troubles in the financial industry and in the broader economy”), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/hr031209.shtml (last visited April 16, 2009).

7 *See* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, Division A, *available at* http://thomas.loc.gov/cgi-bin/query/z?c110:H.R.1424.enr:.

8 *See* U.S. Securities and Exchange Commission, Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting, *available at* http://www.sec.gov/news/studies/2008/marktomarket123008.pdf (last visited April 16, 2009). *See also* Congressionally-Mandated Study Says Improve, Do Not Suspend, Fair Value Accounting Standards (Dec. 30, 2008), *available at* http://www.sec.gov/news/press/2008/2008-307.htm.

On March 12, 2009, the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises held a hearing on mark-to-market accounting. At the hearing, legislators urged the FASB to act quickly to improve fair value accounting guidance, indicating that Congressional intervention could otherwise result. In response to pressure from Congress and constituents for further guidance, as well as in response to the SEC recommendations set forth in its study and report to Congress, the FASB issued FAS 157-4, FAS 115-2, and FAS 107-1.

II. FSP FAS 157-4

On April 9, 2009, the FASB issued FSP 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*. FAS 157-4 provides further guidance on how to estimate fair value in inactive markets or where the price inputs being used represent distressed sales. This FSP emphasizes that even in circumstances when the volume and level of activity for a given asset or liability have significantly decreased, and regardless of the valuation technique used, the objective of fair value measurement remains the same--to reflect how much an asset would be sold for in an orderly transaction (as opposed to a distressed or forced transaction) at the date of the financial statements under current market conditions. This FSP reaffirms the need to use judgment to discern whether a market has become inactive and to determine fair values in inactive markets.

FAS 157-4 sets forth several factors which may indicate that there has been a significant decrease in the volume and level of activity for a given asset or liability, rendering the market for that asset or liability inactive. These factors include, but are not limited to:

- There are few recent transactions;
- Price quotations are not based on current information;
- Price quotations vary substantially either over time or among market makers;
- Indexes that used to be highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability;
- There is a significant increase in implied liquidity risk premiums, yields, or performance indicators for observed transactions or quoted prices when compared with the reporting entity's estimate of expected cash flows;
- There is a wide bid-ask spread or significant increase in the bid-ask spread;
- There is a significant decline or absence of a primary market for new issuances for the asset or liability or similar assets or liabilities; and
- Little information is publicly released.

If upon evaluating the significance and relevance of these factors, the reporting entity determines that there has been a significant decrease in the volume and level of activity for the asset or liability, transactions or quoted prices may not be determinative of fair value. Further analysis is required, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with SFAS 157. However, FAS 157-4 notes that even if there has been a significant decrease in the volume and level of activity for the asset

or liability, it is inappropriate to conclude that all transactions are not orderly (that is, distressed or forced). Circumstances which may indicate that a transaction is not orderly include, but are not limited to:

- There was not adequate exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities under current market conditions;
- There was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant;
- The seller is distressed, insofar as it is in or near bankruptcy or receivership, or the seller was forced to sell in order to meet regulatory or legal requirements;
- The transaction price is an outlier when compared to other recent transactions for the same or similar asset or liability.

A reporting entity should evaluate the circumstances to determine whether the transaction is orderly based on the weight of the evidence. In determining whether a transaction was orderly, a reporting entity need not undertake all possible efforts, but it must not ignore information that is available without undue cost and effort.

In estimating fair value, (a) more weight should be placed on transaction prices in orderly transactions; (b) less weight should be placed on transaction prices for which the entity does not have sufficient information to conclude whether the transactions were orderly; and (c) little or no weight should be placed on transaction prices in transactions which were not orderly. Further, in estimating fair value, and regardless of the valuation technique used, the entity must include appropriate risk adjustments. That is, a fair value measurement should include a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) in the cash flows. Risk premiums should be reflective of an orderly transaction between market participants at the measurement date under current market conditions. This FSP requires reporting entities to disclose in interim and annual periods the inputs and valuation techniques used to measure fair value and discuss any changes in valuation techniques and related inputs.

III. FSP FAS 115-2 and FAS 124-2

On April 9, 2009, the FASB issued FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*. This FSP was intended to bring greater consistency to the timing of impairment recognition, and provide greater clarity to investors about the credit and noncredit components of impaired debt securities that are not expected to be sold. FAS 115-2 amends prior OTTI guidance in two important ways. Specifically, it both changes the method for determining whether an OTTI exists and modifies how impairments are reflected on financial statements. This FSP amends the OTTI guidance in U.S. GAAP for debt securities to make the guidance more operational and to improve the presentation and disclosure of OTTIs in financial statements. FAS 115-2 does not amend existing recognition and measurement guidance related to OTTIs of equity securities.[9]

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[9] FAS 115-2 explicitly states that it provides guidance for assessing whether an impairment of a debt security is other than temporary but does not amend existing recognition and measurement guidance for OTTIs of equity securities because the FASB does not believe the requirement for an entity to assess whether the entity more likely than not will be required to sell a security before its recovery would be more operational in the case of equity securities. As a direct result of the FASB's issuance of FAS 115-2, on April 13, 2009, the SEC issued staff accounting bulletin No. 111 ("SAB 111") which amended Topic 5.M. in the Staff Accounting Bulletin Series entitled *Other Than Temporary Impairment of*

A. Determining Whether an OTTI Exists

If the fair value of a debt security is less than its amortized cost basis at the measurement date, U.S. GAAP requires that a reporting entity assess the impaired security to determine whether the impairment is other than temporary. This FSP clarifies the interaction of factors that should be considered when determining whether a debt security is other-than-temporarily impaired. FAS 115-2 modifies the existing requirements that to avoid recognizing an OTTI, an investor must assert that it has both the intent and the ability to hold a security for a period of time sufficient to allow for recovery of its amortized cost basis. Rather, in the case of debt securities, an entity must now assess whether (a) it has the intent to sell the security or (b) it is more likely than not that it will be required to sell the security before recovery of its amortized cost basis. If either of these conditions is met, the entity must recognize an OTTI. The entity must also recognize an OTTI if it does not expect to recover the entire amortized cost basis of the security, even if it does not intend to sell the security.

A credit loss exists when the present value of cash flows that is expected to be collected is less than the amortized cost basis of the security. As alluded to above, when a credit loss exists, an OTTI shall be considered to have occurred. This FSP sets forth numerous factors which an entity must consider in determining whether a credit loss exists and the period of time over which the debt security is expected to recover. The list of factors set forth in the FSP is not all-inclusive, but some of the factors which an entity must consider are as follows:

- The length of time and the extent to which the fair value has been less than the amortized cost basis;
- Adverse conditions specifically related to the security, an industry, or a geographic area;
- The historical and implied volatility of the fair value of the security;
- The payment structure of the debt security and the likelihood that the issuer will be able to make payments that increase in the future;
- Failure of the issuer of the security to make scheduled interest or principal payments;
- Any changes to the rating of the security by a rating agency; and
- Recoveries or additional declines in fair value subsequent to the balance sheet date.

In making a determination regarding whether a security is other-than-temporarily impaired, an entity must consider all available information relevant to the collectibility of the security, including information about past events, current conditions, and reasonable and supportable forecasts, when developing the estimate of cash flows expected to be collected.

Certain Investments in Debt and Equity Securities ("Topic 5.M.") to exclude debt securities from its scope. Prior to issuance of SAB 111, Topic 5.M. provided guidance on OTTIs for both debt and equity securities. SAB 111 is available at http://www.sec.gov/interps/account/sab111.htm.

B. Reflecting Impairments on a Financial Statement

Currently, OTTIs are recognized entirely in the earnings sections of financial statements (or the "performance indicator" in the case of not-for-profit entities). However, under this new FSP, the amount of an OTTI which must be recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss.

If an entity intends to sell the security or it is more likely than not that the entity will be required to sell the security before recovering its amortized cost basis less any current-period credit loss, the OTTI shall be recognized in earnings in an amount equal to the entire difference between the investment's amortized cost basis and its fair value.

If an 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 before recovering its cost basis, no OTTI exists unless there are credit losses associated with the security. In such a case, the OTTI shall be separated into (i) the amount representing the credit loss and (ii) the amount related to all other factors. The amount of the OTTI related to the credit loss shall be recognized in earnings; the amount of the OTTI related to other factors shall be recognized in other comprehensive income. The previous amortized cost basis less the OTTI recognized in earnings shall become the new amortized cost basis of the investment. That new amortized cost basis shall not be adjusted for subsequent recoveries in fair value but would be adjusted for accretion and amortization.

This FSP requires more frequent and extensive disclosures to assist users of financial statements. For example, reporting entities must now disclose both quarterly and annually the types of available-for-sale and held-to-maturity debt and equity securities held, including information about investments in an unrealized loss position for which an OTTI has or has not been recognized. In addition, in its quarterly and annual reports, reporting entities must disclose information regarding the reasons that a portion of an OTTI of a debt security was not recognized in earnings and the methodology and significant inputs used to calculate the portion of the total OTTI that was recognized in earnings.

IV. FSP FAS 107-1 and APB 28-1

On April 9, 2009, the FASB issued FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*. This FSP amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* ("SFAS 107"), and Accounting Principles Board Opinion No. 28, *Interim Financial Reporting* ("APB 28"). FAS 107-1 deals with disclosure for any financial instruments that are not currently reflected on the balance sheet of publicly traded companies at fair values. It amends SFAS 107 and APB 28 by requiring fair value disclosures for these assets and liabilities in quarterly reports, and not just in annual financial statements. Fair value information must be presented together with the related carrying amount in a form that makes it clear whether the fair value and carrying amount represent assets or liabilities and how the carrying amount relates to what is reported in the statement of financial position. The reporting entity must also disclose the methods and significant assumptions it used to estimate the fair value of financial instruments and must describe any changes to these methods and assumptions which occurred during the reporting period.

All three FSPs discussed in this memorandum are effective for interim and annual reporting periods ending after June 15, 2009, and shall be applied prospectively. Early adoption is permitted for periods ending after March 15, 2009. If a reporting entity elects to early adopt one FSP, it must also early adopt the others as well.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Abigail Darwin at 212.701.3240 or adarwin@cahill.com.