

April 10, 2009

Determining Fair Value in the Current Economic Environment

FASB issues additional guidance

In response to the mark-to-market study conducted for Congress by the Securities and Exchange Commission (SEC) and the hearings held by the U.S. House of Representatives on mark-to-market accounting on March 12, the Financial Accounting Standards Board (FASB) recently issued FASB Staff Position (FSP) 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*.

This FSP addresses concerns that FASB Statement No. 157, *Fair Value Measurements*, emphasized the use of an observable market transaction even when that transaction may not have been orderly or the market for that transaction may not have been active. FSP FAS 157-4 provides additional guidance on: (a) determining when the volume and level of activity for the asset or liability has significantly decreased; (b) identifying circumstances in which a transaction is not orderly; and (c) understanding the fair value measurement implications of both (a) and (b).

This guidance from the FASB is welcome practical guidance to help with today's difficult valuation issues. Determination of fair value can be difficult, and the rigorous analysis required is emphasized in the FSP. The objectives of fair value measurement under Statement 157 have not changed.

The final FASB Staff Position document is available at www.fasb.org.

Is there an active market for the asset or liability?

FSP FAS 157-4 provides a list of factors that a company should evaluate to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability. The factors include but are not limited to:

- There are few recent transactions.
- Price quotations are not based on current information or vary substantially either over time or among market makers.
- Indexes that previously were 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.
- There is a wide bid-ask spread or a significant increase in the bid-ask spread.
- There is a significant decline in, or absence of, a market for new issuances of the asset or liability.
- Little information is released publicly.



When the company concludes there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal levels, transactions or quoted prices may not be determinative of fair value. Further analysis is needed and a significant adjustment to such prices may be necessary to estimate fair value in accordance with Statement 157 or whether changes to the valuation approach are necessary. However, the FSP reiterates that even in circumstances where there has been a significant decrease in the volume and level of activity for the asset or liability, the objective of a fair value measurement remains the same, that is, an exit price to a market participant based on market conditions on the measurement date.

A significant decrease in the volume and level of activity for the asset or liability does not automatically lead to the conclusion that there are no orderly transactions for the asset or liability. As discussed in the next topic, whether or not a transaction is orderly requires evaluating other characteristics of the transaction.

Are the transactions orderly and how does this affect fair value measurement?

FSP FAS 157-4 clarifies that when there has been a significant decrease in the volume and level of activity for the asset or liability, some transactions may not be orderly. In those situations, the company must evaluate the weight of the evidence to determine whether the transaction is orderly. Evidence that may indicate that a transaction is not orderly includes:

- There was not adequate exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities.
- 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 such as in or near bankruptcy or receivership or the seller was required to sell 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.

In estimating fair value or market risk premiums: (a) more weight should be placed on transactions that the company concludes are orderly; (b) less weight should be placed on

transactions for which the company does not have sufficient information to conclude whether the transaction is orderly; and (c) little, if any, weight should be placed on transactions that the company concludes are not orderly. In making its determinations as to whether a transaction is orderly, management need not undertake all possible efforts, but should not ignore information that is available without undue cost and effort. The exact weighting of the information available depends on a complete assessment of the relevant facts and circumstances.

Regardless of the valuation technique used, the company must include appropriate risk adjustments. 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. Otherwise, the measurement would not faithfully represent fair value. Risk premiums should be reflective of an orderly transaction (that is, not a forced or distressed sale) between market participants at the measurement date under market conditions at that date.

When estimating fair value, Statement 157 does not preclude the use of quoted prices provided by third parties such as pricing services or brokers when such prices provided are determined in accordance with Statement 157. However, when there has been a significant decrease in the volume or level of activity for the asset or liability, the company should evaluate those quoted prices to determine whether those quoted prices are based on current information that reflects orderly transactions or a valuation technique that reflects market participant assumptions.

Are there new disclosure requirements?

The FSP requires several new disclosures, including the inputs and valuation techniques used to measure fair value and a discussion of changes in valuation techniques and related inputs, if any, in both interim and annual periods. In addition, the FSP refines the definition of *major category* (as it is used in paragraphs 32 and 33 of Statement 157) to align with *major security types* as described in paragraph 19 of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

FSP No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, and FSP No. FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*, which were issued at the same time as FSP FAS 157-4, include additional disclosure requirements.

When is adoption required?

The guidance provided by this FSP is effective for interim and annual reporting periods ending after June 15, 2009, and is applied prospectively. Early adoption is permitted for periods ending after March 15, 2009. However, earlier adoption for periods ending before March 15, 2009 is not permitted. As such, for a calendar year-end company, the guidance in the FSP: (a) has to be adopted no later than in its quarter ending June 30, 2009; (b) may be adopted early in its quarter ending March 31, 2009; and (c) may not be adopted in its year ending December 31, 2008.

FSP FAS 157-4 and FSP FAS 115-2/FAS 124-2 must be adopted at the same time.

What should we do now?

Understanding the implications of this FSP and its effective date can assist you in measuring fair value in the current economic environment and prepare you to comply with its additional disclosure requirements.

The application of these new standards will not be easy. Management will need to provide sufficient appropriate evidence in support of its determination as to whether or not an active market exists, whether or not transactions were orderly, and its determination of the fair value of securities for which an active market does not exist.

To help you further understand the implications of FSP FAS 157-4, please contact McGladrey & Pullen to arrange a review of your specific situation with one of our audit specialists.