

Hot Topic

Update on major accounting
and auditing activities

FASB to propose FSPs to address fair value measurements and other-than-temporary impairments

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At its 16 March 2009 Board meeting, the FASB agreed to expose for public comment two proposed FSPs: (i) FSP 157-x, *Determining Whether a Market is Not Active and a Transaction is Not Distressed* (FSP 157-x), and (ii) an FSP that would address the measurement and presentation of other-than-temporary impairments (OTTI). Both FSPs are intended to address recommendations made by the Securities Exchange Commission (SEC) in its 2008 Congressionally mandated study on mark-to-market accounting. In its study, the SEC concluded that fair value accounting should not be suspended, but recommended improvements to existing practice, including reconsidering the accounting for impairments and the need for additional application guidance for determining fair value in illiquid or inactive markets. While the FASB has recently issued guidance related to both these areas (FSP 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* was issued in October 2008, and FSP EITF 99-20-1, *Amendments to the Impairment Guidance of EITF Issue No. 99-20* was issued in January 2009), many constituents continue to believe additional guidance is necessary. On 12 March 2009, the Chairman of the FASB

committed to members of the US House of Representatives to move expeditiously on these two projects, with a goal of issuing final standards within three weeks.

Both FSPs are expected to be exposed on 17 March 2009, and provide for 15-day comment periods ending 1 April, such that they could be finalized at the Board's scheduled meeting on 2 April 2009. In addition, pending responses received during the comment period, the Board tentatively agreed that both FSPs would be effective for interim and annual periods ending after 15 March 2009, and would provide for prospective transition.

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

FASB Statement No. 157, *Fair Value Measurements*, is clear that the objective of a fair value measurement is to determine the price that would be received in an orderly transaction, not a forced liquidation or distress sale. However, when markets are inactive or lack transparency, many constituents have noted it is difficult to obtain evidence to support that a transaction is distressed. As such, some constituents

believe there is a current bias to conclude that an observed transaction is not a distressed sale.

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 proposal recommended by the FASB staff (and agreed to be exposed by the Board) provides for a two-step approach when evaluating whether it is necessary to make significant adjustments to observed transactions (or quoted prices) and is described below.

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, but are not necessarily limited to the following:

- ▶ 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
- ▶ Price quotations are not based on current information
- ▶ Price quotations vary substantially either over time or among market makers (e.g., some brokered markets)
- ▶ Indices that previously were highly correlated with the fair values of the asset are demonstrably uncorrelated with recent fair values
- ▶ 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
- ▶ Significant widening of the bid-ask spread
- ▶ Little information is released publicly (e.g., a principal-to-principal market)

If after evaluation, the evidence indicates that the market is not active, the reporting entity must apply step 2.

Step 2: Evaluate the quoted price (e.g., a recent transaction or broker price quotation) to determine whether the quoted price is not associated with a distressed transaction.

The reporting entity must 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:

- i. 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 (e.g., there was not a regulatory requirement to sell)
- ii. There were multiple bidders for the asset

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 and the quoted price may be a relevant observable input that must be considered in estimating fair value. However, the FASB staff proposal notes the reporting entity should consider whether any other factors or conditions warrant making an adjustment to the quoted price.

Conversely, if the reporting entity does not have evidence that both of the above factors are present (including situations in which there is insufficient information on which to base a conclusion), then the reporting entity must consider the quoted price to be associated with a distressed transaction and must use a valuation technique other than one that uses the quoted price without significant adjustment (e.g., a present value technique). The FASB staff's proposal notes that the inputs used in a valuation technique should be reflective of an orderly transaction between market participants at the measurement date and, therefore, should reflect all risks inherent in the asset, including a reasonable profit margin for bearing uncertainty that market participants would consider in pricing the asset in a non-distressed transaction.

Proposed FSP on OTTI

The FASB staff described five potential approaches to amend the OTTI models in 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 Purchases Beneficial Interests and Beneficial Interests That Continue to be Held by a Transferor in Securitized Financial Assets." The five approaches, which are described in more detail in the 16 March 2009 Board Meeting Handout (available on the FASB's website), are summarized below:

Approach A: Under Approach A (which would only apply to debt securities), 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. 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, and (2) the amount of the total impairment charge related to all other factors.

Approach B: Under Approach B (which would only apply to debt securities), the reporting entity would continue to determine and measure other-than-temporary impairment losses 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 would be recognized in earnings with the remainder of the impairment loss 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). This means, 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. For securities classified as held-to-maturity, this will 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. 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.

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 (i.e., there is no credit loss), the entire impairment would be recognized (or in the case of an available-for-sale security, remain) 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.

Approach B1: Approach B1 (which would only apply to debt securities) 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.

Approach B2: Approach B2 (which would only apply to debt securities) 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 provided it is able to assert that it has the intent and ability to hold the security for the foreseeable future.

Approach C: Approach C (which would apply to both debt and equity securities) 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.

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.

The Board's proposal

With three of the five Board members expressing a preference for Approach C, the Board decided to expose an FSP for comment that proposes Approach C. However, the Board suggested that they will include in the exposure draft a significant number of questions on the exposed approach for constituents' consideration and comment.

The FSP also will propose to require entities to disclose the methodology and key inputs used to measure the incurred loss amount (i.e., the credit portion recognized as an OTTI), but only for those securities for which there is no intent to sell or for which it is more-likely-than-not that the entity will not be required to sell the security prior to its recovery. That is, if the difference between the fair value and the cost of the instrument is recognized partially in earnings and partially in other comprehensive income, the methodology and key inputs used to determine the former component must be disclosed.

The Board also discussed concerns expressed by constituents that paragraph 16 of Statement 115 (and EITF 99-20) creates an unintended "cliff-effect" when it is probable that the reporting entity will not collect "all" of the cash flows from a security. The cliff-effect occurs because an insignificant amount of loss (or delay in the case of securities within the scope of EITF 99-20) triggers the 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 unrealized losses associated with liquidity risk that are not expected to be realized. These constituents requested that the Board consider amending paragraph 16 of FAS 115 (and EITF 99-20) by 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." The FASB staff recommended, and the Board agreed, not to add language similar to that contained in paragraph 8 of Statement 114 on the basis that the proposed FSP on OTTI will largely address the constituent's concern. That is, as long as there is no intention to sell a security and it is not more-likely-than-not that the entity will be required to sell the security prior to recovery of its cost basis, then only credit losses will be recognized in earnings and not the total difference between the cost basis and fair value.

A call to comment

Fair value and OTTI are two issues that have received a great deal of attention in this current credit crisis. The accounting models used in measuring fair value and in determining and measuring an other-than-temporary impairment have both received heavy criticism, with some suggesting they are contributors to the current crisis. While many have disagreed with a view that these accounting requirements have contributed to the crisis, almost all have agreed on the need for the Board to provide further guidance on these issues. Both preparers and users of financial statements should take the time to analyze the proposed FSPs and provide their comments to the Board.

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