DechertOnPoint

March 2009 / Issue 8

A legal update from Dechert's Financial Services Group

FASB Proposes Guidance on Fair Valuation Accounting Standards

On March 17, 2009, the Financial Accounting Standards Board ("FASB") proposed for public comment a staff position, FSP 157-e,[1] which builds on prior guidance regarding fair valuation determinations under Statement of Financial Accounting Standards 157 ("FAS 157").[2] FSP 157-e responds to requests from various commenters, as well as to certain recommendations in a recent report by the staff of the Securities and Exchange Commission ("SEC") on mark-to-market accounting.[3]

FSP 157-e proposes a two-step process for determining whether a market for a financial asset is inactive and, if so, whether a transaction in the market is distressed. As a result, it would impact the way registered investment companies and other issuers determine fair valuation measurements under FAS 157.

If adopted as proposed, FSP 157-e would be effective for interim and annual periods ending after March 15, 2009. Comments on FSP 157-e are due April 1, 2009.

Background

FAS 157, issued in September 2006, defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosure requirements for fair value measurements. Under FAS 157, "fair value" generally means the price that would be received to sell an asset or paid to transfer a liability in an "orderly transaction" between market participants in the principal or most advantageous market at the measurement date.[4] Forced transactions, such as a forced liquidation or a distressed sale, are not "orderly transactions" under FAS 157. On September 30, 2008, the SEC Office of the Chief Accountant and FASB issued a joint release that was designed to clarify certain aspects of FAS 157 in light of then current market conditions.[5] The Joint Release provided, among other things, that where an active market does not exist for a security, market quotations may be factored as an input (but are not necessarily determinative), and while a fair value measurement may include a distressed or

1 FASB Staff Position FAS 157-e, "Determining Whether a Market Is Not Active and a Transaction Is Not Distressed" (Mar. 17, 2009) ("FSP 157-e").

2 *See,* e.g., FASB Staff Position FAS 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active" (Oct. 10, 2008) ("FSP 157-3").

3 SEC Office of the Chief Accountant, Division of Corporation Finance, "Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting," (Dec. 2008), available at: www.sec.gov/news/studies/2008/marktomarket123008.pdf.

4 It is important to bear in mind that "fair value" as used in FAS 157 is different from fair value as used in the Investment Company Act of 1940 ("1940 Act"). Fair value under FAS 157 often includes market quotations as sources of value, whereas fair value under the 1940 Act contemplates determinations of value in the absence of readily available market quotations.

5 SEC Release No. 2008-234, "SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting" (Sept. 30, 2008) (the "Joint Release"). *See DechertOnPoint*, "SEC and FASB Clarify Fair Value Accounting Standard" (Nov. 2008), available at: www.dechert.com/library/FS_38_11-08_FASB.pdf.

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forced liquidation sales price as an input, the fact that it is from a disorderly transaction should be taken into account. On October 10, 2008, FASB issued FSP 157-3, which clarified application of FAS 157 to inactive markets.

As noted in FSP 157-e, many commenters have raised concerns that FAS 157 and FSP 157-3 do not provide sufficient guidance on how to determine whether a historically active market is no longer active and whether a transaction is not distressed. FSP 157-e also notes concerns that an emphasis on the use of the last transaction price as the sole or primary basis of fair value, even when a significant adjustment to the transaction price may be required or when other valuation techniques should be considered, may result in misapplication of FAS 157. In addition, the SEC staff report on mark-to-market accounting recommended that additional measures be taken to improve the application of, and practice for determining, fair value in illiquid or inactive markets. The SEC's suggestions for additional guidance included: (a) how to determine when markets become inactive; and (b) how to determine if a transaction or group of transactions is forced or distressed.

Guidance Regarding Inactive Markets and Distressed Transactions

FSP 157-e would establish the following two-step process for determining whether a market for a financial asset is inactive, and if so, whether a transaction in that market is distressed.

Step 1: The first step requires an entity (using its own judgment) to consider all factors that may indicate that a market is not active at the measurement date. FSP 157-e provides the following non-exclusive list:

"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. Indexes 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 with reasonable estimates (using realistic assumptions) of credit and other nonperformance risk for the asset class.

f. Abnormally wide bid-ask spread or significant increases in the bid-ask spread.

g. Little information is released publicly (for example, a principal-to-principal market)."

Step 2: If the entity concludes that the market is *not* active, it is expected to proceed to step 2. In step 2, the entity *must* presume that a quoted price is associated with a distressed transaction unless the entity has evidence demonstrating that the following two criteria are met for the quoted price: (a) there was sufficient time before the measurement date to allow for "usual and customary marketing activities" for the asset (for example, there was not a regulatory requirement to sell); *and* (b) there were multiple bidders for the asset.

FSP 157-e instructs that, if the entity has evidence that both of these factors are present for a given quoted price, then that quoted price is presumed not to be associated with a distressed transaction. As a result, the quoted price may be a relevant observable input to be considered in estimating fair value (with possible adjustment).

Importantly, FSP 157-e further instructs that, if the entity does not have evidence demonstrating that both factors are present for a quoted price (including because there is insufficient information on which to base a conclusion), then it must consider the quoted price to be associated with a distressed transaction. In that case, the entity must use a valuation technique other than one that uses the quoted price without significant adjustment. For example, the entity could use a present value technique that uses inputs reflecting an orderly transaction between market participants at the measurement date.

Conclusion

While FSP 157-e does not suspend the use of mark-to-market accounting, it represents an additional step away from reliance on quoted prices during periods of market turbulence. FSP 157-e presumes that a quoted price in an inactive market is distressed (therefore necessitating use of a valuation technique other than one using the quoted price without significant adjustment), unless the entity has sufficient evidence to support a position that the quoted price is not distressed.

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