FASB STAFF POSITION

No. FAS 157-3

Title: Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active

Date Issued: October 10, 2008

Objective

1. This FASB Staff Position (FSP) clarifies the application of FASB Statement No. 157, *Fair Value Measurements,* in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active.

Background

2. Statement 157 was issued in September 2006, and is effective for financial assets and financial liabilities for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early application was encouraged. FSP FAS 157-2, *Effective Date of FASB Statement No. 157,* amended Statement 157 to delay the effective date of Statement 157 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years.

3. Statement 157 establishes a single definition of fair value and a framework for measuring fair value in generally accepted accounting principles (GAAP) that result in increased consistency and comparability in fair value measurements. Statement 157 also expands disclosures about fair value measurements, thereby improving the quality of information provided to users of financial statements. Statement 157 does not require any new fair value measurements.

4. The FASB staff obtained extensive input from various constituents, including financial statement users, preparers, and auditors, on determining fair value in accordance with Statement 157. Many of those constituents indicated that the fair value measurement framework in Statement 157 and related disclosures have improved the quality and transparency of financial information.

5. However, certain constituents expressed concerns that Statement 157 does not provide sufficient guidance on how to determine the fair value of financial assets when the market for that asset is not active. Application issues include:

a. How the reporting entity's own assumptions (that is, expected cash flows and appropriately risk-adjusted discount rates) should be considered when measuring fair value when relevant observable inputs do not exist
b. How available observable inputs in a market that is not active should be considered when measuring fair value
c. How the use of market quotes (for example, broker quotes or pricing services for the same or similar financial assets) should be considered when assessing the relevance of observable and unobservable inputs available to measure fair value.

6. The Office of the Chief Accountant of the SEC and the FASB staff jointly issued a press release on September 30, 2008, that addresses similar Statement 157 application issues. That press release provides financial statement users, preparers, and auditors with additional guidance useful in dealing with those issues. The guidance included in this FSP is consistent with and amplifies the guidance contained in that press release.

All paragraphs in this FSP have equal authority. Paragraphs in bold set out the main principles.

FASB Staff Position

Scope

7. **This FSP applies to financial assets within the scope of accounting pronouncements that require or permit fair value measurements in accordance with Statement 157.**

8. **This FSP clarifies the application of Statement 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active.**

9. Key existing principles of Statement 157 illustrated in the example include:

a. A fair value measurement represents the price at which a transaction would occur between market participants at the measurement date. As discussed in Statement 157, in situations in which there is little, if any, market activity for an asset at the measurement date, the fair value measurement objective remains the same, that is, the price that would be received by the holder of the financial asset in an orderly transaction (an exit price notion) that is not a forced liquidation or distressed sale at the measurement date.[1] Even in times of market dislocation, it is not appropriate to conclude that all market activity represents forced liquidations or distressed sales. However, it is also not appropriate to automatically conclude that any transaction price is determinative of fair value. Determining fair value in a dislocated market depends on the facts and circumstances and may require the use of significant judgment about whether individual transactions are forced liquidations or distressed sales.

b. In determining fair value for a financial asset, the use of a reporting entity's own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available. Statement 157 discusses a range of information and valuation techniques that a reporting entity might use to estimate fair value when relevant observable inputs are not available.[2] In some cases an entity may determine that observable inputs (Level 2) require significant adjustment based on unobservable data and thus would be considered a Level 3 fair value measurement. For example, in cases where the volume and level of trading activity in the asset have declined significantly, the available prices vary significantly over time or among market participants, or the prices are not current, the observable inputs might not be relevant and could require significant adjustment. Regardless of the valuation technique used, an entity must include appropriate risk adjustments that market participants would make for nonperformance and liquidity risks.

c. Broker (or pricing service) quotes may be an appropriate input when measuring fair value, but they are not necessarily determinative if an active market does not exist for the financial asset. In an active market, a broker quote should reflect market information from actual transactions. However, when markets are not active, brokers may rely more on models with inputs based on information available only to the broker. In weighing a broker quote as an input to a fair value measurement, an entity should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote (for

[1] See paragraph 7 of Statement 157.

[2] Paragraph B6 of Statement 157 describes two present value techniques for determining fair value. The present value techniques differ in how they adjust for risk and in the type of cash flows they use.

example, whether the quote is an indicative price or a binding offer) should be considered when weighing the available evidence.

10. For recurring fair value measurements using significant unobservable inputs (Level 3), paragraph 32 of Statement 157 requires an entity to reconcile the beginning and ending balances, including separately presenting changes that occurred during the period that are attributable to transfers in and/or out of Level 3. For both recurring and nonrecurring fair value measurements using significant unobservable inputs (Level 3), paragraphs 32 and 33 of Statement 157 require an entity to describe the inputs and the information used to develop those inputs.[3]

Amendment to Add an Illustrative Example to Statement 157

11. Statement 157 is amended as follows: [Added text is underlined.]

    a. Paragraphs A32A–A32F and the heading preceding them are added as follows:

Example 11—Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active

Note: The conclusions reached in this example are based on the assumed facts and circumstances presented. Other approaches to determining fair value may be appropriate. Also, this example assumes that the observable transactions considered in determining fair value were not forced liquidations or distressed transactions.

A32A. On January 1, 20X8, Entity A invested in a AA-rated tranche of a collateralized debt obligation security. The underlying collateral for the collateralized debt obligation security is unguaranteed nonconforming residential mortgage loans. Prior to June 30, 20X8, Entity A was able to determine the fair value of the collateralized debt obligation security using a market approach valuation technique based on Level 2 inputs that did not require significant adjustment. The Level 2 inputs included:

a. Quoted prices in active markets for similar collateralized debt obligation securities with insignificant adjustments for differences between the collateralized debt obligation security that Entity A holds and the similar collateralized debt obligation securities

[3] The Board observes that the SEC's Division of Corporation Finance issued letters in March 2008 and September 2008 for issuers to consider in enhancing the transparency of disclosures relating to fair value measurements.

b. Quoted prices in markets that are not active that represent current transactions for the same or similar collateralized debt obligation securities that do not require significant adjustment based on unobservable inputs.

A32B. Since June 30, 20X8, the market for collateralized debt obligation securities has become increasingly inactive. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which collateralized debt obligation securities trade and then by a significant decrease in the volume of trades relative to historical levels as well as other relevant factors. At September 30, 20X8 (the measurement date), Entity A determines that the market for its collateralized debt obligation security is not active and that markets for similar collateralized debt obligation securities (such as higher-rated tranches within the same collateralized debt obligation security vehicle) also are not active. That determination was made considering that there are few observable transactions for the collateralized debt obligation security or similar collateralized debt obligation securities, the prices for those transactions that have occurred are not current, and the observable prices for those transactions vary substantially either over time or among market makers, thus reducing the potential relevance of those observations. Consequently, while Entity A appropriately considers those observable inputs, ultimately, Entity A's collateralized debt obligation security will be classified within Level 3 of the fair value hierarchy because Entity A determines that significant adjustments using unobservable inputs are required to determine fair value at the measurement date.

A32C. Entity A determines that an income approach valuation technique (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs will be equally or more representative of fair value than the market approach valuation technique used at prior measurement dates, which would now require significant adjustments.[21a] Specifically, Entity A uses the discount rate adjustment technique described in Appendix B of this Statement to determine fair value.

A32D. Entity A determines that the appropriate discount rate[21b] used to discount the contractual cash flows[21c] of its collateralized debt obligation security is 22 percent after considering the following:

a. The implied rate of return at the last date on which the market was considered active for the collateralized debt obligation security was 15 percent. Based on an analysis of available observable inputs for mortgage-related debt securities, Entity A determines that market rates of return generally have increased in the marketplace since the last date on which the market was considered active for the collateralized debt obligation security. Entity A estimates that credit spreads have widened by approximately 100 basis points and liquidity risk premiums have increased during that period by approximately 400 basis points. Other risks (for example, interest rate risk) have not changed. Using this information, Entity A estimates that an indication of an appropriate rate of return for the collateralized debt obligation security is 20 percent.[21d] In making that determination, Entity A considered all available market information that could be obtained without undue cost and effort. For this collateralized debt obligation security, the available market information used in assessing the risks in the security (including nonperformance risk [for example, default risk and collateral value risk] and liquidity risk) included:

(1) Quoted prices that are not current for the same or similar collateralized debt obligation securities
(2) Relevant reports issued by analysts and ratings agencies
(3) The current level of interest rates and any directional movements in relevant indexes, such as credit risk indexes
(4) Information about the performance of the underlying mortgage loans, such as delinquency and foreclosure rates, loss experience, and prepayment rates
(5) Other relevant observable inputs.

b. Two indicative quotes (that is, nonbinding quotes) for the collateralized debt obligation security from brokers imply a rate of return of 23 percent and 27 percent. The indicative quotes are based on proprietary pricing models utilizing significant unobservable inputs (that is, Level 3 inputs), rather than actual transactions.

A32E. Because Entity A has multiple indications of the appropriate rate of return that market participants would consider relevant in estimating fair value, it evaluates and weighs, as appropriate, the respective indications of the appropriate rate of return, considering the reasonableness of the range indicated by the results. Entity A concludes that 22 percent is the point within the range of relevant inputs that is most representative of fair value in the circumstances. Entity A placed more weight on the 20 percent estimated rate of return (that is, its own estimate) because (a) the indications of an appropriate rate of return provided by the broker quotes were nonbinding quotes based on the brokers' own models using significant unobservable inputs, and (b) Entity A was able to corroborate some of the inputs, such as default rates, with relevant observable market data, which it used to make significant adjustments to the implied rate of return when the market was last considered active.

A32F. In accordance with the requirements of this Statement, Entity A determines that the risk-adjusted discount rate appropriately reflects the reporting entity's estimate of the assumptions that market participants would use to estimate the selling price of the asset at the measurement date. Risks incorporated in the discount rate include nonperformance risk (for example, default risk and collateral value risk) and liquidity risk (that is, the compensation that a market participant receives for buying an asset that is difficult to sell under current market conditions).

[21a] See paragraphs 20 and 21.
[21b] See paragraphs B7–B11.
[21c] The discount rate adjustment technique described in paragraphs B7–B11 would not be appropriate when determining whether the change in fair value results in an impairment and/or necessitates a change in yield under 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," because that technique uses contractual cash flows rather than cash flows expected by market participants.
[21d] Calculated as the 15 percent implied rate of return at the last date on which the market was considered active, plus the increase in (a) credit spreads of 100 basis points (1 percent) and (b) liquidity risk premiums of 400 basis points (4 percent).

Effective Date and Transition

12. This FSP shall be effective upon issuance, including prior periods for which financial statements have not been issued. Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate (FASB Statement No. 154, *Accounting Changes and Error Corrections,* paragraph 19). The disclosure provisions of Statement 154 for a change in accounting estimate are not required for revisions resulting from a change in valuation technique or its application.

The provisions of this FSP need not be applied to immaterial items.