FASB ISSUES GUIDANCE ON FAIR VALUE DETERMINATION IN ILLIQUID OR INACTIVE MARKETS

April 17, 2009

To Our Clients and Friends:

On April 9, 2009, the Financial Accounting Standards Board issued FASB Staff Position 157-4 amending FASB Standard No. 157, *Fair Value Measurements*. FSP 157-4 does not change existing fair value accounting rules. Instead, it is intended to help companies, auditors and investors assess the fair value of assets and liabilities in illiquid markets by providing additional guidance for (i) estimating fair value when the volume and level of activity for an asset or liability have significantly decreased and (ii) identifying transactions that are not orderly. FSP 157-4 is available at http://www.fasb.org/pdf/fsp_fas157-4.pdf.

FASB No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an *orderly transaction* between market participants. FSP 157-4 makes clear that when a market for an asset or liability is inactive (*i.e.*, there is a significant decrease in the volume and level of activity for an asset or liability when compared with normal market activity for the asset or liability (or similar asset or liability)), transactions or quoted prices may not be determinative of fair value because there may be increased instances of transactions that are not orderly. In those circumstances, a significant adjustment to those transactions or quoted prices or the use of one or more alternative valuation techniques (*e.g.*, a present value technique) in addition to a market approach technique may be required to estimate fair value in accordance with FASB No. 157. In addition, it may be appropriate to disregard market inputs entirely to the extent that such transactions are not orderly (*e.g.*, they represent forced or distressed sales).

FSP 157-4 establishes the following framework for companies to estimate the fair value of assets and liabilities in inactive markets and identify transactions that are not orderly:

Determine whether the market in question is inactive. FSP 157-4 provides the following non-exclusive 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 an asset or liability:

- 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 previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for such asset or liability.
- A significant increase in implied liquidity risk premiums, yields or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the reporting entity's estimate of expected cash flows, considering all available market data about credit and other non-performance risk for the asset or liability.
- Abnormally wide bid-ask spread or significant increases in the bid-ask spread.
- A significant decline or absence of market for new issuances (that is, a primary market) for the asset or liability or similar assets or liabilities.
- Little information is released publicly (*e.g.*, principal-to-principal market).

Determine whether transactions in an inactive market are orderly. Even if the market for an asset or liability is inactive, a company should not presume that all transactions are not orderly. FSP 157-4 provides the following list of non-exclusive circumstances that a company should evaluate to determine whether a transaction is orderly and, as a result, a relevant input for purposes of a fair value estimate:

- Inadequate 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.
- The seller marketed the asset or liability to a single market participant.
- The seller is in or near bankruptcy or receivership (that is, distressed), or the seller was required to sell to meet regulatory or legal requirements (that is, forced).
- The transaction price is an outlier when compared with other recent transactions for the same or similar asset or liability.

A company need not undertake all possible efforts to determine whether a transaction is orderly or not. However, a company should not ignore information that is available without undue cost and effort in order to make such determination.

Determine how much weight to place on a transaction in determining the fair value of an asset or liability.

- If the weight of the evidence indicates the transaction is not orderly, the company should place little, if any, weight (compared with other indications of fair value) on that transaction price when estimating fair value or market risk premiums.
- If the weight of the evidence indicates the transaction is orderly, the company should consider that transaction price when estimating fair value or market risk premiums. The amount of weight placed on that transaction price when compared with other indications of fair value will depend on the facts and circumstances such as the volume of the transaction, the comparability of the transaction to the asset or liability being measured at fair value and the proximity of the transaction to the measurement date.
- If the company does not have sufficient information to conclude that the transaction is orderly or that the transaction is not orderly, it should consider that transaction price when estimating fair value or market risk premiums. However, that transaction price may not be determinative of fair value (that is, that transaction price may not be the sole or primary basis for estimating fair value or market risk premiums). The company shall place less weight on transactions on which a reporting entity does not have sufficient information to conclude whether the transaction is orderly when compared with other transactions that are known to be orderly.

To the extent that a company uses quoted prices provided by third parties to estimate fair value of an asset or liability in an inactive market, it should evaluate whether those quoted prices are based on current information that reflects orderly transactions or a valuation technique that reflects market participant assumptions (including assumptions about risks). In addition, in weighting a quoted price as an input to a fair value measurement, a company should consider the nature of the quote and assign less weight to quotes that do not reflect the result of transactions (*e.g.*, an indicative bid).

Significant adjustments to market inputs in an inactive market may be required to permit a fair value estimate. When a market for an asset or liability is inactive, a company may also use one or more valuation techniques in addition to or instead of a market approach technique to determine the point within a reasonable range of fair value estimates that is most representative of fair value under current market conditions. Any revisions resulting from a change in a company's valuation technique as a result of the application of FSP 157-4 must be accounted for as a change in accounting estimates. Regardless of the valuation technique used, a company's fair value measurement should include a risk adjustment reflecting the risk premium that market participants would demand for the asset or liability. A company's intention to hold the asset or liability is not relevant in estimating fair value.

FSP 157-4 also requires companies to disclose in interim and annual periods the inputs and valuation techniques used to measure fair value and a discussion of changes in valuation techniques and related inputs, if any, during the period.

FSP 157-4 supersedes FSP 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*, and is effective for interim and annual periods ending after June 15, 2009, with early application permitted for the period ending March 15, 2009. If a company elects to early adopt FSP 157-4, it must also early adopt FSP 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*. FAS 115-2 and FAS 124-2 can be found at http://fasb.org/pdf/fsp_fas115-2andfas124-2.pdf.

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Please do not hesitate to call us to discuss the interpretive guidance or this memorandum generally.

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