

MINUTES



Financial Accounting
Standards Board

To: FASB Board Members

From: FAS 157 Team
(Clark x443)

Subject: Minutes of the October 10, 2008 Board Meeting: FSP FAS 157-d, *Determining the Fair Value of a Financial Asset when the Market for That Asset Is Not Active* **Date:** October 20, 2008

cc: FASB: Golden, Bielstein, Proestakes, Stoklosa, Bossio, Mechanick, Clark, Prince, Anderson, Willis (consultant), Glotzer, Lott, C. Smith, Lapolla, Gabriele, Sutay, Mills, FASB Intranet, Chookaszian, Posta, Klimek, Allen; GASB: Reese, Schermann; IASB: Leisenring

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement, Interpretation, or FASB Staff Position.

Topic: Proposed FSP FAS 157-d

Basis for Discussion: Board Memorandum 4

Length of Discussion: 9:00 a.m.–9:40 a.m.

Attendance:

Board members present: FASB: Herz, Seidman, and Smith
IASB: Leisenring

Board members participating by phone: FASB: Batavick and Linsmeier

Board members absent: None

Staff in charge of topic: Anderson

Other staff at Board table: FASB: Golden, Proestakes, Vaheb, Clark, and Mills (by phone)

Summary of Decisions Reached:

The Board discussed the comments received on proposed FSP FAS 157-d, *Determining the Fair Value of a Financial Asset in a Market That Is Not Active*, which would clarify the application of FASB Statement No. 157, *Fair Value Measurements*. The Board affirmed its decision to limit the scope of the FSP to financial assets. The Board also affirmed that the final FSP will be effective upon issuance. Prior periods for financial statements that have not been issued would comply with the guidance in the final FSP.

Based on the comments received, the Board also decided to make the following clarifications to the FSP:

1. Clarify that when distinguishing between an active market and an inactive market, practitioners should (a) look to the market for a particular asset or class of assets being measured rather than the overall market and (b) consider the factors that characterize an inactive market, such as a decline in the volume and level of activity, prices that are not current, and prices that vary substantially
2. Include a discussion about disorderly markets and the distinction between distressed markets and distressed transactions
3. Emphasize that significant judgment is needed when determining if a particular transaction is an indicator of fair value
4. Clarify that the use of contractual cash flows using the discount rate adjustment valuation technique in the example would not change the application of EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets," when determining whether a particular instrument is subject to other-than-temporary impairment.

The Board directed the staff to proceed with a draft of a final FSP for vote by written ballot.

Objective of Meeting:

The objective of the meeting was to discuss (a) the comment letters received in response to the proposed FSP, (b) the concerns raised in those letters, and (c) the staff's recommended approach to addressing those concerns. In addition, the staff planned to ask the Board whether it desired to proceed with final issuance of the FSP. The objectives were met.

Matters Discussed and Decisions Reached

1. Mr. Herz stated that the purpose of the meeting was to discuss comments submitted by over 90 respondents in response to the proposed FSP. He thanked all of those people who took the time to comment on the proposed FSP.

2. Mr. Herz stated that he is of the view that Statement 157 did not necessarily contemplate current market conditions when it was written. He added, however, that the framework of Statement 157 does contemplate markets that are not active. He emphasized that it was important that practitioners apply Statement 157 and its framework and that, when a dearth of observable inputs exists, exercise great judgment.

3. Mr. Herz mentioned the International Accounting Standards Board's Expert Advisory Panel (EAP) and the guidance, which will be similar to that of the proposed FSP, on which it is currently working. He stated that both the EAP's guidance and the FASB's guidance generally reach the same conclusions given a particular set of facts and circumstances. Mr. Golden added that the FASB staff has been engaged in a constant dialogue with the IASB staff and that the IASB staff believes that the proposed FSP is consistent with the guidance the EAP intends to release.

Issue 1: Measurement Attributes and Markets That Are Not Active

4. Mr. Anderson stated that a number of constituents expressed concern about whether fair value, as defined by Statement 157, is the most relevant measurement attribute in periods during which there is little or no market activity for an asset. He added that those constituents do not believe that an exit price notion considering market participant assumptions about risk is relevant for estimating fair value when the market is inactive. Instead, those constituents believe that a more appropriate measurement attribute is one that considers management's intent and ability to hold the asset. Such a measurement would not consider market participant assumptions about risks such as nonperformance and liquidity.

5. Mr. Anderson stated that the staff believes that this concern is beyond the scope of the FSP, as proposed. The FSP, as proposed, is intended only to clarify and illustrate key principles in Statement 157 on **how** to determine the fair value of a financial asset in a market that is not active and is not intended to give guidance as to **when** to apply fair value measurement principles. The staff did not recommend any changes to the proposed FSP based on this issue.

Issue 1 Board Comments

6. Ms. Seidman agreed with Mr. Anderson's reasoning that the purpose of the FSP is to provide guidance on how to apply fair value measurement principles in markets that are not active rather than to provide guidance on when to apply fair value measurement principles.

Issue 2: Active versus Not Active Markets

7. Mr. Anderson stated that some constituents asked that the FSP provide more definitive guidance on how to determine whether a market is active or inactive. He noted that paragraph 24 of Statement 157 states that an active market is one in which transactions for the asset occurs with sufficient frequency and volume to provide pricing information on an ongoing basis. He added that paragraph 28(b) of Statement 157 also indicates that an inactive market is one characterized by few transactions for the asset, prices that are not current, prices that vary substantially, or some combination thereof.

8. Mr. Anderson stated that the staff does not believe that additional clarification of the principles-based guidance in Statement 157 would be possible without establishing "bright lines." He added that the staff had discussed this issue with the FASB's Valuation Resource Group approximately one year ago and that the Valuation Resource Group was in agreement with the staff view. In addition, he noted that although a quoted price in an active market should be used as the basis for determining the fair value of an asset when available, inactive markets could provide relevant market data that should be considered in determining fair value.

Issue 2 Board Comments

9. Mr. Herz commented that when discerning whether a market is active or not active, the assessment should be done for a particular asset or class of assets rather than the overall market. Mr. Linsmeier added that he would like the FSP to clarify that making that assessment is a matter of judgment and that there are several factors, such as those outlined in paragraph 9 of the proposed FSP, one must consider.

10. Ms. Seidman stated that a consensus exists among comment letter respondents as to the need to make more prominent the discussion contained in paragraph 9 of the proposed FSP (a discussion of the factors to consider when determining whether a previously active market is no

longer active). The Board members agreed to modify the proposed FSP to reflect Ms. Seidman's suggestion.

Issue 3: Distressed Markets and Distressed or Forced Transactions

11. Mr. Anderson stated that some constituents indicated that the proposed FSP should be revised to address the issue of distressed markets and distressed or forced transactions. He added that some constituents have suggested that all transactions occurring in a distressed market are considered forced or distressed and, as a result, should not be considered in a fair value measurement.

12. The staff noted that the press release issued jointly by the SEC and the FASB defines an orderly transaction and states that a distressed transaction is not an orderly transaction (a fact that should be considered when weighing available information).¹ The release also states that determining whether a particular transaction is distressed requires judgment. Nevertheless, Mr. Anderson noted that the example included in the proposed FSP neither addresses the question of distressed markets and distressed or forced transactions nor clarifies that the determination that a market transaction is "distressed" or "disorderly" should be made at the individual transaction level and should not be assumed to have occurred based on an entity's conclusion that an entire market for the asset is distressed. Based on the feedback received from constituents noting the absence of such guidance in a draft of the proposed FSP, the staff modified the proposed FSP to include language to provide clarification on distressed sales.

Issue 3 Board Comments

13. Mr. Smith stated that the FSP, as proposed, would be effective in stopping the characterization of the issue at hand as one of "when does a good Level 3 measurement trump a bad Level 2 measurement." He highlighted the discussion the Board members had amongst themselves regarding the determination of when particular transactions are indicative of fair value. He illustrated a situation in which practitioners are attempting to value an asset for which there are three different transactions involving the same or similar assets. The transactions are small in value, but the range of values is wide. In that situation, he added, the fair value measurement that results from utilizing the three transaction prices would likely need significant

¹ The release can be found on the FASB's external website at <http://www.fasb.org/news/2008-FairValue.pdf>.

adjustments and, as such, would not be determinative of fair value. However, if the circumstances were changed to reflect an asset for which there are three transactions each of which was of a large value and within a small range and that involved the same or similar assets, the fair value measurement that results from utilizing those three transaction prices may not need significant adjustment and thus would likely be determinative of fair value.

14. Mr. Smith also highlighted the discussion he and Mr. Golden had about a circumstance in which there was only one transaction that involved a particular asset. He stated that in that case, practitioners would need to look at the facts and circumstances of the transaction and whether the underlying data pertaining to the asset (for example, default rates, population, and so forth) served to corroborate the price at which the asset was sold or the liability transferred in the market for that asset or liability. He added that practitioners must exercise significant judgment in determining whether a particular transaction price is indicative of fair value.

15. Ms. Seidman suggested that the FSP include a discussion about disorderly markets. Specifically, she stated that the FSP should communicate that (a) prices in a dislocated or distressed market cannot automatically be discarded as not being indicative of fair value and, by the same token, (b) prices in a dislocated or distressed market cannot automatically be accepted as being indicative of fair value. Mr. Linsmeier agreed. He stated that it was important to clarify that a distressed market is not in and of itself the same as a distressed transaction. Mr. Leisenring stated that modifying the proposed FSP per Ms. Seidman's suggestion would be very helpful. The Board agreed.

Issue 4: Other-Than-Temporary-Impairment Analysis 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"

16. Several constituents suggested that the use of contractual cash flows to determine the fair value of the collateralized debt obligation security in the example (which, given the facts and circumstances of the example, falls under the scope of Issue 99-20) is inconsistent with the guidance in Issue 99-20, which requires the use of market participant cash flows.

17. The staff noted that determining whether other-than-temporary impairment exists is beyond the scope of the FSP as proposed. Specifically, the staff noted that the FSP would not amend or change the requirement in Issue 99-20 to use market participant cash flows, not contractual cash

flows, to determine whether there has been an adverse change in estimated cash flows. Based on the feedback received from constituents on a draft of the proposed FSP, the staff modified the proposed FSP to include language that provides clarification on the issue of the use of market participant cash flows under Issue 99-20 versus the use of contractual cash flows for purposes of fair value measurements.

Issue 4 Board Comments

18. Ms. Seidman agreed that the FSP should be modified. She stated that such a modification could be made to the example itself so that the terms of the collateralized debt obligation security contained within the example did not fall within the scope of Issue 99-20 or the FSP could just state that the example is not meant to change the other-than-temporary-impairment analysis of Issue 99-20. Mr. Linsmeier stated that he would prefer that the FSP state its intent, rather than change the terms of the instrument contained within the example, so as to avoid any unnecessary confusion. The Board agreed with Mr. Linsmeier's comment.

Issue 5: Concerns about the Example Included in the FSP

19. Mr. Anderson stated that a number of comment letters provided suggestions on how to improve the example included in the proposed FSP. He added that the staff has considered those suggestions and made several changes to the example to improve its usefulness, including adding additional detail to the discussion on the reporting entity's use of indicative broker quotes in its fair value measurement. The staff also added a discussion of the reporting entity's rationale for reconciling and weighing the various indications of an appropriate discount rate to use in its income approach valuation technique.

Issue 5 Board Comments

20. Mr. Herz stated that some of the suggestions made by respondents were helpful in illustrating the thought process, given the facts and circumstances of the example contained within the proposed FSP, behind determining the fair value of an asset in a market that is not active. Ms. Seidman added that the staff will make technical corrections to the proposed FSP in response to some of the comments made by respondents.

Issue 6: Concerns about Other Areas of the FSP

21. Mr. Anderson highlighted other areas of the proposed FSP with which constituents are concerned, including:

- a. Scope—Several constituents expressed concern that the scope of the FSP only applies to financial assets. They are concerned that derivative instruments can be classified as a financial asset in one period and a financial liability in a different period and believe that, for that reason, the scope of the FSP should be expanded to include both financial assets and financial liabilities. The staff did not modify the scope of the FSP, but raised the issue for the Board's consideration.
- b. Disclosures—Several comment letters suggested that additional disclosures to provide financial statement users with more information on fair value measurements using unobservable inputs should be required. The staff noted that Statement 157 provides a robust disclosure framework, but agreed that additional disclosures on fair value measurements using unobservable information may be helpful to users. The FSP as proposed does not require any additional disclosures, but the staff plans to propose a separate short-term project to address additional fair value measurement disclosures to the Chairman and Board members for their consideration.
- c. Effective Date—A few comment letters expressed concern regarding the proposed effective date for the FSP—the FSP would be effective upon issuance, including prior periods for which financial statements have not been issued. The specific concern raised was that companies may have already closed their books for the quarter ending on September 30, but have not yet issued financial statements. The staff noted the concern, but maintained that the FSP should be effective upon issuance. The staff did so based on the urgency in the current market environment to assist financial statement preparers with fair value measurements for the third quarter and the need for increased consistency and comparability of fair value measurement information for users.

Issue 6 Board Comments

22. The Board commented on the issues as follows:

- a. Scope—Ms. Seidman stated that the original draft of the proposed FSP was scoped to include both financial assets and financial liabilities. She added, however, that the

staff changed the scope so as not to interfere with a current project that is addressing fair value measurement of liabilities with restrictions on transfer. Mr. Linsmeier added that the current project may, in its final state, scope-in financial assets with restrictions on transfer.

- b. Additional Disclosures—Mr. Linsmeier asked the staff how soon they expected to initiate and complete the project surrounding additional fair value measurement disclosures. Mr. Golden stated that the staff would present an agenda request to the Board within the next two to three weeks. He added that the staff hopes to complete the project in time for the fiscal year-end 2008 reporting period. Mr. Linsmeier emphasized the importance of completing that project for the fiscal year ended 2008.

Mr. Herz stated that the staff will have to consider the effects of the actions taken by the U.S. Treasury Department related to the current market crisis on disclosure and valuation. Mr. Linsmeier added that the program may also interact with classification principles.

Ms. Seidman highlighted the need for increased disclosure around the movement of inputs out of Level 1 and Level 2 and into Level 3. She stated that the recently issued standard on derivative disclosures, FSP FAS 133-1 and FIN 45-4, *Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45*; and *Clarification of the Effective Date of FASB Statement No. 161*, will go into effect for reporting periods (annual or interim) ending after November 15, 2008.

Mr. Leisenring added that the IASB will expose a document that includes the Level 1, Level 2, and Level 3 disclosures in Statement 157.

- c. Effective Date—Mr. Herz and Ms. Seidman expressed sympathy for preparers who had already attempted to comply with the disclosures in Statement 157. However, they both noted that there was no way to effectively allow that group of people to apply the new guidance at a later date. Mr. Mills raised concern about the ability of those preparers who were switching from a market approach to an income approach to apply the new guidance in a timely manner. Mr. Golden stated that most companies leave their books open until the financial statements are finalized. As

such, he recommends that the FSP remain effective upon issuance. Mr. Linsmeier added that because the due process associated with the new guidance was expedited to provide practitioners with necessary information as soon as possible, the FSP should be effective upon issuance. The Board affirmed its prior decision to make the FSP effective upon issuance.

Other Issues

23. Mr. Batavick suggested that it might be helpful to change the name of the FSP to "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active." He raised the concern that with the title as proposed, some constituents might continue to examine whether the overall market is active or not active instead of properly examining whether the market for a particular asset is active or not active. Mr. Smith suggested the title of the FSP alternatively could read "Determining the Fair Value of a Financial Asset When Its Market Is Not Active."

24. Ms. Seidman emphasized that all of the comment letters received had been read by the staff and that all concerns raised by respondents were considered, even if not publicly discussed during the meeting. Mr. Smith inquired as to when the FSP would be issued. Mr. Anderson stated that the FSP should be issued by the end of the day on October 10, 2008.

Follow-up Items

The Board directed the staff to draft the final FSP for balloting and publication.

General Announcements

None.