



Centre for  
Financial  
Market  
Integrity



LETTER OF COMMENT NO.

96

9 October 2008  
Mr. Robert Herz  
Chair, Financial Accounting Standards Board  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06865-5116

[director@fasb.org](mailto:director@fasb.org)

**Re: Proposed FASB Staff Position No. 157-d: Determining the Fair Value of a Financial Asset in a Market that is not active**

Dear Mr. Herz,

The CFA Institute Centre for Financial Market Integrity (CFA Institute Centre),<sup>1</sup> in consultation with its Corporate Disclosure Policy Council (CDPC)<sup>2</sup>, appreciates the opportunity to comment on the proposed FASB Staff Position No. 157-d (FSP 157-d), *Determining the Fair Value of a Financial Asset in a Market That Is Not Active*.

The CFA Institute Centre represents the views of its members, including portfolio managers, investment analysts, and advisors, worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protection. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics and Standards of Professional Conduct*.

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<sup>1</sup> The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 97,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

<sup>2</sup> The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The Council is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the Council provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

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## INTRODUCTION

Given the backdrop of the ongoing credit crisis, we would like to express our broad support for the recently issued FSP 157-d that clarifies key principles in the application of Statement 157. Continuing use of fair value in accounting for financial instruments is vital to the integrity and transparency of markets. This position paper in conjunction with the International Accounting Standards Board's (IASB) valuation expert advisory group report issued on September 16<sup>th</sup> 2008 (herein referred to as the "EAP paper"), uphold the application of fair value in the valuation of financial instruments while addressing the key difficulties that can arise when measuring financial instruments in inactive markets. The accompanying example in the FSP also provides a useful illustration of the application of principles discussed in Statement 157.

The guidance relating to illiquid instruments illustrates that fair value measurement in accordance with Statement No. 157 aims to reflect the economic reality of reporting entities in all instances. This is the case across the three levels of the valuation hierarchy. The principles enunciated reaffirm that liquidity and credit risks are an integral part of economic reality and must be considered in determining fair value. This guidance should help dispel the misconception that there are scenarios in which Statement 157 permits reporting entities to provide misleading values because of prevailing distressed markets. In particular, it is helpful that the paper clarifies that:

- Statement No. 157 does not prohibit the use of management's internal assumptions when observable market inputs are unavailable. However, the assumptions used must include appropriate risk adjustments that market participants would make for nonperformance and liquidity risks; and
- Broker quotes and pricing service evaluations may be an input into the fair value determination, but are not necessarily determinative if the market is not active. An entity should place less reliance on the quote that does not reflect the results of market transactions.

In our response below, we would like to provide some brief comments on two areas: 1) The definition of active markets and 2) Determination of distressed transactions. Thereafter, we reiterate<sup>3</sup> our support for enhanced disclosures including those proposed in the EAP paper. Although the focus at this particular juncture is on inactive markets, we would urge the board to address the disclosures necessary for different market conditions.

## DEFINITION OF ACTIVE MARKETS

We strongly urge the board and staff to cross reference any further deliberations on these matters to the findings contained in the EAP paper. The EAP paper provides indicators to be considered in determining whether a market is active or inactive. These include:

- Range of the bid-ask spreads;
- Volume and regularity of transactions; and
- Date of last trade.

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<sup>3</sup> In our comment letter to the IASB on *Reducing Complexity for Reporting Financial Instruments*, dated 19<sup>th</sup> September 2008, we also urge the IASB to integrate the valuation expert group findings in its review of International Financial Reporting Standard, Statement no 7, Financial Instruments: Disclosures (IFRS 7)

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We concur with the view that there are difficulties and undesirable consequences associated with establishing bright lines to differentiate between active or inactive markets. For this reason, we agree that management judgement is indispensable when determining whether a market is active or inactive.

From an investor perspective, what is necessary is to ensure that there is a consistent definition, application and disclosure about the valuation policy.

### **DISTRESSED TRANSACTIONS**

As a starting point, the clarification that there is a distinction between a **distressed market** and a **distressed transaction** within the FSP would be most helpful. These terms tend to be used interchangeably, contributing to confusion. We are concerned that there are instances where entities disregard market transactions occurring in what they believe is a distressed market without evidence that a specific transaction is distressed. As a general principle we strongly believe that the threshold of definition of a distressed transaction should be extremely high. As a result, we believe that absent tangible evidence to the contrary, a market transaction should be presumed to be "orderly" and included in a valuation regardless of the liquidity or distress in the market. For example, we do not believe that a distressed transaction occurs simply because a company has sold an asset below what it believes to be the intrinsic value due to de-leveraging. We suggest the FASB staff consider including additional guidance on how to distinguish distressed transactions and require disclosure about the nature and extent of those transactions deemed to be distressed and the rationale for such assessments.

The Center for Audit Quality (CAQ) has previously provided guidance on evaluating distressed transactions in its white paper "*Measurements of Fair Value in Illiquid (Or Less Liquid) Markets*" published in October 2007. This document provides a useful reference point on how to deal with distressed transactions. The CAQ paper clarifies that significantly reduced transaction volume in a market does not necessarily mean that transactions occurring are forced or distressed. The CAQ paper requires persuasive evidence to establish that an observable transaction is a forced or distressed transaction. It establishes that it is not appropriate to assume that all transactions in a relatively illiquid market are forced or distressed transactions or to disregard observable prices in an illiquid market

### **ENHANCED DISCLOSURES**

The EAP paper provides a comprehensive set of recommendations of key disclosures for consideration about fair value measurement. Similarly the "Dear CFO" letters issued by the SEC staff in March and September 2008 recommend certain disclosures for public companies. We strongly urge the board to adopt the proposals contained in those documents.

In the quest for enhanced disclosure, there is an inherent risk of data overload that could obscure useful information. In addition, preparers of financial statements argue frequently that additional disclosures cannot be assimilated or are not used. We counter that more accurate and useful information does not result in overload. Moreover, key attributes of any disclosures should be parsimony and transparency. A crucial determinant of the decision usefulness of any disclosed information is the level of aggregation. Therefore, management should aim to achieve the level of aggregation that is meaningful. Two recently

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published studies<sup>4</sup> of disclosure by Price Waterhouse Coopers and Fitch Ratings show that some reporting entities provide highly summarised and therefore meaningless information.

We believe that management should use clear and succinct formats using a combination of tables and narrative to convey the substance of a company's current sources of value and risk. As the EAP paper discusses, it is important to consider the materiality of the instrument, uncertainty and subjectivity of reported values, and the complexity of the instruments when determining the level of disclosure.

Below we would like to reinforce specific items of disclosure that would be useful to investors across the spectrum of financial instruments. These include:

- Movements and reconciliation of movements across all three levels of the valuation hierarchy. This should include a roll-forward of balances, realized and unrealized gains and losses within each level of the valuation hierarchy. In addition, the beginning and ending balances should identify the initial investment or proceeds and the cumulative losses recorded to date. The hedges of any of the balances should be clearly identified.
- Income effects of observable and unobservable inputs.
- Effect of changes to key assumptions on significant balance sheet elements valued using internal models (e.g. Mortgage Servicing Rights).
- For loans designated as "Held for Sale", the weighted average holding period since acquisition.
- Disclosure guidance on how the reporting entity applies the "distressed" transaction guidance.
- Sources of indirect market proxies and unobservable inputs.
- Distinction between impairment losses and mark to market adjustments and disclosure about the basis for recognizing and measuring impairment.
- To the extent that an entity uses "filters" to consider financial instruments for other than temporary impairment, disclosure on filters used (e.g. severity and duration) and the presentation of the available for sale and held to maturity portfolios within a table showing the severity and duration categories used in the assessment.
- Effect of credit risk deterioration and the credit value adjustments.

#### *Sensitivity Analysis*

Sensitivity analysis is crucial to conveying the range of outcomes possible. Consideration should be given to the nature and extent of sensitivity analysis that is relevant to users. We believe that investors are best served when managers provide sufficient information about the estimation model or process and the key inputs and assumptions so that investors can construct a reasonable model of the measurements. In addition, it is helpful to know how management uses sensitivity analysis in its risk management process and which assumptions are central to a firm's largest risks.

Some useful considerations to improving sensitivity analysis include:

- Separating forward looking and retrospective sensitivity analysis.
- Providing symmetrical risk analysis -- investors are interested in knowing both the upside and downside potential of the assets and liabilities held.

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<sup>4</sup> Accounting for change: Transparency in the Midst of Turmoil- A Survey of Banks' 2007 Annual Reports, August 2008- Price Waterhouse Coopers 2) Fair Value Disclosures: A Reality Check, June 26<sup>th</sup> 2008-Fitch Ratings

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- Disclosing multifactor risk analysis because it is more informative than a single factor sensitivity analysis. This is especially the case due to the correlation of key risk factors e.g. liquidity risk and counterparty credit risk.
- Balancing the level of aggregation in sensitivity analyses. Too much aggregation could offset countervailing risk factor effects, yet highly disaggregated sensitivity could provide information overload to investors.

### CLOSING REMARKS

If you, other board members or your staff have questions or seek further elaboration of our views, please contact either Vincent T. Papa, CFA, by phone at +44.207.531.0763, or by e-mail at [vincent.papa@cfainstitute.org](mailto:vincent.papa@cfainstitute.org), or Patrick Finnegan, CFA, by phone at +1.212.754.8350 or by e-mail at [patrick.finnegan@cfainstitute.org](mailto:patrick.finnegan@cfainstitute.org).

Sincerely,

*/s/Kurt N. Schacht*

Kurt N. Schacht, CFA  
Managing Director

*/s/ Gerald I. White*

Gerald I. White, CFA  
Chair, Corporate Disclosure Policy Council

cc: Corporate Disclosure Policy Council