

FASB STAFF POSITION

No. FAS 157-4

Title: Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly

Date Posted: April 9, 2009

Objective

1. This FASB Staff Position (FSP) provides additional guidance for estimating fair value in accordance with FASB Statement No. 157, *Fair Value Measurements*, when the volume and level of activity for the asset or liability have significantly decreased. This FSP also includes guidance on identifying circumstances that indicate a transaction is not orderly.
2. This FSP emphasizes that even if there has been a significant decrease in the volume and level of activity for the asset or liability and regardless of the valuation technique(s) used, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions.

Background

3. 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.

4. Statement 157 establishes a single definition of fair value and a framework for measuring fair value in U.S. generally accepted accounting principles (GAAP) that results 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.

5. The FASB obtained extensive input from various constituents, including financial statement users, preparers, and auditors, on determining fair value in connection with Statement 157. Many of those constituents indicated that the fair value measurement framework and related disclosures in Statement 157 have improved the quality and transparency of financial information. However, certain constituents requested additional authoritative guidance on the application of Statement 157.

6. Some constituents indicated that Statement 157 and FSP FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*, do not provide sufficient guidance on how to determine whether a market for a financial asset that historically was active is no longer active (including guidance on when to make a significant adjustment to a transaction or quoted price) and whether a transaction is not orderly. Some constituents observed an emphasis on the use of the so-called last transaction price (or quoted price) as the sole or primary basis of fair value even when a significant adjustment to the transaction price (or quoted price) may be required or when other valuation techniques should be considered. They indicated that this emphasis has resulted in a misapplication of Statement 157 when estimating the fair value of certain financial assets.

7. Paragraph 7 of Statement 157 states that “a fair value measurement assumes that the asset or liability is exchanged in an *orderly transaction* between market participants to sell the asset or transfer the liability at the measurement date. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement

date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; *it is not a forced transaction* (for example, a forced liquidation or distress sale)” (emphasis added). The notion that a transaction resulting from a forced liquidation or distressed sale does not represent fair value also is discussed in paragraphs 10 and 17 of Statement 157.

8. On October 3, 2008, the Emergency Economic Stabilization Act of 2008 (the Act) was signed into law. Section 133 of the Act mandated that the Securities and Exchange Commission (SEC) conduct a study on mark-to-market accounting standards. The SEC provided its study, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting*, to the United States Congress on December 30, 2008. One of the recommendations in the study stated that “additional measures should be taken to improve the application and practice related to existing fair value requirements (particularly as they relate to both Level 2 and Level 3 estimates).” This recommendation further noted that “fair value requirements should be improved through development of application and best practices guidance 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 thus potentially require significant adjustment to transactions or quoted prices and (b) how to determine if a transaction or group of transactions is forced or distressed (that is, not orderly). The guidance included in this FSP addresses the recommendations specific to these issues in the SEC’s study on mark-to-market accounting.

9. In the Board’s view, the primary concern of many constituents when estimating fair value for an asset or liability is determining when a transaction or quoted price in a market that is not active should be significantly adjusted (for example, by considering multiple valuation techniques). This FSP provides additional guidance on determining fair value when the volume and level of activity for the asset or liability have significantly decreased when compared with normal market activity for the asset or liability (or similar assets or liabilities). In the Board’s view, a significant decrease in the volume and level of activity for the asset or liability is an indication that transactions or

quoted prices may not be determinative of fair value because in such market conditions there may be increased instances of transactions that are not orderly. In those circumstances, further analysis of transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with Statement 157.

<p>All paragraphs in this FSP have equal authority. Paragraphs in bold set out the main principles.</p>
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FASB Staff Position

Scope

10. This FSP applies to all assets and liabilities within the scope of accounting pronouncements that require or permit fair value measurements, except as discussed in paragraphs 2 and 3 of Statement 157.

11. This FSP does not change the requirements in paragraphs 24–27 of Statement 157, which provide guidance on the use of Level 1 inputs. Accordingly, this FSP does not apply to quoted prices for an identical asset or liability in an active market (that is, a Level 1 input). For example, although the volume and level of activity for an asset or liability may significantly decrease, transactions for the asset or liability may still occur with sufficient frequency and volume to provide pricing information on an ongoing basis.

Determining Fair Value When the Volume and Level of Activity for an Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly

12. A reporting entity should evaluate the following factors to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability when compared with normal market activity for the asset or liability (or similar assets or liabilities). The factors include, but are not limited to:

- a. There are few recent transactions.
- 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 or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability.
- e. There is 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 nonperformance risk for the asset or liability.
- f. There is a wide bid-ask spread or significant increase in the bid-ask spread.
- g. There is a significant decline or absence of a market for new issuances (that is, a primary market) for the asset or liability or similar assets or liabilities.
- h. Little information is released publicly (for example, a principal-to-principal market).

A reporting entity shall evaluate the significance and relevance of the factors to determine whether, based on the weight of the evidence, there has been a significant decrease in the volume and level of activity for the asset or liability.

13. If the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities), transactions or quoted prices may not be determinative of fair value (for example, there may be increased instances of transactions that are not orderly). Further analysis of the transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with Statement 157. Significant adjustments also may be necessary in other circumstances (for example, when a price for a similar asset requires significant adjustment to make it more comparable to the asset being measured or when the price is stale).

14. Statement 157 does not prescribe a methodology for making significant adjustments to transactions or quoted prices when estimating fair value. Paragraphs 18–20 of Statement 157 discuss the use of valuation techniques in estimating fair value. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate (for example, the use of a market approach and a present value technique). **When weighting indications of fair value resulting from the use of multiple valuation techniques, a reporting entity shall consider the reasonableness of the range of fair value estimates. The objective is to determine the point within that range that is most representative of fair value under current market conditions. A wide range of fair value estimates may be an indication that further analysis is needed.**

15. **Even in circumstances where there has been a significant decrease in the volume and level of activity for the asset or liability and regardless of the valuation technique(s) used, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. Determining the price at which willing market participants would transact at the measurement date under current market conditions if there has been a significant decrease in the volume and level of activity for the asset or liability depends on the facts and circumstances and requires the use of significant judgment. However, a reporting entity’s intention to hold the asset or liability is not relevant in estimating fair value. Fair value is a market-based measurement, not an entity-specific measurement.**

16. Even if there has been a significant decrease in the volume and level of activity for the asset or liability, it is not appropriate to conclude that all transactions are not orderly (that is, distressed or forced). Circumstances that may indicate that a transaction is not orderly include, but are not limited to:

- a. There was not adequate 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.
- b. There was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant.
- c. 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).
- d. The transaction price is an outlier when compared with other recent transactions for the same or similar asset or liability.

A reporting entity shall evaluate the circumstances to determine whether the transaction is orderly based on the weight of the evidence.

17. The determination of whether a transaction is orderly (or not orderly) is more difficult if there has been a significant decrease in the volume and level of activity for the asset or liability. **Accordingly, a reporting entity shall consider the following guidance:**

- a. **If the weight of the evidence indicates the transaction is not orderly, a reporting entity shall place little, if any, weight (compared with other indications of fair value) on that transaction price when estimating fair value or market risk premiums.**
- b. **If the weight of the evidence indicates the transaction is orderly, a reporting entity shall 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.**
- c. **If a reporting entity does not have sufficient information to conclude that the transaction is orderly or that the transaction is not orderly, it shall 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). A reporting entity 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.**

In its determinations, a reporting entity need not undertake all possible efforts, but shall not ignore information that is available without undue cost and effort. A reporting entity would be expected to have sufficient information to conclude whether a transaction is orderly when it is party to the transaction.

18. Regardless of the valuation technique(s) used, a reporting entity shall include appropriate risk adjustments. Paragraph B5 of Statement 157 indicates that “risk-averse market participants generally seek compensation for bearing the uncertainty inherent in the cash flows of an asset or liability (risk premium). A fair value measurement should include a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) in the cash flows. Otherwise, the measurement would not faithfully represent fair value. In some cases, determining the appropriate risk premium might be difficult. However, the degree of difficulty alone is not a sufficient basis on which to exclude a risk adjustment.” Risk premiums should be reflective of an orderly transaction (that is, not a forced or distressed sale) between market participants at the measurement date under current market conditions.

19. When estimating fair value, Statement 157 does not preclude the use of quoted prices provided by third parties, such as pricing services or brokers, when a reporting entity has determined that the quoted prices provided by those parties are determined in accordance with Statement 157. However, when there has been a significant decrease in the volume or level of activity for the asset or liability, a reporting entity 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 weighting a quoted price as an input to a fair value measurement, a reporting entity should place less weight (when compared with other indications of fair value that are based on transactions) on quotes that do not reflect the result of transactions. Furthermore, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighting the available evidence, with more weight given to quotes based on binding offers.

Disclosures

20. This FSP amends Statement 157 to require that a reporting entity:
- a. Disclose in interim and annual periods the inputs and valuation technique(s) used to measure fair value and a discussion of changes in valuation techniques and related inputs, if any, during the period
 - b. Define *major category* (see paragraphs 32 and 33 of Statement 157) for equity securities and debt securities to be *major security types* as described in paragraph 19 of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (as amended by FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*), which states in part:

Major security types shall be based on the nature and risks of the security. An enterprise should consider the (shared) activity or business sector, vintage, geographic concentration, credit quality, or economic characteristic in determining whether disclosure for a particular security type is necessary and whether it is necessary to further separate a particular security type into greater detail. In complying with this requirement, financial institutions shall include in their disclosure the following major security types, though additional types also may be necessary:

- a. Equity securities (segregated by industry type, company size, or investment objective)
- b. Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies
- c. Debt securities issued by states of the United States and political subdivisions of the states
- d. Debt securities issued by foreign governments
- e. Corporate debt securities
- f. Residential mortgage-backed securities
- g. Commercial mortgage-backed securities
- h. Collateralized debt obligations
- i. Other debt obligations. [Footnote reference omitted.]

This requirement applies to all equity and debt securities measured at fair value even if the equity securities or debt securities are not within the scope of Statement 115. For example, this requirement includes those securities measured at fair value on a recurring basis in accordance with the AICPA Audit and Accounting Guide, *Investment Companies*.

Effective Date and Transition

21. This FSP shall be effective for interim and annual reporting periods ending after June 15, 2009, and shall be applied prospectively. Early adoption is permitted for periods ending after March 15, 2009. Earlier adoption for periods ending before March 15, 2009, is not permitted. If a reporting entity elects to adopt early either FSP FAS 115-2 and FAS 124-2 or FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*, the reporting entity also is required to adopt early this FSP. Additionally, if the reporting entity elects to adopt early this FSP, FSP FAS 115-2 and FAS 124-2 also must be adopted early. This FSP does not require disclosures for earlier periods presented for comparative purposes at initial adoption. In periods after initial adoption, this FSP requires comparative disclosures only for periods ending after initial adoption.

22. Revisions resulting from a change in valuation technique or its application shall be accounted for as a change in accounting estimate (paragraph 19 of FASB Statement No. 154, *Accounting Changes and Error Corrections*). In the period of adoption, a reporting entity shall disclose a change, if any, in valuation technique and related inputs resulting from the application of this FSP, and quantify the total effect of the change in valuation technique and related inputs, if practicable, by major category.

<p>The provisions of this FSP need not be applied to immaterial items.</p>

This FSP was adopted by the unanimous vote of the five members of the Financial Accounting Standards Board:

Robert H. Herz, *Chairman*
Thomas J. Linsmeier
Leslie F. Seidman
Marc A. Siegel
Lawrence W. Smith

Appendix

AMENDMENTS TO STATEMENT 157 AND FSP FAS 157-3

A1. Statement 157 is amended as follows: [Added text is underlined and deleted text is ~~struck out.~~]

a. Paragraph 21:

In this Statement, *inputs* refer broadly to the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk, for example, the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and/or the risk inherent in the inputs to the valuation technique. Inputs may be observable or unobservable:

- a. *Observable inputs* are inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity.
- b. *Unobservable inputs* are inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

Valuation techniques used to measure fair value shall maximize the use of relevant observable inputs (that is, Level 1 and Level 2 inputs that do not require significant adjustment) and minimize the use of unobservable inputs.

b. Paragraph 28:

Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

- a. Quoted prices for similar assets or liabilities in active markets
- b. Quoted prices for identical or similar assets or liabilities in markets that are not active (Paragraph 29A includes example factors that may indicate a market is not active or that there

has been a significant decrease in the volume and level of activity for the asset or liability when compared to normal market activity for the asset or liability (or similar assets or liabilities), depending on the degree to which the factors exist.), that is, markets in which there are few transactions for the asset or liability, the prices are not current, or price quotations vary substantially either over time or among market makers (for example, some brokered markets), or in which little information is released publicly (for example, a principal-to-principal market)

- c. Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates)
 - d. Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).
- c. Paragraph 29A–29H are added as follows:

29A. The reporting entity should evaluate the following factors to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability when compared with normal market activity for the asset or liability (or similar assets or liabilities). The factors include, but are not limited to:

- a. There are few recent transactions.
- 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 or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability.
- e. There is 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 nonperformance risk for the asset or liability.

f. There is a wide bid-ask spread or significant increase in the bid-ask spread.

g. There is a significant decline or absence of a market for new issuances (that is, a primary market) for the asset or liability or similar assets or liabilities.

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

The reporting entity shall evaluate the significance and relevance of the factors to determine whether, based on the weight of the evidence, there has been a significant decrease in the volume and level of activity for the asset or liability.

29B. If the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities), transactions or quoted prices may not be determinative of fair value (for example, there may be increased instances of transactions that are not orderly). Further analysis of the transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with this Statement. Significant adjustments also may be necessary in other circumstances (for example, when a price for a similar asset requires significant adjustment to make it more comparable to the asset being measured or when the price is stale).

29C. This Statement does not prescribe a methodology for making significant adjustments to transactions or quoted prices when estimating fair value. Paragraphs 18–20 discuss the use of valuation techniques in estimating fair value. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate (for example, the use of a market approach and a present value technique). When weighting indications of fair value resulting from the use of multiple valuation techniques, the reporting entity shall consider the reasonableness of the range of fair value estimates. The objective is to determine the point within that range that is most representative of fair value under current market conditions. A wide range of fair value estimates may be an indication that further analysis is needed.

29D. Even in circumstances where there has been a significant decrease in the volume and level of activity for the asset or liability and regardless of the valuation technique(s) used, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. Determining the price at which willing market participants would transact at the measurement date under current market conditions if there has been a significant decrease in the volume and level of activity for the asset or liability depends on the facts and circumstances and requires the use of significant judgment. However, the reporting entity's intention to hold the asset or liability is not relevant in estimating fair value. Fair value is a market-based measurement, not an entity-specific measurement.

29E. Even if there has been a significant decrease in the volume and level of activity for the asset or liability, it is not appropriate to conclude that all transactions are not orderly (that is, distressed or forced). Circumstances that may indicate that a transaction is not orderly include, but are not limited to:

- a. There was not adequate 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.
- b. There was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant.
- c. 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).
- d. The transaction price is an outlier when compared with other recent transactions for the same or similar asset or liability.

The reporting entity shall evaluate the circumstances to determine whether the transaction is orderly based on the weight of the evidence.

29F. The determination of whether a transaction is orderly (or not orderly) is more difficult if there has been a significant decrease in the volume and level of activity for the asset or liability. Accordingly, the reporting entity shall consider the following guidance:

- a. If the weight of the evidence indicates the transaction is not orderly, the reporting entity shall place little, if any, weight

(compared with other indications of fair value) on that transaction price when estimating fair value or market risk premiums.

- b. If the weight of the evidence indicates the transaction is orderly, the reporting entity shall 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.
- c. If the reporting entity does not have sufficient information to conclude that the transaction is orderly or that the transaction is not orderly, it shall 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 reporting entity shall place less weight on transactions on which the 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.

In its determinations, the reporting entity need not undertake all possible efforts, but shall not ignore information that is available without undue cost and effort. The reporting entity would be expected to have sufficient information to conclude whether a transaction is orderly when it is party to the transaction.

29G. Regardless of the valuation technique(s) used, the reporting entity shall include appropriate risk adjustments. Paragraph B5 of this Statement indicates that “risk-averse market participants generally seek compensation for bearing the uncertainty inherent in the cash flows of an asset or liability (risk premium). A fair value measurement should include a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) in the cash flows. Otherwise, the measurement would not faithfully represent fair value. In some cases, determining the appropriate risk premium might be difficult. However, the degree of difficulty alone is not a sufficient basis on which to exclude a risk adjustment.” Risk premiums should be reflective of an orderly transaction (that is, not a forced or distressed sale) between market participants at the measurement date under current market conditions.

29H. When estimating fair value, this Statement does not preclude the use of quoted prices provided by third parties, such as pricing services or brokers, when the reporting entity has determined that the quoted prices provided by those parties are determined in accordance with this Statement. However, when there has been a significant decrease in the volume or level of activity for the asset or liability, the reporting entity 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 weighting a quoted price as an input to a fair value measurement, the reporting entity should place less weight (when compared with other indications of fair value that are based on transactions) on quotes that do not reflect the result of transactions. Furthermore, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighting the available evidence, with more weight given to quotes based on binding offers.

d. Paragraph 30:

Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity's own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.

e. Paragraphs 32 and 33:

32. For assets and liabilities that are measured at fair value on a recurring basis in periods subsequent to initial recognition (for example, trading securities), the reporting entity shall disclose information that enables

users of its financial statements to assess the inputs used to develop those measurements and for recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on earnings (or changes in net assets) for the period. To meet that objective, the reporting entity shall disclose the following information for each interim and annual period (~~except as otherwise specified~~) separately for each major category of assets and liabilities (for equity and debt securities major category shall be defined as major security type as described in paragraph 19 of FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities even if the equity securities or debt securities are not within the scope of Statement 115):

- a. The fair value measurements at the reporting date
 - b. The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)
 - c. For fair value measurements using significant unobservable inputs (Level 3), a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to the following:¹²
 - (1) Total gains or losses for the period (realized and unrealized), segregating those gains or losses included in earnings (or changes in net assets), and a description of where those gains or losses included in earnings (or changes in net assets) are reported in the statement of income (or activities)
 - (2) Purchases, sales, issuances, and settlements (net)
 - (3) Transfers in and/or out of Level 3 (for example, transfers due to changes in the observability of significant inputs)
 - d. The amount of the total gains or losses for the period in subparagraph (c)(1) above included in earnings (or changes in net assets) that are attributable to the change in unrealized gains or losses relating to those assets and liabilities still held at the reporting date and a description of where those unrealized gains or losses are reported in the statement of income (or activities)
 - e. ~~In annual periods only, T~~he inputs and valuation technique(s) used to measure fair value and a discussion of changes in valuation techniques and related inputs, if any, during the period.
33. For assets and liabilities that are measured at fair value on a nonrecurring basis in periods subsequent to initial recognition (for example, impaired assets), the reporting entity shall disclose information that enables users of its financial statements to assess the inputs used to develop those measurements. To meet that objective, the reporting entity shall disclose the following information for each interim and annual period

~~(except as otherwise specified)~~ separately for each major category of assets and liabilities ~~(for equity and debt securities *major category* shall be defined as *major security type* as described in paragraph 19 of Statement 115 even if the equity securities or debt securities are not within the scope of Statement 115):~~

- a. The fair value measurements recorded during the period and the reasons for the measurements
- b. The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)
- c. For fair value measurements using significant unobservable inputs (Level 3), a description of the inputs and the information used to develop the inputs
- d. ~~In annual periods only,~~ The inputs and valuation technique(s) used to measure fair value and a discussion of changes, if any, in the valuation technique(s) and related inputs used to measure similar assets and/or liabilities in prior periods.

f. Paragraph A20:

This Statement emphasizes that valuation techniques used to measure the fair value of an asset or liability should maximize the use of relevant observable inputs, that is, inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity. Examples of markets in which inputs might be observable for some assets and liabilities (for example, financial instruments) include the following:

[The remaining section of this paragraph is omitted because it is unaffected by this FSP.]

- g. Example 11 (paragraphs A32A–A32F) and the related heading and footnotes are deleted and replaced with paragraphs A32A–A32G and their related heading and footnotes:

~~*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~~
- ~~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 Statement 157 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 Statement 157, 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).~~

^{24a} See paragraphs 20 and 21 of Statement 157.

^{24b} See paragraphs B7–B11 of Statement 157.

^{24c} The discount rate adjustment technique described in paragraphs B7–B11 of Statement 157 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 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.

^{24d} 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).

Example 11—Determining Fair Value When the Volume and Level of Activity for the Asset Have Significantly Decreased

Note: The conclusions reached in this example are based on the assumed, hypothetical facts and circumstances presented. Other approaches to determining fair value may be appropriate.

A32A. On January 1, 20X8 (the issuance date of the security), Entity A invested in a junior AAA-rated tranche of a residential

mortgage backed security. The junior tranche is the third most senior of a total of seven tranches. The underlying collateral for the residential mortgage backed security is unguaranteed Alt-A nonconforming residential mortgage loans that were issued in the second half of 2006. At March 31, 20X9 (the measurement date), the junior tranche of the residential mortgage backed security is now A-rated. This tranche of the residential mortgage backed security was previously traded through a brokered market; however, trading volume was infrequent, with only a few transactions per month from January 1, 20X8 through June 30, 20X8 and little, if any, trading activity during the nine months before March 31, 20X9.

A32B. Entity A considers the guidance in paragraph 29A to determine whether there has been a significant decrease in the volume and level of activity for the junior tranche of the residential mortgage backed security in which it has invested. After evaluating the significance and relevance of the factors, Entity A concludes that the volume and level of activity for the junior tranche of the residential mortgage backed security have significantly decreased. Entity A supported its judgment primarily on the basis of its observation that there was little, if any, trading activity for an extended period of time before the measurement date.

A32C. Because there is little, if any, trading activity to support a market approach valuation technique, Entity A decides to use the discount rate adjustment technique described in Appendix B of this Statement to estimate fair value for its security at the measurement date.^{21a} Entity A uses the contractual cash flows from the residential mortgage backed security.^{21b} Entity A then estimates a discount rate (that is, the market rate of return) that will be used to discount the contractual cash flows. The available information that Entity A uses to estimate an appropriate market rate of return included:

- a. The risk-free rate based on the rate of return on government debt securities
- b. Estimated adjustments for differences between the available market data and the junior tranche of the residential mortgage backed security in which Entity A has invested. Entity A evaluates available market data about expected nonperformance and uncertainty risks (for example, default risk, collateral value risk, and liquidity risk) that market participants would consider in pricing the asset in an orderly transaction at the measurement date under current market conditions. In determining those adjustments, Entity A considered:
 1. The credit spread for the junior tranche of the residential mortgage backed security at the issuance date implied by the original transaction price

2. The change in credit spread implied by any observed transactions from the issuance date to the measurement date for comparable residential mortgage backed securities, or based on relevant indexes
3. The specific characteristics of the junior tranche of the residential mortgage backed security compared with comparable residential mortgage backed securities or indexes, including the quality of the underlying assets (that is, information about the performance of the underlying mortgage loans, such as delinquency and foreclosure rates, loss experience, and prepayment rates), seniority and subordination of the residential mortgage backed security tranche held, and other relevant factors
4. Relevant reports issued by analysts and rating agencies
5. Quoted prices from third parties such as brokers or pricing services.

A32D. Entity A estimates that one indication of an appropriate market rate of return that market participants would use in pricing the junior tranche of the residential mortgage backed security is 12 percent (1,200 basis points). This market rate of return was estimated as follows:

- a. 300 basis points for the appropriate risk-free rate at March 31, 20X9.
- b. Add: 250 basis points for the credit spread over the risk-free rate at issuance of Entity A's junior tranche of the residential mortgage backed security in January 20X8.
- c. Add: 700 basis points for the estimated change in the credit spread over the risk-free rate for Entity A's junior tranche of the residential mortgage backed security between January 1, 20X8 and March 31, 20X9. This estimate was based on the change in the most comparable index available for the period between January 1, 20X8 and March 31, 20X9.
- d. Subtract: 50 basis points (net) to adjust for differences between the index used to estimate the change in credit spreads and Entity A's junior tranche of the residential mortgage backed security. The referenced index consists of subprime mortgage loans, while Entity A's residential mortgage backed security consists of Alt-A mortgage loans, making it more attractive to market participants. However, the index does not reflect an appropriate liquidity risk premium for Entity A's junior tranche of the residential mortgage backed security under current market conditions. Thus, the 50 basis point adjustment is the net of 2 adjustments.

1. The first adjustment is a 350 basis point subtraction, which was estimated by comparing the implied yield from the most recent transactions for the residential mortgage backed security in June 20X8 with the implied yield in the index price on those same dates. There was no information available that indicated that the relationship between Entity A's security and the index has changed.
2. The second adjustment is a 300 basis point addition, which is Entity A's best estimate of the additional liquidity risk inherent in its security (the cash position) when compared with the index (the synthetic position). This estimate was derived after considering liquidity risk premiums implied in recent cash transactions for a range of similar securities.

A32E. As an additional indication of an appropriate market rate of return, Entity A also considers 2 recent indicative quotes (that is, nonbinding quotes) provided by reputable brokers for the junior tranche of the residential mortgage backed security that imply yields of 15 to 17 percent. Entity A confirms that the quotes are not based on transactions, but it is unable to evaluate the valuation technique(s) or any other market data used to develop the quotes.

A32F. 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 weights, 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 13 percent is the point within the range of relevant inputs that is most representative of fair value under current market conditions. Entity A placed more weight on the 12 percent estimated market rate of return (that is, its own estimate) because (a) Entity A concluded that its own estimate appropriately incorporated nonperformance risk (for example, default risk and collateral value risk) and liquidity risk that market participants would use to estimate the selling price of the asset in an orderly transaction in the current market, and (b) the indications of an appropriate rate of return provided by the broker quotes were nonbinding quotes that were not based on transactions. Additionally, Entity A was not able to evaluate the valuation technique(s) or significant inputs used to develop the quotes.

A32G. Because changing the selected market rate of return would change the fair value of Entity A's junior tranche of the residential mortgage backed security significantly, Entity A voluntarily discloses

that input and quantifies the effect of using other reasonably possible discount rate estimates.

^{21a} See paragraphs 20 and 21 of this Statement.

^{21b} The discount rate adjustment technique described in paragraphs B7–B11 of this Statement would not be appropriate when determining whether there has been an other-than-temporary impairment and/or a change in yield under 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 that technique uses contractual cash flows rather than most likely cash flows.

h. Paragraphs A34 and A35 and their related heading:

Assets Measured at Fair Value on a Recurring Basis

A34. For assets and liabilities measured at fair value on a recurring basis during the period, this Statement requires quantitative disclosures about the fair value measurements separately for each major category of assets and liabilities (paragraph 32(a) and (b)). For assets, that information might be presented as follows:

<u>Description</u>	<u>12/31/XX</u>	<u>Fair Value Measurements at Reporting Date Using</u>		
		<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
Trading securities:				
<u>Equity securities – real estate</u>	\$115	\$105	\$10	
Available-for-sale securities:				
<u>Residential mortgage- backed securities</u>	75	<u>75</u>		<u>75</u>
Derivatives	60	25	15	\$20
Venture capital investments	<u>10</u>	<u>—</u>	<u>—</u>	<u>10</u>
Total	<u>\$260</u>	<u>\$130205</u>	<u>\$25</u>	<u>\$10530</u>

(Note: For liabilities, a similar table should be presented.)

Assets Measured at Fair Value on a Recurring Basis Using Significant Unobservable Inputs (Level 3)

A35. For assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the period, this Statement requires a reconciliation of the beginning and ending balances, separately for each major category of assets and liabilities, except for

derivative assets and liabilities, which may be presented net (paragraph 32(c) and (d)). For assets, the reconciliation might be presented as follows:

(\$ in 000s)	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)			
	<u>Residential Mortgage- Backed Securities</u>	<u>Derivatives</u>	<u>Venture Capital Investments</u>	<u>Total</u>
Beginning balance	\$80	\$14	\$11	\$105 25
Total gains or losses (realized/unrealized)				
Included in earnings (or changes in net assets)		11	(3)	8
Included in other comprehensive income	<u>(5)</u>	4		<u>(1)4</u>
Purchases, issuances, and settlements		(7)	2	(5)
Transfers in and/or out of Level 3	<u>0</u>	<u>(2)</u>	<u>0</u>	<u>(2)</u>
Ending balance	<u>\$75</u>	<u>\$20</u>	<u>\$10</u>	<u>\$10530</u>
The amount of total gains or losses for the period included in earnings (or changes in net assets) attributable to the change in unrealized gains or losses relating to assets still held at the reporting date	<u>\$ 0</u>	<u>\$ 7</u>	<u>\$ 2</u>	<u>\$ 9</u>

(Note: For liabilities, a similar table should be presented.)

Gains and losses (realized and unrealized) included in earnings (or changes in net assets) for the period (above) are reported in trading revenues and in other revenues as follows:

	<u>Trading Revenues</u>	<u>Other Revenues</u>
Total gains or losses included in earnings (or changes in net assets) for the period (above)	<u>\$11</u>	<u>\$(3)</u>
Change in unrealized gains or losses relating to assets still held at reporting date	<u>\$7</u>	<u>\$2</u>

A2. FSP FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*, is superseded by this FSP.