

Heads Up

In This Issue:

- Background
- Inactive Markets and Distressed Transactions
- Other-Than-Temporary Impairment
- Effective Dates and Transition

FAST-B Moves Quickly Guidance Proposed on Inactive Markets, Distressed Transactions, and Other-Than-Temporary Impairments

by John Sarno, Shahid Shah, and Angela Bacarella, Deloitte & Touche LLP

Late Tuesday night, the FASB exposed for public comment two proposed Staff Positions, [FSP FAS 157-e](#)¹ and [FSP FAS 115-a, FAS 124-a, and EITF 99-20-b](#).² The pair of FSPs is in response to the SEC's recommendations in its mark-to-market study³ and to last week's congressional hearings. Neither FSP suspends the use of mark-to-market accounting, but FSP FAS 157-e provides guidance on whether a market for a financial asset is inactive and, if so, whether transactions in that market are distressed (see below for details on the proposal for what it means to be an inactive market and a distressed transaction). The other FSP provides guidance on other-than-temporary impairment (OTTI) — more specifically, it seeks to change how an entity assesses whether an OTTI has occurred and, if so, where to record the OTTI (i.e., in the income statement or other comprehensive income). So, if you are holding (1) assets that are recorded at fair value on a recurring basis or (2) securities in which the fair value is below cost, we encourage you to read on.

Background

The SEC's mark-to-market study recommends (1) additional guidance on determining fair value in illiquid and inactive markets and (2) modifications to the OTTI guidance. More recently, on March 12 the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Entities held a hearing on mark-to-market accounting. During those proceedings, the Subcommittee reiterated the public's request for a "fix" to mark-to-market accounting. The Subcommittee urged FASB Chairman Robert Herz to provide additional guidance within three weeks. The proposed FSPs are the FASB's response to the recommendations from the SEC and the request from constituents and the Subcommittee.

Inactive Markets and Distressed Transactions

Some constituents believe that the fair value measurement guidance outlined in Statement 157's fair value hierarchy prioritizes an entity's use of observable transaction prices over an entity's own assumptions even when observable transaction prices are from a market that is not active. Other constituents believe that in today's market environment, observable transaction prices in inactive markets are not representative

Neither FSP
suspends the use of
mark-to-market
accounting.

¹ Proposed FSP FAS 157-e, "Determining Whether a Market Is Not Active and a Transaction Is Not Distressed."

² Proposed FSP FAS 115-a, FAS 124-a, and EITF 99-20-b, "Recognition and Presentation of Other-Than-Temporary Impairments."

³ See Deloitte's [January 9, 2009, Heads Up, "Study Finalized on Mark-to-Market Accounting."](#)

Proposed FSP FAS
157-e establishes a
two-step approach
for determining
whether a market is
not active and, if so,
whether a
transaction is
distressed.

of “fair value,” but instead represent a price associated with a distressed transaction. In addition, the FASB’s Valuation Resource Group has noted a current bias in favor of the presumption that a transaction price is **not** distressed unless the entity has evidence to the contrary.

To address the bias toward the use of observable transaction prices in markets that are not active, proposed FSP FAS 157-e establishes a **two-step approach** for determining whether a market is not active and, if so, whether a transaction is distressed. The intent is to allow entities greater flexibility to use their own judgment (based on realistic assumptions) when measuring the fair value of these financial assets rather than relying solely on observable prices in markets that are not active. **Caution:** Application of this approach requires significant professional judgment.

In step 1 of the two-step approach, the entity determines whether there are factors present that indicate that the market for the financial asset is not active as of the measurement date. Proposed FSP FAS 157-e states that such factors would include (but not be limited to) the following:

- a. Few recent transactions (based on volume and level of activity in the market). Thus, there is not sufficient frequency and volume to provide pricing information on an ongoing basis.
- 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 assets are demonstrably uncorrelated with recent fair values.
- e. Abnormal (or significant increases in) liquidity risk premiums or implied yields for quoted prices when compared with reasonable estimates (using realistic assumptions) of credit and other nonperformance risk for the asset class.
- f. Abnormally wide bid-ask spread or significant increases in the bid-ask spread.
- g. Little information is released publicly (for example, a principal-to-principal market).

The proposed FSP states that an entity must evaluate all factors before concluding whether a market is not active. If the entity concludes that the market is not active, the entity **must presume** that the observed transaction price is associated with a “distressed” transaction unless there is evidence that the observed transaction meets both of the following criteria (i.e., step 2):

- a. There was a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities (for example, there was not a regulatory requirement to sell).
- b. There were multiple bidders for the asset.

Step 2 represents a significant change from the current practice of entities generally presuming that a quoted price in an inactive market is **not** distressed unless evidence exists to the contrary. Under the two-step approach, the opposite is true. That is, the proposed FSP requires an entity to presume that a quoted price in an inactive market **is** distressed unless the entity is able to prove that the quoted price meets both of the step-2 criteria outlined above. If the entity determines that it does not have enough evidence to conclude that the quoted price meets both of the step-2 criteria, then the quoted price is deemed to be distressed, and an entity must use a valuation technique other than one that uses the transaction price without significant adjustment (for example, a present value technique) to estimate fair value. The inputs to the valuation technique should reflect an orderly transaction between market participants as of the measurement date.

Keep in mind that the two-step approach does not change current practice if, on the basis of the second step, an entity concludes that the quoted price is not a distressed transaction. Then, the quoted price would be deemed a relevant observable input that the entity should consider in estimating fair value. However, the entity is still required to consider whether there are other factors present that may warrant an adjustment to the quoted price (e.g., the quoted price is not current).

The proposed FSP eliminates an entity's requirement to assert its intent and ability to hold an investment until its forecasted recovery to avoid recognizing an impairment loss.

Other-Than-Temporary Impairment

Under the existing OTTI model, entities must assess, among other factors, whether they have the intent and ability to hold a security for a period sufficient to allow for a recovery in value of the investment to, at least, its current cost basis. Constituents have commented that it is difficult for an entity to assess whether an investment will recover in value or whether it intends to hold the investment until recovery, which may not be until maturity. In addition, some constituents are also concerned that if an OTTI is determined to have occurred, writing an asset down to a value that has been determined in a depressed market (see discussion above) is not representative of the underlying cash flows that the entity intends to collect on the investments. For example, if an entity expects only a small change in the underlying cash flows of an investment in a debt security, some believe that writing the security down to its value in a depressed market is not representationally faithful, especially if the entity intends to hold onto the security for the foreseeable future. Proposed FSP FAS 115-a, FAS 124-a, and EITF 99-20-b addresses both of these concerns.

The proposed FSP eliminates an entity's requirement to assert its intent and ability to hold an investment until its forecasted recovery to avoid recognizing an impairment loss. The proposed FSP turns the intent and ability assertion around, requiring an entity to recognize an OTTI when the entity intends to sell the security or it is more likely than not that it will be required to sell the security before recovery. In such a case, the entire amount of OTTI (i.e., the difference between fair value and the entity's cost basis) will be recorded in earnings (same measurement as the current OTTI model). Of course, entities will need to continue to assess the other factors used to determine whether a security is other-than-temporarily impaired (e.g., the severity and duration of the decline in the value of the security below its cost basis).

The proposal also changes the presentation of OTTI for underwater held-to-maturity or available-for-sale **debt securities** that the entity does not intend to sell (and will not more likely than not be required to sell), but for which there is a credit impairment (i.e., all contractual cash flows will not be received when due). The proposed FSP requires an entity to record in earnings on a net basis only the credit losses associated with this set of debt instruments. All other amounts of the OTTI loss are recorded in other comprehensive income (even held-to-maturity securities). Sound familiar? Some have likened the amount of the credit impairment recognized in earnings in this model to the amount in the incurred-loss model for impairments of loans under Statement 114.⁴

Under the new impairment model, subsequent changes in fair value of an available-for-sale debt security, for which a portion of the OTTI loss was recognized in other comprehensive income, would remain in other comprehensive income unless (1) there are additional credit losses, (2) the entity intends to sell the security, or (3) the entity can no longer assert that it is more likely than not that the entity will not be required to sell the security before recovery.

Lastly, for held-to-maturity debt securities, the portion of the OTTI loss recorded in other comprehensive income is amortized prospectively as an increase (i.e., a credit) to other comprehensive income and an increase (i.e., debit) to the investment balance.

Effective Dates and Transition

The proposed FSPs would be effective prospectively for interim and annual periods ending after March 15, 2009. Therefore, for calendar-year-end entities, they would be effective for the first quarter of 2009. Any changes in fair value resulting from an entity's application of FSP FAS 157-e are accounted for as a change in estimate under Statement 154.⁵

⁴ FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*.

⁵ FASB Statement No. 154, *Accounting Changes and Error Corrections*.

Subscriptions

If you wish to receive *Heads Up* and other accounting publications issued by Deloitte's Accounting Standards and Communications Group, please [register](http://www.deloitte.com/us/subscriptions) at www.deloitte.com/us/subscriptions.

Dbriefs for Financial Executives

We invite you to participate in *Dbriefs*, Deloitte's webcast series that delivers practical strategies you need to stay on top of important issues. Gain access to valuable ideas and critical information from webcasts in the "Financial Executives" series on the following topics:

- Corporate governance.
- FAS 109.
- Private companies.
- Transactions and business events.
- Driving enterprise value.
- Financial reporting.
- Risk intelligence.

Dbriefs also provides a convenient and flexible way to earn CPE credit — right at your desk. [Join *Dbriefs*](#) to receive notifications about future webcasts at www.deloitte.com/us/dbriefs.

Registration is available for this upcoming 60-minute *Dbriefs* webcast:

- [Oversight of the Fiscal Stimulus Bill: Transparency in a New Age](#) (March 23).

Use the link above to register. The webcast begins at 2 p.m. (EDT).

Technical Library: The Deloitte Accounting Research Tool

Deloitte makes available, on a subscription basis, access to its online library of accounting and financial disclosure literature. Called Technical Library: The Deloitte Accounting Research Tool, the library includes material from the FASB, the EITF, the AICPA, the PCAOB, the IASB, and the SEC, in addition to Deloitte's own accounting and SEC manuals and other interpretive accounting and SEC guidance.

Updated every business day, Technical Library has an intuitive design and navigation system that, together with its powerful search features, enable users to quickly locate information anytime, from any computer. In addition, Technical Library subscribers receive *Technically Speaking*, the weekly publication that highlights recent additions to the library.

For more information, including subscription details and an online demonstration, visit www.deloitte.com/us/techlibrary.

Heads Up is prepared by the National Office Accounting Standards and Communications Group of Deloitte as developments warrant. This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

As used in this document, "Deloitte" means Deloitte & Touche LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.

Copyright © 2009 Deloitte Development LLC. All rights reserved.