KPMG

Defining Issues®

KPMG LLP

March 2009, No. 09-13

FASB Proposals on Fair-Value Measurements and Other-Than-Temporary Impairments

New, fast-track proposed FASB Staff Positions would change how companies determine whether an observed transaction price or a quote from a broker or pricing service is a "forced liquidation price" or a "distressed sale price" and therefore assumed not to be representative of fair value, and how other-than-temporary impairments of investments in debt and equity securities are recognized and measured.[1] The proposed guidance may, in many circumstances, preclude companies from using traditional sources for valuations, including external pricing sources, which could require companies to develop alternative valuation techniques. If adopted without change, the proposals would be effective prospectively for interim and annual periods ending after March 15, 2009. Comments are due by April 1.

The proposals attempt to respond to concerns raised by certain constituent groups about the effects of accounting requirements for write-downs of investment securities in the current economic environment, concerns emphasized in a recent hearing on fair-value accounting held by the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Entities. The subcommittee instructed the FASB to take immediate action to address those constituent concerns.

The Board is expected to discuss comments received at a meeting on April 2, 2009. We anticipate that the final Staff Positions will be issued shortly after the meeting.

[1] Proposed FASB Staff Position No. FAS 157-e, Determining Whether a Market Is Not Active and a Transaction is Not Distressed, and Proposed FASB Staff Position No. FAS 115-a, FAS 124-a, and EITF 99-20-b, Recognition and Presentation of Other-Than-Temporary Impairments, both available at www.fasb.org.

Identifying Inactive Markets and Distressed Transactions

Statement 157, which defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, says that an orderly transaction is not a forced transaction, such as a forced liquidation or distressed sale.[2] The first proposed Staff Position would revise Statement 157's requirements for determining whether a market is inactive and whether an observed transaction price or a quote from a broker or pricing service should be considered a distressed transaction price. The price obtained from a transaction or quote would be assumed not to be representative of fair value under Statement 157 if a company applying the model concluded that the market was inactive and the transaction met the conditions to be considered distressed. Under the proposed Staff Position, a price that is presumed to be associated with a distressed transaction could not be considered without significant adjustment when measuring the fair value of a financial asset.

The proposal does not explicitly modify the "exit price" measurement objective described in Statement 157. However, it is not clear how inputs would be determined in applying that measurement objective when the market for an asset is inactive, because, under the proposed Staff Position, information about market transactions that occur often would not be considered "relevant observable inputs" for purposes of estimating fair value.

As the second step in the model described below makes clearer, this proposal would change current requirements, which specify that it is not appropriate to assume that all market activity represents forced liquidations or distressed sales, even in times of market dislocation. In current practice, prices from observed transactions or quotes from brokers and pricing services are generally presumed to be relevant inputs to a fair-value measurement unless the company has evidence supporting a conclusion that the price reflected a forced liquidation or distressed sale. However, those pricing inputs might still require adjustment in a fair-value measurement under the existing guidance (for example, if the prices are not current). The proposed Staff Position would reverse the presumption for financial assets that are transacted in an inactive market by starting with the premise that prices from observed transactions in such markets or quotes from brokers or pricing services derived from transactions in such markets are distressed transaction prices unless the company has evidence indicating that the pricing inputs represent prices for an orderly transaction.

The proposed Staff Position would require financial-statement preparers to apply the following two-step process for purposes of determining whether an observed transaction price or a quote from a broker or pricing service is a distressed transaction price.

Step 1. Determine whether factors indicate that the market for the asset is not active at the measurement date. The proposal lists the following factors, but the list is not meant to be all-inclusive:

- Transaction frequency and volume are insufficient to provide ongoing pricing information.
- Price quotations are not based on current information or vary substantially either over time or among market makers (for example, some brokered markets).
- Indexes that previously were highly correlated with the asset's fair values are demonstrably uncorrelated with recent fair values.
- Liquidity-risk premiums or implied yields for quoted prices are abnormally or significantly increased when compared to reasonable estimates of credit and other nonperformance risk for the asset class.
- Bid-ask spreads are abnormally wide or significantly increased.
- Little information is released publicly (for example, a principal-to-principal market).

The company would consider the significance and relevance of each factor in the market being analyzed. If the company concludes that the evidence indicates that the market is not active, it would apply Step 2 to determine whether the observed transaction price or the price quote represents a distressed transaction price.

Step 2. An observed transaction or price quote in an inactive market would be presumed to be associated with a distressed transaction unless evidence indicates that both of the following conditions are present:

- There was sufficient time before the measurement date to allow for usual and customary marketing activities for the asset, and
- More than one party bid for the asset.

[2] FASB Statement No. 157, Fair Value Measurements, available at www.fasb.org.

Evidence that both conditions are present would mean the observed transaction price or price quote is presumed not to be associated with a distressed transaction and therefore may be a relevant observable input that should be considered when estimating fair value. However, under Statement 157, other factors or conditions may necessitate a price adjustment even if the above factors are present. For example, if an observed price or price quote that is not associated with a distressed transaction is not current or is a consequence of a trade with an insignificant volume relative to the total market for that asset, the company should consider whether to adjust that price in determining fair value for the related asset.

In the absence of evidence that both of the above conditions are present, the observed transaction price or price quote would be assumed to be associated with a distressed transaction, and the company would be required to apply a valuation technique that does not use that price without a significant adjustment. The result would typically be a "Level 3" measurement under Statement 157's fair-value hierarchy. In such circumstances, the company could apply a present-value technique to estimate fair value, using inputs that reflect an orderly transaction between market participants at the measurement date. An orderly transaction price would reflect all risks inherent in the asset, including a reasonable risk premium for bearing uncertainty that would be considered by willing buyers and sellers in pricing the asset in a nondistressed transaction at the measurement date.

Other-Than-Temporarily Impaired Debt and Equity Securities

Under current guidance in Statements 115 and 124 and related interpretations, a company is required to consider relevant factors in determining whether an impairment of a debt or equity security is considered to be other-than-temporary, in which case the loss is recognized in earnings.[3] Some examples of those factors include the extent and severity of the impairment, the financial condition and near-term prospects of the issuer, and the investor's intent and ability to hold the security for a period of time that is sufficient to allow the security to recover its value. The second proposed Staff Position would modify the "intent and ability to hold to recovery" indicator of other-than-temporary impairment by specifying that if a company does not intend to sell a security prior to recovery and if it is "not more-likely-than-not" that the company will sell the security prior to recovery, the security would not be considered other-than-temporarily impaired unless the investment is a debt security with credit losses. The Board believes this revised indicator will be more operational for companies. Other relevant indicators considered in evaluating whether a security is other-than-temporarily impaired would not be affected by the proposal. For example, companies would still need to consider the severity and duration of the impairment and the financial condition and near-term prospects of the issuer.

The proposal would require the amount of the impairment loss recorded in earnings for a debt or equity security to be the entire difference between the security's cost and its fair value if the company intends to sell prior to recovery or will more-likely-than-not need to sell prior to recovery. In those circumstances, the amount of the impairment loss recognized in the income statement would be consistent with the current requirements for recording other-than-temporary impairments. However, the proposed Staff Position would change the amount of an other-than-temporary impairment loss recognized in the income statement when the impairment is recorded because of a credit loss on a debt security, provided that the entity neither intends to sell the security prior to recovery nor concludes that it is more-likely-than-not that it will sell the security prior to recovery. In that circumstance, the impairment loss recorded in earnings would be limited to the credit loss, and the remaining difference between the security's fair value and its cost basis (for example, the portion of loss attributable to increases in interest rates or liquidity premiums) would be recognized in other comprehensive income. One method of estimating the portion of the total other-than-temporary impairment charge that is attributable to credit losses would be the measurement methodology described in Statement 114.[4] Companies would continue to estimate the total impairment charge for credit losses on debt securities within the scope of EITF 99-20 in accordance with its Consensus and its interpretations.[5]

---

[3] FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, FASB Statement No. 124, Accounting for Certain Investments Held by Not-for-Profit Organizations, and FSP FAS 115-1 and 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, all available at www.fasb.org, and SEC Staff Accounting Bulletin Topic 5M, Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities, available at www.sec.gov.

[4] FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan, available at www.fasb.org.

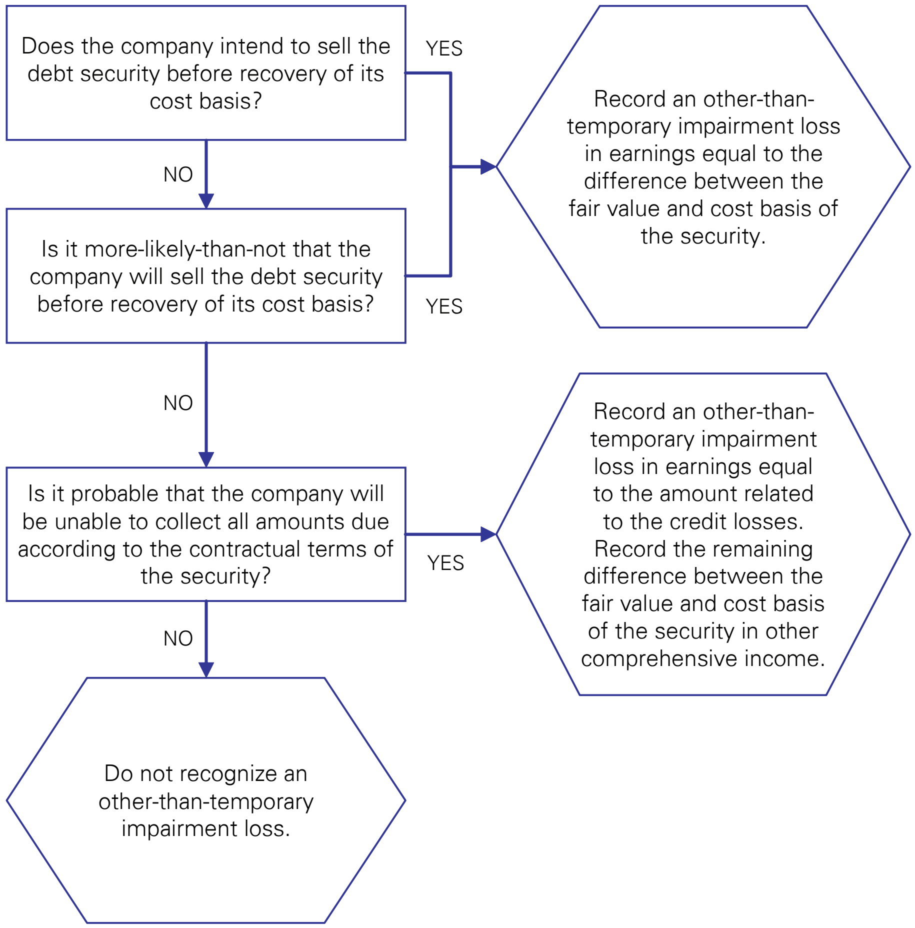
[5] EITF Issue No. 99-20, Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets, and FSP EITF 99-20-1, Amendments to the Impairment Guidance in EITF Issue No. 99-20, both available at www.fasb.org.

The nearby flowchart illustrates the decision process that would be required to apply the proposed Staff Position to a debt security with a fair value that is less than its cost for purposes of determining whether there is an other-than-temporary impairment loss and the amount of the loss that would be recognized in the income statement.

Companies would be required to present the total amount of the impairment separately in the income statement and to present the amount recognized in other comprehensive income as a deduction from the total impairment. Companies must also disclose the methodology and key inputs used to measure the portion of the total impairment that relates to credit losses.

Companies that recognize other-than-temporary impairment losses for debt securities must in subsequent periods account for the other-than-temporarily impaired debt security as if the debt security had been purchased on the measurement date of the other than-temporary impairment at a cost equal to the previous basis less the impairment recognized in earnings. The discount or reduced premium recorded for the debt security, based on the new cost basis, would be amortized prospectively over the remaining life of the debt based on the amount and timing of future estimated cash flows unless a sale of the debt security becomes imminent.

Application of the Guidance in the Proposed Staff Position to a Debt Security with a Fair Value Less Than its Cost Basis



The proposed Staff Position would establish a new category within other comprehensive income for the portion of other-than-temporary impairments for held-to-maturity debt securities that is not related to credit losses. The impairment recognized in other comprehensive income for a held-to-maturity debt security would be amortized prospectively back through other comprehensive income over the remaining life of the debt security based on the amount and timing of future estimated cash flows by increasing the recorded value of the asset, unless additional other-than-temporary impairments attributable to credit losses are recognized in a future period. Earnings would not be affected by subsequently amortizing the portion of an other-than-temporary impairment loss that was recognized in other comprehensive income.

The nearby boxed example, based on the example in the handout for the FASB's March 16 meeting, shows how the proposed Staff Position would change accounting for other-than-temporary impairments.

Example: Proposed Changes in Accounting for Other-Than-Temporary Impairments

Company A holds debt securities X, Y, and Z. Securities X and Y are classified as available-for-sale. Security Z is classified as held-to-maturity. The cost basis of each security at 12/31/x1 is $10,000,000 ($30,000,000 in total). The estimated fair values of securities X, Y, and Z are, respectively, $7,000,000, $8,000,000, and $9,000,000 ($24,000,000 in total). Company A concludes that the impairments of securities X and Z are other-than-temporary because it is probable that it will be unable to collect all amounts due according to the securities' contractual terms. It does not have the intent and ability to hold security Y until recovery.

Company A believes that it is more-likely-than-not that it will sell security X prior to its recovery. However, Company A does not intend to sell security Y, and it is more-likely-than-not that it will not sell security Y prior to its recovery. Company A estimates that $1,700,000 of security X's and $400,000 of security Z's other-than-temporary impairment losses are related to credit losses and that the remainder of the losses (i.e., $1,300,000 for security X and $600,000 for security Z) are attributable to other factors. Company A does not anticipate any credit losses for security Y.

Current GAAP

Impairment loss recorded in the income statement ($3,000,000 for security X, $2,000,000 for security Y, and $1,000,000 for security Z)	$6,000,000

Proposed Approach

Total impairment loss ($3,000,000 for security X and $1,000,000 for security Z)	$4,000,000
Less: Noncredit losses recorded in accumulated other comprehensive income on securities more-likely-than-not to be held to recovery (security Z)	(600,000)
Net impairment loss recorded in the income statement ($3,000,000 for security X and $400,000 for security Z)	$3,400,000

Effective Date and Transition

If approved as proposed, both Staff Positions would be effective for interim and annual periods ending after March 15, 2009. However, some Board members at the March 16, 2009 FASB meeting expressed concern about the ability of some companies to implement the proposed guidance in such a short time frame. The Board is therefore expected to consider after the comment period whether to change to a later effective date, while permitting early adoption.

Regardless of the effective date, the proposed requirements would be applied prospectively as a change in accounting estimate, and companies would not be permitted to revise previously issued financial statements.

This is a publication of KPMG's Department of Professional Practice—Audit
212-909-5600

Contributing authors:
Mark A. Northan
Brian C. Stevens
Hillary H. Larson

Earlier editions are available at:
www.us.kpmg.com/definingissues