Notice for Recipients of This Proposed FASB Staff Position

This proposed FASB Staff Position (FSP) provides additional guidance on determining whether a market for a financial asset is not active and a transaction is not distressed for fair value measurements under FASB Statement No. 157, *Fair Value Measurements.*

The Board invites individuals and organizations to send written comments on all matters in this proposed FSP. Respondents need not comment on all of the issues presented and are encouraged to comment on additional issues as well. Comments are requested from those who agree with the provisions of this proposed FSP as well as from those who do not. Comments are most helpful if they identify the issues to which they relate and clearly explain the reasons for the positions taken. Those who disagree with provisions of this proposed FSP are asked to describe their suggested alternatives, supported by specific reasoning.

The Board requests that constituents provide comments on the following questions:

1. Is the proposed effective date of interim and annual periods ending after March 15, 2009, operational?
2. Will this proposed FSP meet the project's objective to improve financial reporting by addressing fair value measurement application issues identified by constituents related to determining whether a market is not active and a transaction is not distressed? Do you believe the amendments to Statement 157 in this proposed FSP are necessary, or do you believe the current requirements in Statement 157 should be retained?
3. Do you believe the proposed two-step model for determining whether a market is not active and a transaction is not distressed is understandable and operational? If not, please suggest alternative ways of identifying inactive markets and distressed transactions.

4. Are the factors listed in paragraph 11 of the FSP that indicate that a market is not active appropriate? Please provide any other factors that indicate that a market is not active.
5. What costs do you expect to incur if the Board were to issue this proposed FSP in its current form as a final FSP? How could the Board further reduce the costs of applying the requirements of the FSP without reducing the benefits?

Responses must be received in writing by April 1, 2009. Earlier responses are encouraged. Interested parties should submit their comments by email to director@fasb.org, File Reference: Proposed FSP FAS 157-e. Those without email may send their comments to "Technical Director, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116, File Reference: Proposed FSP FAS 157-e." Responses should not be sent by fax. All comments received by the FASB are considered public information. Those comments will be posted to the FASB website and included as part of the project record with other project materials.

PROPOSED FASB STAFF POSITION

No. FAS 157-e

Title: Determining Whether a Market Is Not Active and a Transaction Is Not Distressed

Date Released: March 17, 2009

Comment Deadline: April 1, 2009

Objective

1. This proposed FASB Staff Position (FSP) provides additional guidance on determining whether a market for a financial asset is not active and a transaction is not distressed for fair value measurements under FASB Statement No. 157, *Fair Value Measurements.*

Background

2. 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.

3. Statement 157 establishes a single definition of fair value and a framework for measuring fair value in generally accepted accounting principles (GAAP) that result 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.

4. The FASB obtained extensive input from various constituents, including financial statement users, preparers, and auditors, on determining fair value in accordance with Statement 157. Many of those constituents indicated that the fair value measurement framework in Statement 157 and related disclosures have improved the quality and

transparency of financial information. However, certain constituents have requested additional authoritative guidance related to the application of Statement 157.

5. Paragraph 7 of Statement 157 states, "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 price for a forced liquidation or distress sale does not represent fair value is also discussed in paragraphs 10 and 17 of Statement 157.

6. Many constituents believe 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 not active and whether a transaction is not distressed. Also, those constituents state that the fair value hierarchy within Statement 157 may be interpreted to emphasize the use of an observable market transaction even when that transaction may be distressed or the market for that transaction may not be active. Constituents have indicated that this emphasis on the use of the so-called last transaction price as the sole or primary basis of fair value even when a significant adjustment may be required to the transaction price or when other valuation techniques should be considered has resulted in a misapplication of Statement 157 when estimating the fair value of certain financial assets.

7. On October 3, 2008, the Emergency Economic Stabilization Act of 2008 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 notes 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 (b) how to determine if a transaction or group of transactions is forced or distressed. The guidance included in this FSP addresses the recommendations specific to these issues in the SEC's study on mark-to-market accounting.

All paragraphs in this FSP have equal authority.
Paragraphs in bold set out the main principles.

FASB Staff Position

Scope

8. **This FSP applies to financial assets within the scope of accounting pronouncements that require or permit fair value measurements in accordance with Statement 157.**

Guidance on Determining Whether a Market Is Not Active and a Transaction Is Not Distressed

9. This FSP provides additional guidance on determining whether a market for a financial asset is not active and a transaction is not distressed for fair value measurements under Statement 157.

10. **This FSP establishes a two-step process to determine whether a market is not active and a transaction is not distressed.**

11. Step 1 provides factors that indicate that a market is not active. Those factors should not be considered all inclusive because other factors may also indicate that a market is not active. Factors include:

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 asset 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).

12. After evaluating all factors and considering the significance and relevance of each factor, the reporting entity shall use its judgment in determining whether the market is active.

13. If the reporting entity concludes in step 1 that the market for the asset is not active, then the reporting entity will proceed to step 2. In step 2, the reporting entity must presume that a quoted price is associated with a distressed transaction unless the reporting entity has evidence that (a) there was sufficient time before the measurement date to allow for usual and customary marketing activities for the asset and (b) there were multiple bidders for the asset.

14. If the reporting entity has evidence that both factors are present for a given quoted price, then that quoted price is presumed not to be associated with a distressed transaction. In that case, the quoted price may be a relevant observable input that should be considered in estimating fair value. However, the reporting entity should consider whether any other factors or conditions warrant making an adjustment to the quoted price as discussed in paragraph 29 of Statement 157. For example, if a quoted price 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 reporting entity should consider whether that quoted price is a relevant observable input (that is, whether the quoted price requires adjustment).

15. If the reporting entity does not have evidence that both factors in paragraph 13 are present for a given quoted price, then the reporting entity shall consider that quoted price to be associated with a distressed transaction. When that is the case, the reporting entity must use a valuation technique other than one that uses that quoted price without significant adjustment. For example, the reporting entity could use an income approach, such as a present value technique to estimate fair value. The inputs to the present value technique should reflect an orderly transaction between market participants at the measurement date. An orderly transaction would reflect all risks inherent in the asset, including a reasonable risk premium for bearing uncertainty that would be considered by willing buyers and willing sellers in pricing the asset in a nondistressed transaction at the measurement date.

Effective Date and Transition

16. This FSP shall be effective for interim and annual periods ending after March 15, 2009, and shall be applied prospectively. Retrospective application to a prior interim or annual reporting period is not permitted.

17. Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate (FASB Statement No. 154, *Accounting Changes and Error Corrections,* paragraph 19). In the period of adoption, entities shall disclose a change in valuation technique resulting from the application of this FSP, and quantify its effects, if practicable.

The provisions of this FSP need not be applied to immaterial items.

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 relevant 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)~~, 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 is added as follows:

When evaluating whether it is necessary to make a significant adjustment to quoted prices for identical or similar assets or liabilities in markets that are not active, the reporting entity shall apply the following two-step approach (significant judgment is required):

Step 1: Determine whether there are factors present that indicate that the market for the asset is not active at the measurement date. Those factors should not be considered all inclusive because other factors may also indicate that a market is not active. Factors include:

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 asset 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).

After evaluating all factors and considering the significance and relevance of each factor, the reporting entity shall use its judgment in determining whether the market is active. The reporting entity shall apply step 2 when the entity determines that the market is not active.

Step 2: Evaluate the quoted price (that is, a recent transaction or broker price quotation) to determine whether the quoted price is associated with a distressed transaction. The reporting entity shall presume that the quoted price is associated with a distressed transaction unless the reporting entity has evidence that indicates that both of the following factors are present for a given quoted price:

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.

If the reporting entity has evidence that both factors are present for a given quoted price, then that quoted price is presumed not to be associated with a distressed transaction. In that case, the quoted price may be a relevant observable input that shall be considered in estimating fair value. However, the reporting entity should consider whether any other factors or conditions warrant making an adjustment to the quoted price (see paragraph 29). For example, if a quoted price 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 reporting entity should consider whether that quoted price is a relevant observable input (that is, whether the quoted price requires adjustment).

If the reporting entity does not have evidence that both factors are present for a given quoted price (including because there is insufficient information on which to base a conclusion), then the reporting entity shall consider the quoted price to be associated with a distressed transaction and shall use a valuation technique other than one that uses the quoted price without significant adjustment (that is, a significant adjustment is required, resulting in a Level 3 measurement). For example, the reporting entity could use an income approach (that is, a present value technique) to estimate fair value. However, the fair value resulting from the present value technique shall not be derived solely from inputs based on the quoted price associated with a distressed transaction. The inputs should be reflective of an orderly (that is, not distressed or forced) transaction between market participants at the measurement date. An orderly transaction would reflect all risks inherent in the asset, including a reasonable risk premium for bearing uncertainty that would be considered by market participants (that is, willing buyers and willing sellers) in pricing the asset in a nondistressed transaction.

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. 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 relevant 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:

f. Paragraphs A32A–A32F and related heading and footnotes are 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*~~

~~*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).~~

~~[21a] See paragraphs 20 and 21 of Statement 157.~~
~~[21b] See paragraphs B7–B11 of Statement 157.~~
~~[21c] 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.~~
~~[21d] 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 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.

A32A. On January 1, 20X8, Entity A invested in a AAA-rated tranche of a collateralized debt obligation security. The underlying collateral for the collateralized debt obligation security is unguaranteed nonconforming residential mortgage loans. At March 31, 20X9 (the measurement date) the collateralized debt obligation security is now A-rated. Entity A believes that the market for its collateralized debt obligation security is not active and that markets for similar collateralized debt obligation securities also are not active.

A32B. Entity A considers the guidance in paragraph 29A to determine whether the market for the collateralized debt obligation security is not active. After evaluating the factors and considering the significance and relevance of each factor, Entity A concludes that the evidence indicates that the market for the collateralized debt obligation security is not active at the measurement date. That determination was made considering that there are few observable transactions for the collateralized debt obligation security or similar collateralized debt obligation securities, the quoted prices for those transactions that have occurred are not current, and those quoted prices indicate abnormal liquidity risk premiums when compared with reasonable estimates of credit risk for collateralized debt obligation securities, thus reducing the potential relevance of those observations.

A32C. Based on the guidance in paragraph 29A, Entity A next evaluates the quoted prices to determine whether those transactions are not distressed. Entity A concludes that it does not have evidence that indicates that the observable transactions are not distressed (that is, there was not evidence that indicates that there was sufficient time to market the collateralized debt obligation security and that there were multiple bidders for the collateralized debt obligation security). Because Entity A did not have sufficient information on which to conclude that the quoted prices are not distressed, Entity A concludes that the quoted prices can not be used as inputs to a fair value measurement without making a significant adjustment.

A32D. Entity A uses the discount rate adjustment technique described in Appendix B this Statement to determine fair value for its collateralized debt obligation security at the measurement date.[21a] Entity A uses an estimate of the most likely cash flows from the collateralized debt obligation security, which were determined on the basis of a model that uses realistic assumptions (considering all available market information discussed below) about the performance of the underlying mortgage loans.[21b] The cash flows represent the most likely outcome from the range of all possible outcomes (that is, it is not the best case scenario and it is not the worst case scenario).

A32E. Entity A then estimates a discount rate to be applied to the cash flows (that is, a range of possible market rates of return). An appropriate market rate of return considers the risks inherent in the collateralized debt obligation security, including reasonable risk premiums for uncertainty. Entity A considers inputs that market participants would consider in estimating a rate of return in an orderly transaction. For this collateralized debt obligation security, the available information used to estimate an appropriate rate of return included:

(1) Risk-free rate based on the rate of return on government debt securities
(2) Credit spreads for current issuances for similarly rated securities
(3) Reasonable assumptions regarding liquidity and nonperformance (for example, default risk and collateral value risk) risks that willing buyers and willing sellers would consider in pricing the asset in an orderly transaction based on current market conditions
(4) Relevant reports issued by analysts and ratings agencies
(5) Information about the performance of the underlying mortgage loans, such as delinquency and foreclosure rates, loss experience, and prepayment rates

A32F. Entity A estimates a range of possible rates of return from 7 percent (based on an estimated rate of return for the collateralized debt obligation in a hypothetical active market at the measurement date) to 15 percent (based on bid-level yields implied by the difference between the contractual cash flow amount and the most likely cash flow estimate adjusted for a reasonable risk premium due to uncertainty). Because 7 percent is not a rate that willing buyers would accept and 15 percent is not a rate that willing sellers would accept, Entity A uses the midpoint or 11 percent (see paragraph 31).

A32G. Because changing the selected discount rate would change the fair value for the collateralized debt obligation security significantly, Entity A voluntarily discloses that input and the effect of using other reasonably possible discount rate estimates.

[21a] See paragraphs 20 and 21 of Statement 157.

[21b] The discount rate adjustment technique described in paragraphs B7–B11 of Statement 157 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

and 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.

A2. FSP FAS 157-3 is amended as follows:

a. Paragraph 9:

Key existing principles of Statement 157 illustrated in the example include:

a. A fair value measurement represents the price at which a transaction would occur between market participants at the measurement date. As discussed in Statement 157, in situations in which there is little, if any, market activity for an asset at the measurement date, the fair value measurement objective remains the same, that is, the price that would be received by the holder of the financial asset in an orderly transaction (an exit price notion) that is not a forced liquidation or distressed sale at the measurement date.[1] Even in times of market illiquidity ~~dislocation~~, it is not appropriate to conclude that all market activity represents forced liquidations or distressed sales. However, it is also not appropriate to automatically conclude that any transaction price is determinative of fair value. Determining fair value in an inactive ~~dislocated~~ market depends on the facts and circumstances and may require the use of significant judgment. Paragraph 29A of Statement 157 provides a two-step process in this circumstance. ~~about whether individual transactions are forced liquidations or distressed sales.~~

b. In determining fair value for a financial asset, the use of a reporting entity's own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available. Statement 157 discusses a range of information and valuation techniques that a reporting entity might use to estimate fair value when relevant observable inputs are not available.[2] In some cases an entity may determine that observable inputs (Level 2) require significant adjustment based on unobservable data and thus would be considered a Level 3 fair value measurement. For example, in cases where the volume and level of trading activity in the asset have declined significantly, the available prices vary significantly over time or among market participants, or the prices are not current, the observable inputs might not be relevant and could require significant adjustment. Regardless of the valuation technique used, an entity must include appropriate risk adjustments that market participants would make for nonperformance and liquidity risks (<u>including reasonable risk premiums for bearing uncertainty and liquidity) in an orderly (that is, not distressed or forced) transaction</u>.

c. Broker (or pricing service) quotes may be an appropriate input when measuring fair value, but they are not necessarily determinative if an active market does not exist for the financial asset. In an active market, a broker quote should reflect market information from actual transactions. However, when markets are not active, brokers may rely more on models with inputs based on information available only to the broker. In weighing a broker quote as an input to a fair value measurement, an entity should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighing the available evidence. <u>When circumstances warrant, paragraph 29A of Statement 157 provides a two-step process that shall be considered.</u>