

Audit Committee Brief



Modifying and Clarifying the Rules on Fair-Value Accounting

In a contentious congressional hearing, the FASB and the SEC received a mandate to “fix” fair-value accounting from the House Financial Services Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises. Critics have blamed accounting standards for causing volatility in financial reporting and contributing to the economic downturn by requiring companies to write down assets to fire-sale prices. Representative Spencer T. Bachus III (R-Alabama), a member of the subcommittee, warned on March 12, “If FASB and the SEC refuse to use their authority to provide useful and timely guidance, this Congress may have no choice but to act in their place.” FASB Chairman Robert H. Herz agreed to issue more fair-value guidance quickly.

Making good on this promise of swift action, the FASB issued three staff positions (FSPs) on April 9:

- (1) [FSP FAS 157-4](#), *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*
- (2) [FSP FAS 115-2](#) and [FAS 124-2](#), *Recognition and Presentation of Other-Than-Temporary Impairments*
- (3) [FSP FAS 107-1](#) and [APB 28-1](#), *Interim Disclosures about Fair Value of Financial Instruments*

[FSP FAS 157-4](#) provides guidance for estimating fair value for assets or liabilities when market volume and activity levels have significantly decreased, and for identifying transactions that are not orderly, including forced liquidations and distressed sales. Although the FSP was issued to provide guidance for measuring fair value, the overall objective of such measurements remains unchanged: providing an exit price notion under

current market conditions. When determining the fair value of an asset or liability that is not a Level 1 fair-value measurement, which is based on observable inputs that reflect quoted prices in active markets, a company should assess whether there are factors present that indicate a significant decline in the volume and level of market activity for the asset or liability being measured. Factors to be evaluated include:

- A lack of recent transactions
- Price quotations not based on current information
- Price quotations varying substantially either over time or among market makers.

Refer to FSP FAS 157-4 for a complete list of factors.

Questions Audit Committees Might Ask Management Concerning Fair-Value Accounting

- Are there factors present that indicate our investments are in a market that has experienced a significant decline in volume and activity level?
- What investments might we have in inactive markets?
- Are our internal models and assumptions robust enough for us to rely more heavily on them and less heavily on the non-orderly transactions in the market? Have we done enough legwork?
- How do we determine the credit loss on our debt securities?
- Should we adopt the FSPs for the period ending after March 15, 2009, early?

If the company concludes that there has been a significant decline in the volume and level of market activity, a quoted price, such as one from an observed transaction, may not be determinative of fair value, and significant adjustment may be required. Statement 157 does not prescribe a specific approach for calculating the adjustment and mentions that significant judgment is involved. However, the FSP clarifies that as part of this judgment, an entity may deem it necessary to change the valuation technique. This could occur, for example, through moving from a market approach, such as a quoted price, to an income approach that uses a present-value technique. The FSP also allows the use of multiple valuation techniques, including a combination of market and income approaches, to estimate fair value. Guidance is provided to assist companies in determining whether a transaction is orderly. Under this FSP, companies should place little, if any, weight on transactions that are not orderly, with more reliance on orderly measurements of related assets or liabilities.

The FSP requires companies to look for and evaluate additional relevant factors in determining fair value when the market activity has significantly declined.

— Bob Bass, vice chairman of Deloitte LLP

Guidelines for the recognition, measurement, and presentation of impairments for debt securities are presented in **FSP FAS 115-2**. Note that this FSP does not address equity securities, except for disclosures; entities with equity securities should continue to follow other-than-temporary impairment guidance, including Staff Accounting Bulletin (SAB) Topic 5.M., *Other-Than-Temporary Impairment of Certain Investments in Debt and Equity Securities*. Previously, companies were required to assert their “intent and ability” to hold a security until recovery of its cost basis in order to conclude that an impairment was other-than-temporary, and thus avoid

SEC’s Study on Fair-Value Accounting

The Emergency Economic Stabilization Act of 2008 mandated that the SEC submit to Congress a detailed report and recommendations regarding mark-to-market accounting. The report, issued on December 30, 2008, addressed the following key issues:

- The effect of fair-value accounting standards on financial institutions’ balance sheets, on bank failures in 2008, and on the quality of financial information available to investors
- The process the FASB follows to develop accounting standards
- Alternatives to fair-value accounting standards
- The advisability and feasibility of modifications to fair-value accounting standards

The SEC concluded that the fair-value accounting requirements should not be suspended and recommended several improvements. Some of the recommendations were included in the rule changes discussed in this article. The SEC’s publication, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting*, is available on its Web site, and Deloitte’s January 9, 2009, *Heads Up* article, “Study Finalized on Mark-to-Market Accounting,” is available on Deloitte’s Center for Corporate Governance Web site.

recognizing in earnings a loss equal to the difference between fair value and the amortized cost basis. FSP FAS 115-2 eliminates the requirement for entities to assert such an intent and ability; instead, it focuses on a company’s intent or requirement to sell a debt security.

“This is a noteworthy change, because the previous requirement was a significant hurdle for many companies,” said Bass. “For example, for a 20-year bond, a company would have to assert its intent and ability to hold that investment until maturity, or at least until the fair value of the investment recovered to a level that exceeds the security’s amortized cost.”

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FSP FAS 115-2 also affects the presentation of impairments. Prior to this FSP, the entire other-than-temporary impairment loss on investments available for sale or held to maturity was recorded in earnings. Under the new rules, such impairments would only be recorded in earnings in three scenarios:

- (1) If a company intends to sell a debt security
- (2) If it is more likely than not that a company will be required to sell a debt security
- (3) If a company does not expect to recover the full amortized cost basis of a security due to, for example, a credit loss

After identifying an other-than-temporary impairment, companies will need to evaluate these three scenarios listed. Under the first two, companies would record the entire impairment loss in earnings. The third scenario requires companies to evaluate the credit worthiness of the underlying debt security, including the issuer of the security. If companies do not expect to be able to collect amounts due according to the debt securities' contractual terms, an impairment should be recorded to earnings. The impairment loss is separated into two portions: the amount representing the credit loss and the amount related to all other factors. The credit loss portion of the impairment would be recorded in earnings, and the amount due to all other factors would be recorded in other comprehensive income.

Finally, **FSP FAS 107-1** expands the fair-value disclosures required for all financial instruments within the scope of Statement 107, *Disclosure about Fair Value of Financial Instruments*, to interim periods for publicly traded companies. Prior to this FSP, the disclosure provisions of Statement 107 were applicable only to annual periods.

The effective date for these three FSPs is for interim and annual periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. However, if adopted early, FSP FAS 157-4 and FSP FAS 115-2 must be adopted concurrently. Additionally, if a company elects to adopt FSP FAS 107-1 early, it must also adopt the other two FSPs early.

Accounting rules are not typically a source of high drama, but due to the economic crisis, the public discussion of fair-value accounting has reached a level of excitement that is hard to ignore. Congress's request for additional guidance was intriguing because it came soon after the completion of the SEC study on market-to-market accounting, as required by the Emergency Economic Stabilization Act of 2008. The SEC concluded that fair-value accounting requirements should not be suspended, which may have been the preferred solution for many financial institutions struggling to maintain capital requirements. However, the proposed accounting changes in FSP FAS 115-2 should help relieve some of the critics' concerns.

More information. Deloitte's April 14 *Heads Up* article, "[FASB Issues Guidance on Measuring Fair Value When Market Activity Declines, Other-Than-Temporary Impairments, and Interim Fair-Value Disclosures](#)," is available on Deloitte's Center for Corporate Governance Web site. A replay of the April 24 Deloitte Dbriefs webcast, "[FASB's Recent Fair-Value Guidance – What's the Impact?](#)," which focused on the changes resulting from the FSPs, when the changes will become effective, and how recent FASB actions on fair value may affect organizations, is available for viewing.

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The Public-Private Investment Program

The U.S. Treasury has announced the Public-Private Investment Program, designed to purchase toxic assets affecting the U.S. financial system. Under the program, banks will auction off their illiquid assets, private investors will set market prices, and the U.S. Treasury will provide the majority of the financing.

Other Related Regulatory Changes

In response to the new guidance issued by the FASB, the SEC released [SAB No. 111](#), which amends SAB Topic 5.M. It maintains the staff's previous views related to equity securities, but excludes debt securities from its scope. Additionally, the PCAOB issued Staff Audit Practice Alert No. 4, [Auditor Considerations Regarding Fair-Value Measurements, Disclosures, and Other-Than-Temporary Impairments](#), to remind auditors of their responsibilities in conducting reviews of interim financial information and annual audits in light of the new FSPs related to fair-value measurements and other-than-temporary impairments.

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