Strafford

presents

New FASB Fair Value Guidelines for Financial Instruments

Implementing Mark-to-Market Revisions for Asset Valuation and Non-Temporary Impairments

A Live 100-Minute Audio Conference with Interactive Q&A

Today's panel features:

David Larsen, Managing Director, **Duff & Phelps**, San Francisco

Kenneth Fick, Director, Forensic and Litigation Practice, **FTI Consulting Inc.**, Washington, D.C.

Xihao Hu, Partner, Regulatory and Capital Markets Consulting Group, **Deloitte & Touche**, McLean, Va.

Mark C. Kanaly, Partner, **Alston & Bird**, Atlanta

Thursday, May 14, 2009

The conference begins at:

1 pm Eastern
12 pm Central
11 am Mountain
10 am Pacific

The audio portion of this conference will be accessible by telephone only. Please refer to the dial in instructions emailed to registrants to access the audio portion of the conference.

CLICK ON EACH FILE IN THE LEFT HAND COLUMN TO SEE INDIVIDUAL PRESENTATIONS.

If no column is present: click **Bookmarks** or **Pages** on the left side of the window.

If no icons are present: Click **View**, select **Navigational Panels**, and chose either **Bookmarks** or **Pages**.

If you need assistance or to register for the audio portion, please call Strafford customer service at **800-926-7926 ext. 10**

New FASB Fair Value Guidelines For Financial Instruments Teleconference

May 14, 2009

David Larsen, Duff & Phelps
david.larsen@duffandphelps.com

Xihao Hu, Deloitte & Touche
xhu@deloitte.com

Kenneth Fick, FTI Consulting Inc.
ken.fick@fticonsulting.com

Mark Kanaly, Alston & Bird
mark.kanaly@alston.com

Today's Program

- Background To Latest FASB Action, slides 4 through 18 (*David Larsen*)
- Latest Fair Market Value Guidance, slides 19 through 34 (*Xihao Hu*)
- Impact Of Fair Value Guidance On Non-Banking Sectors, slides 35 through 47 (*David Larsen*)
- Recognition And Treatment Of Other-Than-Temporary Impairments, slides 48 through 58 (*Kenneth Fick*)
- Particular Impacts On Financial Institutions, slides 59 through 65 (*Mark Kanaly*)

Advisory to attendees of this teleconference: The views expressed in this outline and during the teleconference are those of the individual speakers and audience members, and do not necessarily represent the positions of the speakers' firms or companies.

Background To Latest FASB Action

FASB Statement No. 157

- **Statement 157 issued in September 2006**
  - Single definition of fair value within U.S. GAAP
  - Establishes a framework for measuring fair value (methods for measuring fair value)
  - Expands disclosures about fair value measurements
  - It does not require any new fair value measurements
  - Does not necessarily signal that the FASB will require more fair value measurements in the future
- **Prior to Statement 157**
  - More than 60 references in GAAP literature to fair value measurements
  - Different definitions, and limited or dispersed guidance, for applying those definitions
  - Need for increased consistency and comparability of fair value measurements
- **Effective for fiscal years after Nov. 15, 2007**
  - Early application if the fair value option (FASB Statement No. 159) is adopted (typically financial institutions)
  - At the Nov. 14, 2007 FASB meeting, the Board decided to defer the effective date of Statement 157 for all non-financial assets and non-financial liabilities until 2009 (fiscal years beginning after Nov. 15, 2008), except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually).

Evolution Of FASB 157 And Market Impacts

- January 2007: FASB issued an invitation to comment on:
  - The need, if any, for valuation guidance related to the use of fair value measurements in financial reporting
  - Who should be involved in developing any such valuation guidance, and
  - The process and form of any such guidance-setting activities.

- June 2007: FASB announces formation of the valuation resource group

- October 2007: Center for Audit Quality issues paper on valuing assets in markets that become illiquid (persuasive evidence needed to determine distressed transactions)

- December 2007: PCAOB releases SAP Alert No. 2 on auditing fair value measurements
  - Evaluate whether management's assumptions are reasonable or are not inconsistent with market information
  - Is historical information representative of future conditions or events?
  - Consistency

- February 2008: FSP FAS 157-1 and FSP FAS 157-2 issued
  - FASB 157 does not apply to leases accounted for under FASB 13
  - Effective date for FASB 157 for non-financial assets is fiscal years beginning after Nov. 15, 2008

Evolution Of FASB 157 And Market Impacts (Cont.)

- March and September 2008: SEC Division of Corporation Finance issued letters to provide real-time guidance for issuers, encouraging them to enhance transparency of fair value measurements disclosed to investors. In general, the letters have produced few additional disclosures
  - March http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm
  - September http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0908.htm
- May 2008: IASB forms expert advisory panel
- July 2008: SEC roundtable discussion
  - Raised question of "good" level 3 vs. "bad" level 2
  - http://www.sec.gov/spotlight/fairvalue.htm
- Sept. 15, 2008: Lehman declares bankruptcy

Summary: Fair Value At Sept. 15, 2008

SFAS 157: Defines fair value, establishes a framework for measuring fair value, expands disclosures about fair value measurements

Fair value: ***The price that would be received to sell an asset or paid to transfer a liability in an <u>orderly</u> transaction between market participants at the measurement date***

Influencers on fair value

- Media: Fair value means mark-to-market = fire sale price; Level 3 is **BAD!**
- Politics: Mark-to-market caused the financial crisis
- PCAOB/auditors: Fair value = last transaction price
- Registrants: Dislocated market = dislocated sales

Fair value application

- Tendency for “sticky” Level 2 pricing
- Judgment is hard to audit
- Level 3 deemed “toxic”
- Levels 1, 2, 3 provide information on the observability of the valuation inputs, not on the quality of the asset or liability

Evolution Of FASB 157 And Market Impacts

- Sept. 29, 2008: U.S. House fails to pass Emergence Economic Stabilization Act (EESA); Dow Jones average drops more than 700 points
- Sept. 30, 2008: SEC/FASB joint press release
- Oct. 1, 2008: U.S. Senate passes EESA; FSP FAS 157-d issued
- Oct. 3, 2008: U.S. House passes EESA, which President Bush signs into law
- Oct. 10, 2008: FSP FAS 157-3 issued
- October 2008: IASB expert advisory panel releases paper, "Measuring and disclosing the fair value of financial instruments in markets that are no longer active"
  - Enhance its guidance on valuing financial instruments when markets are no longer active
  - Strengthen its standards to achieve better disclosures about valuations, methodologies and the uncertainty associated with valuationsDec. 30, 2008: SEC releases EESA-mandated fair value (mark-to-market) study

Sept. 30, 2008 SEC/FASB Joint Press Release

Given questions about FV accounting, the SEC & FASB issued a joint press release on Sept. 30, 2008 covering the following questions:

- **Can management's internal assumptions (e.g., expected cash flows) be used to measure fair value when relevant market evidence does not exist?**

- Yes. When an active market for a security does not exist, the use of management estimates that incorporate current market participant expectations of future cash flows, and that include appropriate risk premiums, is acceptable. Further, in some cases using unobservable inputs (Level 3) might be more appropriate than using observable inputs (Level 2). For example, when significant adjustments are required to available observable inputs, it may be appropriate to utilize an estimate based primarily on unobservable inputs

- **How should the use of "market" quotes (e.g., broker quotes or information from a pricing service) be considered when assessing the mix of information available to measure fair value?**

- Broker quotes may be an input when measuring fair value, but are not necessarily determinative if an active market does not exist for the security

Sept. 30, 2008 SEC/FASB Joint Press Release (Cont.)

- **Are transactions that are determined to be disorderly representative of fair value? When is a distressed (disorderly) sale indicative of fair value?**
- The results of disorderly transactions are not determinative when measuring fair value. The concept of a fair value measurement assumes an orderly transaction between market participants. An orderly transaction is one that involves market participants that are willing to transact and allows for adequate exposure to the market. Determining forced or disorderly requires judgment
- **Can transactions in an inactive market affect fair value measurements?**
- Yes. A quoted market price in an active market for the identical asset is most representative of fair value and thus is required to be used (generally without adjustment). Transactions in inactive markets may be inputs when measuring fair value, but would likely not be determinative. If they are orderly, transactions should be considered in management’s estimate of fair value. However, if prices in an inactive market do not reflect current prices for the same or similar assets, adjustments may be necessary to arrive at fair value

EESA – SEC-Mandated Study On “Mark-to-Market”Accounting

U.S. Emergency Economic Stabilization Act of 2008 (October) mandated that the SEC perform a study that considers:

1. The effects of such accounting standards on a financial institution’s balance sheet
2. The impacts of such accounting on bank failures in 2008
3. The impact of such standards on the quality of financial information available to investors
4. The process used by FASB in developing accounting standards
5. The advisability and feasibility of modifications to such standards; and
6. Alternative accounting standards to those provided in Statement No. 157

FSP (FASB Staff Position) FAS 157-3

- On Oct. 10, 2008, the fastest due-process document in the history of accounting standard-setting was issued (10 days): FSP FAS 157-3
- FSP 157-3 is consistent with the joint press release
- Highlights include:
  - Distressed market ≠ distressed sale
  - Observable prices (Level 2) may require significant adjustment when:
    - Volume and level of trading activity have declined significantly
    - Available prices vary significantly over time or among participants (wide bid/ask spread)
    - Prices are not current
  - Risk adjustments remain necessary, based on expected market participants' assessment of non-performance and liquidity risks
  - Broker (pricing services) quotes:
    - Not necessarily determinative if there is no active market data
    - Less reliance on quotes if not based on market transactions

New Example – FSP FAS 157-3

New example added to FAS 157; Example 11

- CDO; initially AA-rated:
  - *Prior to June 30, 2008*: Fair value determined using a market approach using Level 2 inputs that did not require significant adjustment
    - Quoted prices in active markets for similar CDOs
    - Quoted prices in markets that are not active represented current transactions for the same or similar CDOs
  - *After June 30, 2008, markets have become increasingly inactive*. Evidenced by increasing bid-as spread and decreasing volume of trades; few observable transactions
- Sept. 30, 2008 fair value determination
  - *Observable transactions vary substantially and are not current*
  - *Income approach used*
    - *Implied rate of return at point when market was last active, 15%*
    - *Estimated that credit spreads have widen 100 basis points and risk premiums have increased 400 basis points, which indicates a rate of return of 20%*
    - *Two indicative quotes (non-binding) imply rates of return of 23% & 27 %*
    - Judgmentally determined that 22% is the most representative rate of return

SEC Study On "Mark-to-Market" Accounting: Recommendations

The SEC released its report on Dec. 30, 2008. It contained eight recommendations:

1. SFAS No. 157 should be improved but not suspended
2. Existing fair value and mark-to-market requirements should not be suspended
3. While the SEC staff does not recommend a suspension of existing fair value standards, 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)
4. The accounting for financial asset impairments should be readdressed.
5. Implement further guidance to foster the use of sound judgment
6. Accounting standards should continue to be established to meet the needs of investors
7. Additional formal measures to address the operation of existing accounting standards in practice should be established
8. Address the need to simplify the accounting for investments in financial assets

SEC Study: Potential Impacts

Recommendation #3: Additional measures should be taken to improve application and practice related to fair value measurements

- Fair value requirements should be improved through application and best practices guidance for determining fair value in illiquid or inactive markets
  - How to determine when markets become inactive
  - How to determine if a transaction or group of transactions is forced or distressed
  - How and when illiquidity should be considered in the valuation of an asset or liability, including whether additional disclosure is warranted
  - How the impact of a change in credit risk on the value of an asset or liability should be estimated
  - When observable market information should be supplemented with and/or reliance placed on unobservable information in the form of management estimates
  - How to confirm that assumptions utilized are those that would be used by market participants and not just by a specific entity.
- Enhance disclosure; expand educational efforts
- FASB should consider elevating the role of the valuation resource group (VRG)

2009 Continued Political And Media Pressure

- Bank lobby puts pressure on Congress, due to OTTI impacts
- Bill Isaacs, Steve Forbes, and others assert that mark-to-market accounting requires fire sale pricing and is leading to banks inappropriately losing capital
- Building pressure on the FASB and the SEC to “fix” the problem
- Mark-to-market accounting
  - Pro-cyclicality
  - Severely depressed asset values
  - Negative impact on banks’ capital
- House subcommittee hearing on March 12
  - “If FASB and SEC don’t take immediate action, Congress will legislate”
  - FASB committed to a “fast track” of three weeks

Evolution Of FASB 157 And Market Impacts: Update

- February 2009: FASB valuation resource group considers SEC study
- March 12, 2009: House Financial Services Subcommittee holds hearings
- March 16, 2009: FASB Board meeting
- March 17, 2009: FASB issues two proposed staff positions (FSPs) dealing with fair value in distressed and inactive markets and OTTI
- April 1, 2009: Receipt of more than 600 comment letters on the proposed FSPs
- April 2, 2009: FASB Board meets on amending proposed FSPs
- April 9, 2009: FASB releases 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”
- May 1, 2009: Proposed FSP 157-f, “Measuring Liabilities,” issued for comment
- May 6, 2009: FASB Board expected to release proposed FSP on measuring fair value for alternative investments

Latest Fair Market Guidance

Significant Decline In Market Activity And Non-Orderly Transactions

Scope

– Applies to **all** assets and liabilities (financial and non-financial) subject to fair value measurement within the scope of Statement 157

- What it does

– Application guidance

» Determining fair value when the volume and level of market activity has **significantly** declined

» Identifying transactions that are **not** orderly

» Use of significant judgment

– Reemphasizes the **exit** price notion

– Amends disclosures

Significant Decline In Non-Orderly Market Activity And Transactions (Cont.)

Effective date

– Effective for interim and annual periods ending after June 15, 2009, with early application permitted for interim and annual periods ending after March 15, 2009 (if early adopted, must adopt FSP FAS 115-2)

Significant Decline In Non-Orderly Market Activity And Transactions (Cont.)

Determining fair value when there has been a significant decline in volume and level of market activity

– Application guidance does not apply to Level 1 measurements

– Assess factors to determine if there has been a **signficant** decline in market activity:

- Few recent transactions
- Price quotations are not current
- Price quotations vary substantially either over time or among market-makers
- Wide bid-ask spread or significant increase in the bid-ask spread
- Significant decline or absence of a market for new issuances
- If **significant** decline, the transaction price or quoted price may not be representative of fair value; perform additional analysis

Note

These factors are not all-inclusive. Refer to paragraph 12 of FSP FAS 157-4 for a listing of all factors. Entities may consider additional factors. Evaluate significance and relevance of factors.

Significant Decline In Non-Orderly Market Activity And Transactions (Cont.)

Determining fair value when there has been a significant decline in volume and level of market activity

– Consider change in valuaton technique **or** multiple valuation techniques
  - Change from market approach (e.g, quoted price) to income approach (e.g., present value technique)
  - Multiple valuation techniques (e.g., market approach and income approach)

– Regardless of the approach taken, measurement objective remains unchanged
  - Fair value is the price that would be received to sell an asset or paid to transfer a liability (i.e., an exit price notion) in an **orderly** transaction between market participants at the measurement date under **current** market conditions
  - Fair value is a **market-based** measurement, not an entity-specific measurement (e.g., intention to hold is not relevant)

Significant Decline In Non-Orderly Market Activity And Transactions (Cont.)

Determining whether transactions **are not** orderly

– Must **not** presume that all transactions are not orderly (forced or distressed)

– Assess factors to determine if the transaction is not orderly:

- Not adequate exposure to market (before measurement date) to allow for marketing activities that are usual and customary under current conditions
- Seller marketed the asset to a single participant
- Seller is in or near bankruptcy or receivership, or required to sell to meet regulatory requirements (that is, forced)
- Transaction price is an outlier when compared to other recent transactions (for same or similar assets or liability)

Note

Entities may consider additional factors. Must evaluate the circumstances to determine whether the transaction is orderly based on the weight of the evidence.

Significant Decline In Non-Orderly Market Activity And Transactions (Cont.)

Determining whether transactions **are** or **are not** orderly

– If based on weight of evidence an entity concludes that the transaction is:

- Not orderly
  – Little, if any, weight to the transaction in estimating fair value
- Orderly
  – Must be considered in determining fair value
- Cannot conclude (lack of information)
  – Must consider transaction in determining fair value
  – Transaction price may not be used as the “sole” or “primary” basis

Note

Entities must not ignore information that is available without undue cost and effort.

– A fair value measurement includes appropriate risk adjustments (market participant view), including liquidity risk

Significant Decline In Non-Orderly Market Activity And Transactions (Cont.)

Quoted prices

– Does not exclude the use of quoted prices (broker quotes or pricing services)

– Entities should evaluate whether the quoted prices are determined in accordance with Statement 157

  - Reflective of an orderly transaction
  - Market participant assumptions (including risk)

– Appropriately weight the quoted price in determining fair value

  - Indicative
  - Binding

What does this mean?

Entities should assess the nature of the quoted price and based on its assessment, appropriately <u>weight</u> the quoted price along with other inputs in determining fair value.

Significant Decline In Non-Orderly Market Activity And Transactions (Cont.)

Example

- On June 1, 2008, Entity A invested in an S&P AA-rated tranche of a CDO
- Underlying collateral is pool of U.S. Treasury and corporate bonds.
- Before Sept. 30, 2008, Entity A was able to determine the fair value of the CDO using a market-based approach
- Significant decline in market activity since Sept. 30, 2008, and no transactions occurring during Q1 2009
- Entity A elects to early adopt FSP FAS 157-4 for March 31, 2009 reporting
- Entity A obtained two broker quotes, which represent indicative offers, implying rates of return of 25% and 29%, respectively
- Entity A calculated a rate of return using the income approach of 22%
- What is the fair value of the CDO security?

Significant Decline In Non-Orderly Market Activity And Transactions (Cont.)

- Disclosure requirements
  - **Interim** and annual disclosure required of inputs and valuation techniques
  - Discussion of **changes** in valuation techniques or inputs must be disclosed during the interim period
  - Fair value hierarchy and Level 3 roll-forward disclosures
    - For **debt** and **equity** securities only, broken out by **major security types**

Note

Major security type should be consistent with paragraph 19 of Statement 115, even if the debt and equity securities are not within the scope of Statement 115. Additional security types may also be necessary.

- Initial adoption impact
  - Comparative disclosures after initial adoption (i.e. for Statement 115 classification and major security types)
  - Comparative disclosures still required after initial adoption of Statement 157 (APB 28, paragraph 30)

Significant Decline In Non-Orderly Market Activity And Transactions (Cont.)

Disclosure – fair value hierarchy

Focus is on debt and equity securities only

($ in 000s)		Fair Value Measurements at Reporting Date Using		
Description	**6/30/X9**	**Quoted Prices In Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Observable Inputs (Level 3)**
Trading securities:				
Equity Securities - real estate	$115	$105	$10	
Available-for-sale securities:				
Residential mortgage backed securities	75			75
Derivatives	60	25	15	20
Venture Capital Investments	10			10
Total	$260	$130	$25	105

Significant Decline In Non-Orderly Market Activity And Transactions (Cont.)

Disclosure – Level 3 roll-forward

($ in 000s)

Breakout for new classification

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

Significant Decline In Non-Orderly Market Activity And Transactions (Cont.)

What's next for fair value?

Standard	Topic	Status	Effective Date
FSP FAS 157-?	Improving Disclosures about Fair Value Measurements	Projected to be exposed in Q2	TBD
FSP FAS 157-?	Applying Fair Value to Interests in Alternative Investments	Projected to be exposed in Q2	TBD
FSP FAS 157-c	Measuring Liabilities under FAS 157	Projected to be exposed/finalized in Q2	The proposed guidance would be effective for periods beginning after July 1, 2009
IASB ED	Fair Value Measurements	Projected to exposed in Q2	TBD
FSP FAS 115-?	Recoveries of Other-Than-Temporary Impairments (Reversals)	Timing to be determined	TBD
IASB/FASB Joint Project	Financial Instruments	Exposure draft expected by year-end	TBD

Significant Decline In Non-Orderly Market Activity And Transactions (Cont.)

IFRSs/GAAP comparison

Subject	U.S. GAAP	IFRSs
Scope	Statement 157 provides comprehensive fair value measurement guidance that applies to both financial instruments and other assets and liabilities.	IAS 39 provides measurement guidance for all recognized financial instruments within its scope and those subject to disclosure under IFRS 7.
Definition: exit price	Exit price notion.	Exit price, except in the absence of observable market data, in which case the transaction price is presumed to be fair value at initial recognition.
Definition: principal (or most advantageous) market	Explicitly required for all fair value measurements.	Contains no principal market concept. For financial instruments traded in active markets, the most advantageous active market to which the entity has access is used.
Definition: market participants	Defined term (characteristics)	Not defined.
Definition: application to assets	The highest-and-best-use valuation premise is assumed in all fair value measurements.	No comparable concept.
Definition: application to liabilities	Assume a liability is transferred to another market participant.	Assume that a liability is settled with the counterparty.

Interim Disclosures About Fair Value

FSP FAS 107-1 and APB 28-1

Disclosures

Fair value disclosures are required for interim financial statements

- Applies to all financial assets and liabilities within the scope of Statement 107 held by publicly traded companies
- Present the fair value and related carrying amount

Disclose method(s) and significant assumptions interim and annually

- Discuss changes in method(s) and significant assumptions, if any, during the period
- No interim disclosures on credit or market risk

Practicability Exception

Continues to apply for FSP FAS 107-1

Interim Disclosures About Fair Value (Cont.)

FSP FAS 107-1 and APB 28-1

Considerations

- Shorter time frame for interim reports vs. annual reports
- Scope of FSP FAS 107-1
- Cost method investments

Effective Date

Interim periods **ending** after June 15, 2009, with early adoption permitted to periods ending after March 15, 2009 (if early adopted, must adopt FSP FAS 157-4 and FSP FAS 115-2)

Impact Of Fair Value Guidance On Non-Banking Sectors

FASB's Valuation Resource Group (VRG)

In January 2007, FASB issued invitation to comment on:
(a) The need, if any, for valuation guidance related to the use of fair value measurements in financial reporting
(b) Who should be involved in developing any such valuation guidance, and
(c) The process and form of any such guidance-setting activities

More than 80 comment letters were received and posted to the FASB Web site. Additionally, FASB held a public roundtable on April 30, 2007 regarding issues raised in the invitation to comment

The FASB Board issued a press release on June 21, 2007 announcing the formation of a resource group to address issues relating to valuation for financial reporting

The resource group met to discuss issues surrounding the implementation of FASB Statement No. 157, "Fair Value," on the following dates:

- Oct. 1, 2007
- Nov. 9, 2007
- Feb. 1, 2008
- May 8, 2008
- Sept. 23, 2008
- Feb. 5, 2009

VRG Members

Member (representing)	Firm		Member (representing)	Firm
Don Charles (accounting/valuation)	Ernst & Young		Greg Forsythe (accounting/valuation)	Deloitte
Brenna Wist (accounting/valuation	KPMG		Andreas Ohl (accounting/valuation	PricewaterhouseCoopers
Anita Ford (accounting/valuation	Clifton Gunderson		Jolene Hart (accounting/valuation)	McGladry & Pullen
Jerry Mehm (valuation)	American Appraisal		Paul Barnes (valuation)	Duff & Phelps
Michael DeLuke (valuation)	Houlihan , Lokey, Howard & Zukin		Michael Mard (valuation	The Financial Valuation Group
Chris Thorne (professional standard setting)	International Valuation Standards Committee		Carla Glass (professional standard setting)	The Appraisal Foundation
Amy Ripepi (accounting specialist)	Financial Reporting Advisors		Greg Ramsey (preparer)	Fannie Mae
Gina Weaver (preparer)	Pfizer		David Larsen (preparer – private equity)	Duff & Phelps
Gordon Goodman (preparer)	Occidental Petroleum		Rebecca McEnally (user)	CFA Institute
Wally Enman (user)	Moodys Investors Service		Shelley Luisi (observer)	SEC
Greg Scates (observer)	PCAOB		Hillary Eastman (observer)	IASB
Laurie Fitzpatrick Priest (observer)	Federal Reserve Board of Governors		Dan Noll (observer)	AICPA

Oct. 1, 2007 VRG Meeting Topics

- Determining the fair value of an asset in which the entity intends to transform the asset from its current form into a different form upon sale (such as whether to value a mortgage loan in the whole loan market vs. the securitization market)
- Definition of an active market
- Determination of the principal market when the majority of an entity's trading activity occurs in a different market than where the majority of market participants' trading occurs
- Highest and best use: Accounting for an asset that an entity does not intend to use or intends to use defensively
- Determination of market participants (such as assets or entities acquired in an auction)
- Assets and liabilities without markets
- Pension plan disclosures
- Use of net asset value to measure certain investments, such as in private equity

Nov. 9, 2007 VRG Meeting Topics

- Deferral of effective date of FASB Statement No. 157, fair value measurement
- Development of market participant assumptions and use of an entity's own data (similar to issue discussed at Oct. 1, 2007 meeting)
- Unit of valuation and exit markets, whether unit of valuation can be more disaggregated than the unit of account (similar to issue discussed at Oct. 1, 2007 meeting)
- Measurement of liabilities
- Applicability of Statement 157 to plan assets of pensions and other post-retirement benefit plans (similar to issue discussed at Oct. 1, 2007 meeting)
- Use of NAV to measure investments in fund of fund or certain investments with restrictions (similar to issue discussed at Oct. 1, 2007 meeting)
- Determining the fair value of a liability with a third-party guarantee
- Highest and best use: Land example
- Definition of "significant" in determining the level in the fair value hierarchy
- Accounting for transaction costs in determining fair value of an investment

Feb. 1, 2008 VRG Meeting Topics

- Accounting for assets that the acquirer does not intend to use or intends to use in a way other than its highest and best use
- Overlapping customer relationships
- Valuation of intangible assets using “current replacement cost”
- Meaning of “legally permissible” in assessing highest and best use
- Allocation of portfolio-based credit adjustments for hedge effectiveness testing

May 8, 2008 VRG Meeting Topics

- Observable vs. unobservable fair value measurements in the current credit environment
- Determining whether a discount should be applied for a restriction on sale
- Employee benefit plans
- Contingent liabilities

The purpose of the VRG is to provide the FASB staff with information on existing implementation issues surrounding fair value measurements used for financial statement reporting purposes and the alternative viewpoints associated with those implementation issues. ***The VRG does not make any authoritative decisions. Any authoritative decisions are subject to the FASB's normal open due process, including public deliberation by the Board***

.

Sept. 23, 2008 VRG Meeting Topics

- The IASB expert advisory panel white paper, “Measuring and disclosing the fair value of financial instruments in markets that are no longer active”
- Fair value disclosures
- Observable vs. unobservable inputs
- Fair value measurement of liabilities under FAS 157
- Allocation of in-use valuation to individual unit of account
- Fair value of accounts receivable, accounts payable and other accrued liabilities
- Identification and allocation of market participant synergies
- Fair value of a non-controlling interest and a previously held equity interest

Feb. 5, 2009 VRG Meeting Topics And VRG Discussion With FASB Board

- Issue 2009-1: The SEC study on mark-to-market accounting
- Issue 2009-2: Proposed FASB Staff Position (FSP), FAS 157-c, "Measuring liabilities under FASB Statement No. 157"
- Issue 2009-3: The AICPA draft issues paper, FASB Statement No. 157, "Valuation considerations for interests in alternative investments"

FASB Statement No. 157: Current PE Differences In Practice

- **Calculation of equity value**
  - Determination of enterprise value; relatively straightforward
  - Less deb:
    - At acquisition leverage? At current leverage?; At acquisition terms? Current terms? At current market? At par?
- **When debt is trading at a discount**
  - Is equity value zero?
  - If both debt and equity are owned, how should debt be valued?
- **EBITDA multiples**
  - Historical average vs. current comps
  - Trailing vs. forward EBITDA
- **Discounts (U.S. vs. Europe)**
  - Liquidity discount
  - Marketability discount

How Does An LP Determine Fair Value?

- Step 1:
  - **Are there secondary transactions?**
    - **If yes, they must be considered**
    - **However, they may require significant adjustment or may not be useable unless there is sufficient transparency to identify:**
      - Price paid in relation to NAV as of what point in time (e.g. staleness of NAV)
      - Value to seller of the elimination of future capital commitments
      - Value to seller of the ability to rebalance their portfolio
    - **Or, the secondary sale may be ignored if deemed a distressed transaction**
      - Persuasive evidence that usual and customary marketing time for the sale was not available (unlikely)

How Does An LP Determine Fair Value? (Cont.)

- Step 2:
  - **Can NAV be used as a starting point?**
    - **Robustness of fair value determination by the GP**
      - GP's policies, procedures, processes; use of third party expert; actively traded investments; reputation of auditor; qualifications to audit report; evidence of compliance with FAS 157; historical adjustments to NAV; SAS 70 report
    - **Adjustments**
      - Carried interest; not fair value; not 157-compliant
    - **In-phase**
      - GP NAV calculation is as of the same date as the LP reporting /measurement date (e.g. no lag)
      - If a lag, adjust for cash flows (if deemed at fair value); adjust for valuation changes

How Does An LP Determine Fair Value? (Cont.)

- Step 3:
  - **Additional considerations**
    - Gates; redemption fees; changes in terms; investment strategy; key person issues; other GP financial issues
  - **If there are no additional considerations, then robustly determined, adjusted, in-phase NAV may the best estimate of fair value**
  - **If there are additional considerations that are deemed to affect fair value (the amount at which market participants would transact), then robustly determined, adjusted, in-phase NAV requires further judgmental modification to estimate fair value**

Recognition And Presentation Of Other-Than-Temporary Impairments: An Overview Of FSP FAS 115-2 And FAS 124-2

Key Issues

- FSP FAS 115-2 significantly changed the accounting requirements for assessing impairment on debt securities. It focuses on the following key issues:
  1. Determining whether impairment on a debt security should be considered other-than-temporary
  2. Separating an impairment loss into the amount that represents credit loss and the amount attributable to all other factors
  3. Changing the presentation of other-than-temporary impairment in the income statement
  4. Requiring enhanced disclosures about debt and equity securities in an unrealized loss position

Determining Other-Than-Temporary Impairment

- Consistent with previous requirements, when the fair value of a debt security is less than its amortized cost basis at the balance sheet date, an entity must assess whether the impairment is other-than-temporary

- Previously, an entity had to assert its intent and ability to hold a security until recovery

NOW

- An entity should consider not only whether it <u>intends</u> to sell the security, but also, the probability it <u>will be required</u> to sell the security before the amortized cost basis is recovered

- If the entity can’t assert the above, then an other-than-temporary impairment must be recorded in earnings

Determining Other-Than-Temporary Impairment (Cont.)

<u>Qualitative analysis</u>

- Consider all available evidence, including but not limited to:
  - The length of time and the extent to which the fair value has been less than the amortized cost basis
  - Adverse conditions specifically related to the security, an industry or geographic area
  - The historical and implied volatility of the fair value of the security
  - The payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future
  - Failure of the issuer of the security to make scheduled interest or principal payments
  - Any changes to the rating of the security by a rating agency
  - Recoveries or additional declines in fair value subsequent to the balance sheet date

<u>SEC staff has clearly indicated that no “bright line” or “rule of thumb” tests should be made when making this assessment</u>

Separation Of The Credit Loss Component

- If a security is other-than-temporary <u>BUT</u> an entity can assert that it does not intend nor will be required to sell the security before the amortized cost basis is recovered, then:
  - Separate the other-than temporary impairment into the amounts attributable to:
    - The credit losses, and
    - All other factors

- FSP FAS 115-2 refers to two measurement methodologies for estimating credit losses
  - One methodology is provided in paragraph 12(b) of ETIF 99-20 for debt securities that are beneficial interests in securitized financial assets
  - The other methodology is provided in paragraphs 12–16 of FAS 114 for all other debt securities

Separation Of The Credit Loss Component (Cont.)

<u>How do I define a credit loss?</u>

1. Estimate the cash flows expected to be collected on an impaired security

- If the security is considered a beneficial interest as per EITF 99-20, then:

2. Calculate the present value of the cash flows expected to be discounted at a rate equal to the current yield used to accrete the beneficial interest

- If it is not a beneficial interest, then follow guidance in Paragraphs 12–16 of FAS 114

2. Calculate the present value of the cash flows expected discounted at the loan's effective interest rate

- The amount of the other-than-temporary impairment related to <u>credit losses</u> should be reflected as an adjustment to the cost basis of the security, with the offset recorded as an other-than-temporary impairment loss in <u>earnings</u>
- The amount attributable to <u>all other factors</u> should be included in <u>other comprehensive income</u>, and is not recognized in earnings

Financial Statement Presentation

- When an entity determines that a security's impairment is other-than-temporary, its income statement should separately present the total amount of the other-than-temporary impairment charge, identifying the portion due to credit loss and the amount related to all other factors

Total other-than-temporary impairment losses	$10,000
Portion of loss recognized in other comprehensive income (before taxes)	($4,000)
Net impairment losses recognized in earnings	$6,000

- In addition, the amount of impairment attributable to factors other than credit risk should be separately identified in the accumulated other comprehensive income ("OCI") account

Additional Disclosure

- The disclosure requirements apply to both debt and equity securities
- For both interim and annual financial statements, the amortized cost basis and total other-than temporary impairment recognized in OCI must be disclosed by major security type, based on the nature and risks of the security
- In periods in which an entity recognizes an other-than-temporary impairment loss and separates the credit loss component from the amount due to other factors, it must disclose, by major security type, the methodology and significant inputs used to measure the amount related to the credit loss
- Examples of significant inputs include, but are not limited to:
  - Performance indicators of the underlying assets in the security (including default rates, delinquency rates and percentage of non-performing assets)
  - Loan-to-collateral-value ratios, third-party guarantees, current levels of subordination, vintage, geographic concentration and credit ratings

Effective Dates And Transition

Effective dates

- Effective for interim and annual reporting periods ending after June 15, 2009 (i.e., the June 30 quarter-end financial statements)
- Early adoption is permitted for periods ending after March 15, 2009
  - However, if an entity early adopts FSP 115-2, it must also early adopt FSP FAS 157-4

Transition provisions

- Evaluate existing debt securities for which an other-then-temporary impairment was previously recognized
- Determine if entity can assert it is not more likely than not that the entity will be required to sell such securities before recovery of its amortized cost basis, and the entity does not intend to sell the securities
- Adjust the opening balance of retained earnings for the amount of impairment that was previously recognized, with an offsetting entry to OCI

Implementation Considerations

Assessing credit loss

- Conducting the discounted present value test is not always straightforward; for example:
  - Determining the appropriate discount rate may not necessarily be clear, particularly for securities within the scope of EITF 99-20.
  - Some structured securities have fixed rate for initial period (i.e., first two 2 yrs. of security with 10-year term) then convert to floating rate
  - Other securities may have been bought at premium or discount, or had prior impairment charge requiring calculation of effective interest rate

Transition adjustments

- Creates the unusual circumstance in which the same loss on a security could be recognized in earnings more then once. For example:
  - Once when the loss was initially recognized (i.e., prior to adoption of FSP 115-2), and
  - A second time if the holder subsequently determines it will be unable to recover the portion of a security's value relating to the amount placed in OCI through the transition adjustment

Takeaways

- FSP 115-2 substantially changed the accounting requirements for recognizing impairment on debt securities
- BUT, it is by no means a "free pass" that enables entities to avoid fair value information when accounting for debt securities
- Significant enhanced disclosure is required
- Application may by tricky, specifically:
  - The calculation of the amount of impairment related to credit risk
  - The accrual of interest on a previously impaired security; and
  - The transition provisions have inherent complexities

Particular Impacts On Financial Institutions

A Look At Financial Institutions

- Financial institutions – Insured depositories

- Early adoption rate of financial institutions
  - As of May 8, 2009:
    - 54 banks had filed their quarterly reports
    - Only eight had early adopted the FSPs
    - None of the “big” banks had filed

What Is The Effect Of Early Adoption?

- Today's banking tension: Credit and capital
  - The market isn't tracking EPS anymore
  - Booking quarterly "losses" has become the norm

- For most banks, the real effect of early adoption is capital-driven
  - The capital effect of early adoption is not the same for all banks
  - There is no capital market for banks to fill any hole that is created

Legal Considerations

- Regulatory environment
  - Banks should confirm their regulators' views of early adoption
  - Federal Home Loan Bank system

- Difficulties in implementation
  - Developing the model (Blackrock/loan Performance/etc.)
  - Developing the inputs for the model (appropriate assumptions, e.g. prepayment speeds, default rates, etc.)
  - Validating the model

Internal Considerations

- Role of auditors
  - Inherent subjectivity in establishing inputs
  - Potential for differing views
  - Resolution

- Effect on historical risk management process
  - Effect of any inconsistencies between valuation model and the model used for risk management
  - Effect on internal controls

Reporting Considerations

- Financial statements
  - Section 18
  - Section 10b-5

- Internal controls
  - Material weakness/remediation

- Certifications
  - 302/906
  - Sub-certification/validation process
  - Sarbanes-Oxley 807

Other Concerns

- Changes in underlying assumptions
  - Results on EPS/capital
  - Challenges
- Timing
- Disagreements among Bank regulators, the SEC and other constituents

Background – FASB FSP 157-e
http://72.3.243.42/project/cl_summary_fspfas157-e.pdf

Background – FASB FAS 107-1 and APB 107-a
http://www.fasb.org/pdf/fsp_fas107-1andapb28-1.pdf