FAS-157-4: Determining fair value in illiquid markets

Background

Since the original pronouncement was issued in September 2006, FASB Statement No. 157 (FAS 157), Fair Value Measurements, has been amended or clarified several times. In April 2009, the Financial Accounting Standards Board issued Staff Position (FSP) FAS 157-4 as a result of the illiquidity experienced by various financial markets since the summer of 2007 and constituents’ complaints that Statement No. 157 and FSP FAS 157-3 did not provide enough guidance on how to determine whether a market for a specific financial asset was inactive and whether a specific transaction was orderly. FSP FAS 157-4 is designed to help reporting entities estimate fair value in accordance with FAS 157, particularly when the volume and level of activity for an asset or liability has decreased significantly.

Objective of fair value

FSP FAS 157-4 clarifies that the objective of fair value measurement does not change if there has been a significant decrease in the volume and level of activity for an asset or liability and regardless of the valuation methods used:

“Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions.”

FSP FAS 157-4 also reiterates that a reporting entity’s intention to hold an asset or liability is not relevant to the estimation of fair value because fair value is a market-based measurement, not an entity-specific measurement.

\[ \text{Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions.)} \]

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1 FSP FAS 157-4, Paragraph 2.
2 FAS 157, Paragraph 7.
3 FSP FAS 157-4, Paragraph 15.
Determining when a market becomes inactive

FSP FAS 157-4 recognizes that an observed transaction or a quoted price may not necessarily be indicative of fair value if the volume and level of activity for the asset or liability have significantly decreased when compared with normal market activity.

FSP FAS 157-4 advises reporting entities to evaluate the following factors when determining whether a market for a particular asset or liability has become inactive:

- Few recent transactions
- Price quotations not based on current information
- Substantial variation in price quotations over time or among market makers
- Lack of correlation between indexes and fair value indications
- Significant increase in implied liquidity risk premiums, yields, or performance indicators for observed transactions or quoted prices when compared with reporting entity’s estimate of expected cash flows
- Wide bid-ask spread or significant increase in bid-ask spread
- Significant decline or absence of primary market for the asset or liability
- Little public information

If the reporting entity concludes that the volume and level of activity for an asset or liability have significantly decreased when compared with normal market activity, transactions or quoted prices may not be indicative of fair value. FSP FAS 157-4 indicates that further analysis is needed and a significant adjustment to the observed transaction or quoted price may be necessary to estimate fair value.\(^6\)

To determine fair value when the volume and level of activity of an asset or liability have decreased significantly, it may be appropriate to change the valuation method or use several valuation methods. However, when using multiple valuation methods, one must consider the reasonableness of the range of values. Fair value should be based on a value within the range that is “most representative” of fair value. Fair value must also include an adequate risk adjustment (i.e., one that is representative of an orderly transaction under current market conditions) because a market participant would demand a higher return if there was an uncertainty in the cash flows.\(^6\)

Determining when a transaction is not orderly

FSP FAS 157-4 states that a reporting entity must undertake reasonable efforts and consider information that is “available without undue cost and effort”\(^7\) in order to determine if a transaction or group of transactions is forced or distressed. The FSP indicates that a reporting entity should consider the following circumstances which may indicate that a transaction is not orderly:

- Inadequate exposure to the market for period before the measurement date
- Asset or liability marketed to a single market participant
- Seller distressed or forced to sell to meet regulatory or legal requirements
- Compared to other recent transactions, the transaction price is an outlier

The weight that a reporting entity should place on a given transaction should be based on a reporting entity’s findings with respect to each transaction.\(^9\)

1. If a reporting entity determines that a transaction price is not representative of an orderly transaction, it should place “little, if any” weight on that transaction when determining fair value.

2. If a reporting entity determines that a transaction price is representative of an orderly transaction, the weight that the reporting entity places on that transaction should depend on the facts and circumstances of that transaction (e.g., the volume of the transaction, the comparability of the transaction, and the proximity of the transaction to measurement date).

\(^1\) FSP FAS 157-4, Paragraph 12.
\(^2\) FSP FAS 157-4, Paragraph 13.
\(^3\) FSP FAS 157-4, Paragraphs 14 and 18.
\(^4\) FSP FAS 157-4, Paragraph 17.
\(^5\) FSP FAS 157-4, Paragraph 16.
\(^6\) FSP FAS 157-4, Paragraph 17.
3. If a reporting entity determines that there is insufficient data to conclude whether a transaction is orderly, the transaction should be considered but less weight should be placed on it.

**Disclosure requirements**

FAS 157 requires reporting entities to disclose, on an annual basis, the assumptions and valuation methods that were used to determine fair value as well as any changes that were made to assumptions and valuation methods during the period. FSP FAS 157-4 extends the disclosure requirements related to fair value measurements to interim periods.

**Effective date**

FSP FAS 157-4 is effective for interim and annual periods ending after June 15, 2009.

**Conclusion**

Although FSP FAS 157-4 provides additional guidance for estimating fair value when a market becomes illiquid or a transaction is not orderly, reporting entities are still required to use significant judgment that is based on facts and circumstances to determine fair value in accordance with FAS 157.

It appears that the FASB will continue to provide additional guidance with respect to fair value measurements. On June 8, 2009, the FASB proposed yet another amendment in FSP FAS 157-g in which it addresses how investors should determine the fair value of their investments in “alternative investment” vehicles. This FSP is currently being vetted during a 30-day comment period.

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10 FSP FAS 157-4, Paragraph 20.
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