CENTER FOR AUDIT QUALITY
Serving Investors, Public Company Auditors & the Markets

October 8, 2008



Russell G. Golden
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116
File Reference: Proposed FSP FAS 157-d

**Proposed FASB Staff Position No. 157-d,"Determining the Fair Value of a Financial Asset in a Market That Is Not Active"**

Dear Mr. Golden:

The Center for Audit Quality (CAQ) is pleased to comment on the above mentioned proposed Financial Accounting Standards Board (FASB or the Board) Staff Position No. 157-d, "Determining the Fair Value of a Financial Asset in a Market That Is Not Active" (the proposed FSP). Given the existing credit crisis and resulting liquidity constraints, we commend the Board for providing clarifying guidance on the application of FASB Statement No. 157, *Fair Value Measurements* (Statement 157), in markets that are not active. The CAQ supports the issuance of the proposed FSP and would encourage the Board to be expeditious in issuing final authoritative guidance. In addition, given the complexity of issues associated with many fair value measurements related to both financial and nonfinancial items, we believe it is important that the Board stay actively involved.

***General Comments***

In our view, the proposed FSP provides useful clarification on a number of key issues that should serve to improve consistency in application of Statement 157 in markets that are not active, including:

- Reiteration that the objective of a fair value measurement under Statement 157 is to determine the price that would be received by the holder of the financial asset in an orderly transaction (that is, not a forced liquidation or distress sale) at the measurement date ("exit value") and that such objective remains consistent even in situations in which there is little, if any, market activity for an asset at the measurement date. .

- Provision of additional guidance on considerations for assessing the priority of inputs under the fair value hierarchy in markets that are not active. The guidance in the proposed FSP highlights that not all observable data are determinative of fair value. Observable market data (Level 2 inputs) that requires significant adjustments using unobservable inputs results in a Level 3 measurement for the asset in its entirety. While providing clarification that the relevance of observable data must be assessed, this guidance remains consistent with the principle of the fair value hierarchy in Statement157 that prioritizes the use of observable inputs over unobservable inputs in valuation techniques used to measure fair value.

- Clarification that when relevant observable market data does not exist, the use of management's internal assumptions about future cash flows and appropriately risk-adjusted discount rates must include appropriate risk adjustments that market participants would make for nonperformance and liquidity risks. Accordingly, the concept of long term or fundamental value based on a strategy to hold the security that does not reflect an appropriate adjustment for both current credit and liquidity conditions is inconsistent with the basic principles and objectives of a current exit value in Statement 157.

- Clarification that broker quotes and information from other third parties needs to be assessed in order to determine the extent of reliance to be placed on it. This clarification underscores the need for entities to understand the source of information received from the broker or other third party in order to make this assessment.

- Clarification that indicative broker quotes based on proprietary pricing models that use significant unobservable inputs (Level 3 inputs), while not determinative, should not be ignored.

***Additional Comments***

We agree with the principles illustrated by the example included in the proposed FSP. However, we have identified a few instances where we believe additional clarity would be useful in helping to promote a consistent understanding and application of the proposed FSP. These items are discussed below.

**Considerations Regarding Indications of Value**

We believe it would be useful for the illustrative example in the proposed FSP to incorporate additional information in paragraph A32D about both the quantity and range of indicative quotes received by Entity A to better illustrate the nature of any necessary related judgments. While the facts in paragraph A32D specify that more than one indicative quote was obtained and considered, paragraph A32E suggests that all of the indicative quotes taken together represented one indication of an appropriate rate of return that the market participants would consider relevant in estimating fair value. That one indication is evaluated and weighed in relation to a second indication that represents Entity A's own judgments about the assumptions that market participants would use. In our view, multiple quotes from different brokers would represent separate indications of value that would need to be weighed against each other and Entity A’s own assumptions about the assumptions market participants would use in estimating fair value.

In addition, the proposed example is unclear as to the judgments necessary when evaluating and weighing the respective indicative quotes as compared to management's own estimation in order to reach an ultimate determination about an appropriate point within the range that is most representative of a market participant's assumption of a rate of return. In a situation where multiple indicative quotes with implied rates of return within a tight band were received, one may allocate more weight to these quotes in comparison to management's own estimation of an appropriate discount rate. As such, we believe additional facts about the quantity of quotes obtained and their relative range of prices would serve to enhance the example. In our view, this information would be important for Entity A to support its determination as to the appropriate rate of return.

Finally, the proposed FSP indicates that Entity A’s conclusion is based in part on the fact that the relative indications of the appropriate rate of return were reasonable in relation to each other. The example should clarify what approach Entity A would have followed if the indications had not been consistent, including considering whether the assumptions and methodology used in the internally-developed estimate should be revised or whether the assumptions used in the broker quote should be analyzed further.

**Use of Contractual Cash Flows in Determining Fair Value**

The illustrative example in the proposed FSP makes use of the discount rate adjustment technique described in Appendix B of Statement 157 in determining management's estimate of fair value. In describing the cash flows to which Entity A applied the appropriate discount rate, paragraph A32D of the proposed FSP states that cash flows are "contractual."

We observe that the example discusses an investment in a BBB rated tranche of a collateralized debt obligation. Given the BBB rating on the date of acquisition, the collateralized debt obligation would be within the scope of Emerging Issues Task Force 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* (EITF 99-20), for purposes of determining whether any impairment of the collateralized debt obligation is other-than-temporary. The impairment model in EITF 99-20 requires holders of investments within its scope to estimate cash flows that a market participant would use in determining the current fair value of the securities.

Contractual cash flows may or may not be management's best estimate of cash flows that a market participant would use in determining the price of an asset or liability. While we suspect it was not the intention of the Board to address or clarify guidance with respect to EITF 99-20 in the proposed FSP, we are concerned that absent a clarification, some constituents may analogize the use of contractual cash flows in the illustrative example (which could be expected to remain constant) in considering whether cash flows have changed under an EITF 99-20 analysis. In order to avoid any such confusion, we suggest that a clarifying footnote be added to paragraph A32D noting the following:

> Although the discount rate adjustment technique described in paragraphs B7 - B11 of Statement 157 may be appropriate for determining the fair value of financial instruments in markets that are not active, this technique 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 99-20, because it uses contractual cash flows rather than cash flows expected by market participants.

**Adjustments to Market Observable Data**

In the illustrative example, Entity A considers various market data associated with its collateralized debt obligation security as of the measurement date (September 30) and determines that significant adjustments are required to this data in order to determine the fair value of the security. As this will result in the market approach producing a Level 3 measurement, Entity A determines that the use of an income approach (that maximizes the use of observable inputs and minimizes the use of unobservable inputs) results in an estimate that will be equally or more representative of fair value. While we do not disagree with the premise of this conclusion, we are concerned that some constituents may read paragraphs A32B and A32C to imply that, in situations where markets are not active, the income approach will generally provide an estimate that will be equally or more representative of fair value. In order to further clarify this point, we recommend that the Board include a footnote to paragraph A32B noting the following:

> If required adjustments to the market data to determine fair value were not significant (e.g., a current observable transaction price for the same or similar instrument was available), a measurement using the market approach would be classified within Level 2 of the fair hierarchy and would likely provide the most relevant information as to the fair value of the security.

In addition to providing further clarity on the issue, we believe the inclusion of the above recommended footnote would serve to increase consistency between the clarifying guidance in the proposed FSP and the draft guidance in the non-authoritative white paper issued by the IASB expert advisory panel in September 2008 entitled, *Measuring and Disclosing Fair Value of Financial Instruments in Markets That Are No Longer Active*. While we acknowledge that the IASB is still considering comments on the white paper, the language in the published draft states that "regardless of the level of market activity, a current transaction price for the same or similar instrument normally provides the best evidence of fair value."

**Dates Used in the Illustrative Example**

Although the proposed FSP is written as of a point in time and is clearly intended to provide relevant guidance given current market conditions, the illustrative example represents a permanent amendment to Statement 157. As such, we suggest the Board change the dates in the illustrative example to be more generic (e.g., second quarter vs. third quarter or 20X1). In addition to the practical result of enhancing the usefulness of the example on a go-forward basis, we believe this change will eliminate the potential for any constituents to inappropriately infer the FASB intended to provide any view on the nature of markets (active or not active) at either June 30, 2008 or September 30, 2008.

*************

We would be pleased to discuss our comments with the Board members or the FASB staff at your convenience.

Very truly yours,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality