CRA Insights

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ASC 820: Determining fair value in circumstances of reduced market liquidity or inactivity

Introduction

Challenging market conditions relating, at least in part, to the COVID-19 pandemic are reminiscent of the financial markets during the global financial crisis of 2007–2008. Similar to market phenomena observed over a decade ago, the pandemic (in conjunction with certain other recent events) caused certain markets to become illiquid or even inactive (with volatility continuing as of the date of this article). While the current market environment may call into question the relevance of market pricing indicia and the applicability of fair value and mark-to-market accounting standards, as summarized in this piece, existing accounting guidance appears sufficient to address such circumstances.

Background

In September 2006, the US Financial Accounting Standards Board (FASB) issued Statement No. 157 (FAS 157), which provided certain fair value and mark-to-market accounting guidance for financial reporting purposes. FAS 157 was a subject of much debate, largely due to concerns by some that, in the wake of the global financial crisis, it may have allowed for the mispricing of assets and liabilities in illiquid markets or in distressed transactions, thus actively contributing to market instability.[1] However, some proponents of FAS 157 believed that the fair value framework it created improved the transparency and reliability of financial reporting, even in times of market instability.[2,3]

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1 US Securities and Exchange Commission (SEC), "SEC Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting," at p. 1.

2 *Id.*, at pp. 1-2.

3 A key issue at the center of the debate was the future use of mark-to-market accounting vis-à-vis a return to historical cost accounting. The question before the SEC and FASB was whether to eliminate the fair value and mark-to-market frameworks completely, or to refine and improve guidance. *Id.*, at p. 6.

FASB released certain clarifying updates to FAS 157, including (but not limited to) FASB Staff Position (FSP) FAS 157-3 (*Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*) in October 2008[4] and 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*) in April 2009.[5] Each of these updates sought to address particular questions and/or uncertainties of market participants related to the application of mark-to-market accounting during challenging market conditions.

FAS 157 was incorporated into Accounting Standards Codification 820, Fair Value Measurement (ASC 820)[6] as part of FASB's transition to a more structured system of Accounting Standards Codification in late 2009.[7] The updated standard retained most of the FAS 157 guidance in terms of measuring fair value in illiquid or inactive markets (or in instances of disorderly transactions).[8]

ASC 820 guidance on determining fair value in illiquid markets

ASC 820 provides general valuation guidance as well as specific guidance tailored to abnormal market developments, including illiquid or inactive markets and disorderly transactions.

ASC 820 states that the objective of fair value measurement is to estimate the price at which an orderly transaction, to sell the asset or to transfer the liability, would take place between market participants at the measurement date under current market conditions (that is, an exit price at the measurement date from the perspective of the market participant that holds the asset or owes the liability).[9] ASC 820 also specifies that fair value should be thought of as a market-based measurement, not an entity-specific measurement. As such, a reporting entity's intent to hold an asset or settle a liability is irrelevant to the proper determination of fair value under US GAAP.[10]

These definitions apply even in circumstances where there is a "significant decrease in the volume or level of activity."[11] However, with respect to performing valuations in abnormal and illiquid market situations, the standard provides specific guidance on two (at least partially overlapping) circumstances that are relevant today – (i) a significant decrease in market volume or level of activity for a particular asset or liability (hereinafter referred to as *illiquid or inactive markets*), and

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4 *Id*., at p. 2. See also FASB, FSP FAS 157-3, at https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220135667&acceptedDisclaimer=true**.**

5 FASB, FSP FAS 157-4," at https://www.fasb.org/project/fas157_active_inactive_distressed.shtml.

6 FASB, Accounting Standards Update, Fair Value Measurement (Topic 820), at pp. 162-164, https://asc.fasb.org/imageRoot/00/7534500.pdf.

7 FASB, Summary of Statement No. 168, at https://www.fasb.org/cs/ContentServer?c=Pronouncement_C&cid=1176156308679&d=&pagename=FASB%2FPronouncement_C%2FSummaryPage.

8 The ever-changing landscape in which ASC 820 is utilized in concert with other accounting guidance has led to numerous updates of the guidance by FASB since its original issuance. This piece is not intended to provide a comprehensive assessment or summary of ASC 820.

9 ASC 820-10-35-54G and ASC 820-10-05-1B. The guidance is similar to guidance provided in paragraph 29D of FAS 157.

10 For example, ASC 820-10-35-54H. The guidance is similar to guidance provided in paragraph 29D of FAS 157.

11 ASC 820-10-35-54G. The guidance is similar to guidance provided in paragraph 29D of FAS 157. This piece sometimes uses the phrase "illiquid or inactive markets" as a shorthand for the guidance phraseology of "significant decrease in the volume or level of activity."

(ii) disorderly transactions. ASC 820 provides the following guidance to assist market participants in identifying and addressing these situations:

1. Illiquid or inactive markets

Key identification factors of an illiquid or inactive market include:[12]

- Few recent transactions;
- Price quotations not based on current information;
- Price quotations exhibiting significant variation (over time or among market makers);
- Previously correlated indices being demonstrably uncorrelated;
- Significant increase in implied risk premiums, yields or other relevant performance indicators;
- Wide bid-ask spread or significant increase in bid-ask spread;
- Significant decline in activity or absence of market for new issues; and
- Little publicly available information.

If a reporting entity determines that the market for an asset or liability is illiquid or inactive, any pricing or transaction inputs it uses to estimate fair value for that asset or liability may need to be adjusted.[13] However, ASC 820 suggests that a significant observed decline in market volume or level of activity, in isolation, is insufficient to render a transaction non-reflective of fair value, and further analysis is recommended.[14] In some situations, further analysis may indicate that it is appropriate to modify the particular approach used to value the asset or liability as compared to techniques used previously, and/or to use multiple approaches (e.g., market approach in combination with an income approach).[15] Regardless, in arriving at a valuation range for an asset or liability, ASC 820 indicates that the reporting entity should attempt to identify the value within any resulting range that is most representative of fair value in an orderly transaction for such asset or liability *under current market conditions*.[16] Therefore, while current market conditions are undoubtedly unique, they must be given proper consideration when performing relevant valuations under the guidance of ASC 820.

2. Disorderly transactions

The language of ASC 820 acknowledges that it might be difficult to determine whether a particular transaction is disorderly (i.e., representative of a distressed or forced liquidation), particularly in situations characterized by a significant decrease in market activity for an asset or liability relative to normal conditions. However, even in potentially illiquid or inactive markets, market participants should not assume that every transaction is disorderly, but should instead consider, among other potential factors, whether:[17]

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[12] ASC 820-10-35-54C. The guidance is similar to guidance provided in paragraph 29A of FAS 157.

[13] ASC 820-10-35-54D. The guidance is similar to that in paragraph 29B of FAS 157.

[14] *Id.*

[15] ASC 820-10-35-54F. The guidance is similar to that in paragraph 29C of FAS 157. Other factors, such as a wide range of values, may also indicate that further analysis is needed.

[16] *Id*. Emphasis added.

[17] ASC 820-10-35-54I. The guidance is similar to that in paragraph 29E of FAS 157.

- There was inadequate market exposure prior to the measurement date;
- The asset or liability was marketed to a single market participant;
- The seller is distressed (i.e., in or near bankruptcy or receivership);
- The seller is forced (i.e., required to sell to meet regulatory or legal requirements);
- The transaction price was an outlier when compared to other recent transactions for the same or similar asset/liability.

ASC 820 recommends that if an entity determines that a transaction is not orderly, little, if any, weight should be placed on that transaction price (as compared to more reliable estimates of fair value under orderly transactions).[18] If, on the other hand, an entity determines that a transaction is orderly, the price should be weighted in the overall valuation in accordance with considerations for the size of the transaction, the comparability of the transaction to the subject asset or liability, and the proximity of the transaction date to the measurement date.[19] If an entity cannot determine whether a particular transaction is orderly, ASC 820-10-35-54Jc advises that the transaction should still be considered but given comparatively less weight than other transactions that are known to be orderly.[20]

Implications of the current environment on valuation guidance

Fair value accounting was a controversial topic following the 2007–2008 financial crisis, as many argued that it increased market volatility due to the enhanced impact of fair value fluctuations on companies' earnings during the crisis. FASB responded to these concerns with clarifying language, but it did not suspend or substantially modify the fair value rules themselves.

In the current crisis, FASB has thus far taken the same approach. For example, a major real estate trade association reached out to FASB at the end of March 2020 with an official request for the suspension of mark-to-market accounting due to the unprecedented credit crisis and market illiquidity caused by COVID-19.[21] FASB denied the trade association's request, noting that ASC 820 provides appropriate guidance in periods of decreased volume or level of activity or in instances of disorderly transactions.[22] While the implications of the COVID-19 pandemic are still emerging, it does not appear that any substantial FASB accounting guidance changes will likely result from the current challenges.

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18 ASC 820-10-35-54J a. The guidance is similar to that in paragraph 29F a. of FAS 157.

19 ASC 820-10-35-54J b. The guidance is similar to that in paragraph 29F b. of FAS 157.

20 ASC 820-10-35-54J c. The guidance is similar to that in paragraph 29F c. of FAS 157.

21 See the letter from Jeffrey D. DeBoer, President and CEO of The Real Estate Roundtable to the chairs of the Federal Reserve System, the SEC, the FASB, and Treasury Secretary Steven Mnuchin, at https://www.rer.org/docs/default-source/comment-letters/2020/3-30-2020---fasb-suspend-mark-to-market-accounting-rules.pdf?sfvrsn=cc8578f_2 (last accessed on July 27, 2020).

22 FASB, Tentative Board Decisions, archived summary at https://www.fasb.org/cs/ContentServer?c=FASBContent_C&cid=1176174436194&d=&pagename=FASB%2FFASBContent_C%2FActionAlertPage (last accessed on July 27, 2020). See also Nicola M. White, "Real Estate Group Denied Request to Suspend Fair Value," Bloomberg Tax, April 8, 2020, at

https://news.bloombergtax.com/financial-accounting/real-estate-group-denied-request-to-suspend-fair-value (last accessed on July 27, 2020).

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