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Summary of FAS 157, Fair Value Measurements

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Summary of FAS 157, *Fair Value Measurements*

The Financial Accounting Standards Board (FASB) released its Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (FAS 157) in September 2006. FAS 157 became effective for fiscal years beginning November 15, 2007 and thereafter. *According to the Summary:*

> This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements [...] Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice.

Creating a "standard definition" of fair value. Prior to the release of FAS 157, there were various definitions of fair value dispersed among the many FASB pronouncements and limited guidance for applying the standards in compliance with GAAP. These differences created inconsistencies, unnecessary complexity, and a need for comparability among fair value measurements as well as expanded disclosures. By creating a single, comprehensive definition of fair value, the FASB hoped to improve the transparency of corporate accounting practices and provide a standard framework for valuation. *FAS 157 defines fair value as:*

...the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Compared to prior definitions, FAS 157 retains the notion of an exchange or "exit price" rather than an entry price, but places it within the context of "a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability," according to the Summary. Fair value is intended to be a market-based measurement, in other words, as opposed to an entity-specific measurement.

To make these measurements market-based, FAS 157 creates a "fair value hierarchy" that distinguishes among three levels of value:

- **Level One:** Observable inputs based on market data obtained from sources independent of the reporting entity, including most frequently the quoted prices (unadjusted) in active markets for identical assets or liabilities at the measurement date.

- **Level Two:** Observable inputs other than quoted prices for the asset or liability, either direct or indirect, including:

(a) Quoted prices for similar assets or liabilities in active markets.

(b) Quoted prices for identical/similar assets or liabilities in markets that are not active; i.e., in which there are few transactions for the asset or liability, the prices are not current, or price quotations vary over time or among market makers (some brokered markets), or in which little information is released publicly (a principal-to-principal market).

(c) Observable inputs other than quoted prices for the asset or liability (e.g., interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates).

(d) Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).

Note: Pratt's Stats®, Mergerstat/BVR's Control Premium Study, and BIZCOMPS—available at BVMarketdata.com—are potential sources of information for this last type of Level Two input.

- **Level Three:** Unobservable inputs, developed from the reporting entity's assessment of market participant assumptions, based on the best information available under the circumstances.

In particular, the notion of unobservable or Level 3 inputs applies when there is little, if any, market activity for the asset or liability at the measurement date. As the Summary to FAS 157 explains: "In those situations, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity must not ignore information about market participant assumptions that is reasonably available without undue cost and effort."

In addition to its emphasis on market-based pricing, FAS 157 clarifies the following concepts:

- **Orderly transaction.** "The Statement clarifies that the exchange price is the price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability." Although FAS 157 specifies a measurement or valuation date, it does presume the asset/liability's exposure to the market for a certain period, to allow for usual and customary market activities.

- **Market participants.** Market participants are buyers and sellers who are independent, knowledgeable, willing, and able to transact for the subject asset or liability in its principal (or most advantageous) market. The reporting entity need not identify specific market participants, but only the characteristics that distinguish them generally, considering the specific asset/liability, its principal market, and the market participants with whom the entity would normally transact.

- **Assets.** FAS 157 fair value measurement assumes the "highest and best use" of an asset, that is: 1) physically possible, 2) legally permissible, and 3) financially feasible. The valuation premise is "in use/in exchange," which maximizes the value of the asset (or group of assets) in the context in which the asset will be used, but bases this value on use by market participants—even if the reporting entity intends a different use; i.e., application of the standard may eliminate buyer-specific strategies.

- **Liabilities.** FAS 157 assumes that the liability is transferred to a market participant, and the non-performance risk remains the same both before and after the transfer. Meaning, the liability continues; it is not settled.

- **Valuation approaches.** FAS 157 requires using valuation techniques consistent with the three traditional approaches (market, income, and/or cost approach), and "that are appropriate in the circumstances and for which sufficient data are available to measure fair value." Such techniques should be consistently applied; a change is appropriate (for example, to the weighing of the various methods) only if it is a better representation of fair value.

- **Risk.** FAS 157 includes market participant assumptions about risk; e.g., the risk inherent in a particular valuation technique (such as a pricing model) and/or the risk inherent in the valuation inputs. "A fair value measurement should include an adjustment for risk if market participants would include one in pricing the related asset or liability," the Statement explains, "even if the adjustment is difficult to determine." For instance, a "mark-to-model" measurement that does not include a risk adjustment would not represent fair value if market participants would include an adjustment in pricing the related asset or liability.

FAS 157 also introduced new disclosure requirements relating to fair value measurements. For each major category of assets and liabilities, the reporting entity must disclose the following information for each interim and annual period:

- Fair value measurements at the reporting date.
- The level within which the fair value measurements fall (i.e. Levels 1, 2, or 3).
- For non-recurring assets and liabilities (e.g., impaired assets) using significant unobservable inputs (Level 3), a description of the inputs and the information used to develop the inputs.
- Recurring fair value measurements with significant Level 3 inputs will require a reconciliation of beginning and ending balances, total gains and losses, and transfers in and/or out of Level 3.
- The valuation techniques used to measure fair value for annual periods and a discussion of changes in valuation techniques, if any, during the period. For nonrecurring fair value measurements, entities must also disclose and discuss

any changes in the valuation techniques used to measure similar assets or liabilities in prior periods.

Convergence with international accounting standards. After the December 2006 release of FAS 157, the International Accounting Standards Board (IASB) issued a discussion paper that presented its "preliminary views on providing consistency in the measurement of fair value." Like FAS 157, the IASB discussion paper did not introduce any new fair value definitions, which are dispersed throughout existing International Financial Reporting Standards (IFRS). Instead, it intended to establish a "concise definition" to simplify IFRS and improve the quality of fair value information in financial reports.

At present, the IASB has nearly completed an exposure draft of an IFRS on fair value measurement, which it plans to publish in the first quarter of 2009. "When preparing an exposure draft, the [IASB] will consider the requirements of FASB's Statement of Financial Accounting Standards No. 157 Fair Value Measurements (SFAS 157)," according to a project update. "However, the IASB's exposure draft might differ from SFAS 157 in its requirements and wording." For more information, go to www.iasb.org.

An additional resource. Expert analysts Al King, Matt Crow, and Jim Travis participated in a recent Business Valuation Resources' teleconference titled ***SFAS 157***, which included in-depth discussions on the ramifications of SFAS 157 to CFOs, auditors, attorneys, and managers. A transcript and CD of the teleconference is available here.
