

Banking & Capital Markets Issues
Technical Accounting Issues | Fall 2006

Please Welcome SFAS 157— The New Fair Value Measurement Standard and Hierarchy

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Historically, there has been no single consistent framework within the accounting literature for applying fair value measurements and developing a reliable estimate of fair value. With authoritative guidance scattered throughout various accounting pronouncements, companies often found fair value estimates difficult to determine. Without a consistent framework applied to identical instruments, situations could arise whereby identical instruments held by different companies could have different fair value estimates. Furthermore, the development of these fair value estimates is becoming more complicated since markets are continually issuing more complex and less liquid financial instruments. After numerous deliberations, the FASB has attempted to address this challenge by publishing Statement of Financial Accounting Standards No. 157, Fair Value Measurements, in September 2006 (the “Statement” or “SFAS 157”).

The purpose of this Statement is to increase consistency and comparability of fair value estimates by:

- Defining fair value;
- Establishing a framework for measuring fair value; and
- Expanding disclosures of fair value measurements.

This pronouncement applies to other accounting pronouncements that require or permit fair value measurements. Furthermore, this Statement emphasizes

that fair value is a market-based measurement rather than entity-based.

SFAS 157 is effective for years beginning after November 15, 2007; although earlier adoption is encouraged and permitted so long as no financial statements have been issued for the fiscal year (including interim financial statements). SFAS 157’s transition provisions require that the standard generally be applied prospectively as of the first interim period for the fiscal year in which it is initially adopted. The Standard must also be applied retrospectively as of the date of adoption for instruments with blockage adjustments, affected by EITF Issue 02-3

“Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities”, or subject to the SFAS 155 fair value election “Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140”

Definition of Fair Value

Paragraph 5 of SFAS 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.”

Paragraph 7 of SFAS 157 further defines what is meant by the price for fair value measurement. A fair value measurement assumes that the asset or liability is exchanged or settled in an orderly market transaction at the measurement date. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distressed sale).

The transaction is considered from the perspective of a market participant that holds the asset (seller) or owes the liability (transferor). Therefore, the objective of a fair value measurement is to determine the price that would be

received to sell the asset or paid to transfer the liability at the measurement date (an exit price).

Valuation Approaches

SFAS 157 describes three main approaches to estimating fair value:

1. The market approach;
2. The income approach; and
3. The cost approach.

The Market Approach

The market approach uses observable prices and other relevant information generated by market transactions involving comparable assets or liabilities. Some potential sources for market values are:

- Exchange Markets;
- Dealer Markets; and
- Quotation Services.

Valuation techniques consistent with the market approach include use of market multiples derived from a set of comparables or matrix pricing. Matrix pricing refers to a mathematical technique used to value debt securities without relying exclusively on quoted prices but rather the securities' relationship to other benchmark quoted securities.

The Income Approach

The income approach uses valuation techniques to convert future cash flow amounts to a single present value

amount. Those valuation techniques may include the following:

- Present Value of Expected Future Cash Flows;
- Option Pricing Models (i.e. Black-Scholes/Binomial models); and
- The multi-period excess earnings method, which is used to estimate fair value of certain intangible assets.

The Cost Approach

The cost approach is based on the amount that currently would be required to replace the service capacity of an asset considering utility and obsolescence. Service capacity is often referred to as current replacement cost.

The Fair Value Hierarchy

The most important development in the fair value measurement project is the introduction of a framework for a fair value hierarchy. The hierarchy is used to evaluate significant inputs to the valuation process, not on the valuation techniques used to value an asset or liability at fair value.

The valuation inputs range from external market sources (observable inputs) and internal entity sources (unobservable inputs). The hierarchy is focused on transparency and using market based information that is readily available to all parties. The selection of appropriate valuation techniques may be affected by the availability of inputs that are relevant to the asset or the lia-

bility, as well as the relative reliability of the inputs.

There are three broad levels to the fair value hierarchy of inputs:

Level 1: Quoted prices: Prices (unadjusted) in active markets for *identical* assets or liabilities that the reporting entity has the ability to access at the measurement date.

- If the entity holds a large position (block) of a financial instrument that has a quoted price in an active market, the fair value of the position is a Level 1 estimate and computed as the quoted price for an individual trading unit multiplied by the quantity held. The quoted price should not be adjusted for the size of the position relative to trading volume (use of a blockage factor);
- Emphasis is on the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market; and
- Emphasis is also placed on whether the reporting entity has the ability to access the price in that market at the measurement date.

Level 2: Inputs other than quoted prices included in Level 1 that are observable either directly or indirectly:

- Quoted prices for *similar* assets or liabilities in active markets;
- Quoted prices for *identical or similar* assets or liabilities in markets that are not active, that is, markets in

which (1) there are few transactions for the asset or liability; (2) the prices are not current; (3) price quotations vary substantially either over time or among market makers (e.g., some brokered markets); or (4) little information is released publicly (e.g., a principal-to-principal market);

- Inputs other than quoted prices that are directly observable for the asset or liability; and
- Inputs that are derived principally from or corroborated by other observable market data through correlation or by other means (market-corroborated inputs). Significant adjustments to Level 2 inputs may cause the fair value measurement to move down to Level 3.

An example of a Level 2 input would be the LIBOR swap rate.

Level 3: Unobservable inputs:

- Unobservable inputs reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing;
- The reporting entity's own data (adjusted if information is reasonably available without undue cost and effort to reflect market based assumptions).

Examples of Level 3 inputs include historical default and returns for an entity's portfolio.

By distinguishing between inputs that are observable and those that are

unobservable, the hierarchy is a useful indicator of the relative reliability of the estimates. SFAS 157 requires that the estimate of fair value maximize the use of observable inputs and minimize the use of unobservable inputs, which may change current practice for some entities.

Disclosures

An important concept about the hierarchy is the expanded disclosures that will be required when measuring fair value subsequent to initial recognition. The requirements differ depending on whether you are measuring on a recurring or non-recurring basis and at what Level in the hierarchy the inputs fall into. The objectives of the disclosures are to inform the reader of the types of instruments valued in accordance with the fair value hierarchy.

Conclusion

SFAS 157 has addressed the fair value challenge by establishing a framework for measuring fair value and expanding disclosures regarding fair value measurements. The fair value framework does not however, eliminate the complexity and judgment required to estimate fair value. For example, given the proliferation of complex financial instruments that have unusual features, the determination of fair value will remain judgmental and not always conclude in a consistent result.

Nevertheless, this Statement does provide a single definition of fair value, a consistent framework to measure fair

value and expanded disclosures that will help increase transparency to investors and address the complexities that are faced by companies as they fair value both assets and liabilities, a definite improvement.

For more information on the newly issued SFAS No. 157, Fair Value Measurements, please contact Douglas Summa at 646.471.8596 (douglas.summa@us.pwc.com)/ Frank Serravalli at 646.471.2669 (frank.serravalli@us.pwc.com)/ Maria Nizza at 646.471.3214 (maria.e.nizza@us.pwc.com)/ David Lukach at 646.471.3150 (david.m.lukach@us.pwc.com).