The Metropolitan Corporate Counsel®

www.metrocorpcounsel.com

Volume 16, No. 3 March 2008

Primer: Statement Of Financial Accounting Standards No. 157

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Today's corporation faces vexing questions related to the "fair value" of its assets and liabilities: How does one value these items? Are assets and liabilities being valued in accordance with generally accepted accounting principles ("GAAP")? In the fall of 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 157 ("SFAS 157") related to fair-value measurement, which establishes a single definition of fair value, sets a framework for measuring fair value under GAAP, and expands the disclosures about fair-value measurements. SFAS 157 was to be effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. But recently the FASB voted to delay until November 15, 2008 the implementation of SFAS 157 *for non-financial assets and liabilities not measured on a recurring basis*. In other words, if your company is not a financial institution, or the preponderance of its assets are not financial in nature, you have nearly all of 2008 to prepare for the adoption of SFAS 157. So for those who are not familiar with the SFAS 157 and its potentially wide ranging implications, what follows is a primer.

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Definition Of Fair Value And Market Participants

Prior to the issuance of SFAS 157, the definition of fair value and methods for measuring fair value were diverse and inconsistent. Additionally, the limited guidance for applying these definitions in GAAP has consequently contributed to the lack of comparability in fair-value measurements and to the increasing complexity in conforming to GAAP. As such, SFAS 157 intends to correct these problems by establishing the standards for defining and measuring fair value and requiring additional disclosures about fair-value measurements.

SFAS 157 applies whenever other accounting standards require (or permit) assets or liabilities to be measured at fair value and does not impose requirements for additional fair-value measures in financial statements. According to Paragraph 5 of SFAS 157, "Fair value is 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 past definitions, this definition of fair value has a few distinctions. First, fair value is defined based on an exit price principle – the price at which assets would be sold rather than the price at which assets would be bought. Second, the definition of fair value highlights the importance of using market participants in valuation by emphasizing that fair value is a market-based measurement, not an entity-specific measurement, and therefore should be based on the assumptions market participants would use when pricing the asset or liability in a principal market.[1] For the purposes of the definition of fair value, SFAS 157 has defined market participants as buyers and sellers in the principal market for the asset or liability who meet the following four criteria: i) independence from the reporting entity; ii) knowledgeable of the asset or liability and the transaction; iii) able to transact for the asset or liability; and iv) willing to transact for the asset or liability without compulsion.

Based on the definition of fair value described above, the following are the implied applications of fair-value measurements for assets and liabilities. According to SFAS 157, a fair-value measurement for assets assumes the highest and best use of the asset by market participants (best use refers to the use of an asset by market participants that would maximize the value of

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the asset).[2] For liabilities, a fair-value measurement assumes that the liability is transferred to a market participant at the measurement date and that the nonperformance risk relating to that liability is the same before and after its transfer. In support of the principles delineated in the definition of fair value, SFAS 157 establishes a fair-value hierarchy that prioritizes the information used to develop these assumptions.

Fair Value Hierarchy

As a way to increase consistency and comparability in fair-value measurements and related disclosures, SFAS 157's fair value hierarchy ranks the quality and reliability of inputs used in the measurement of fair value into three levels. The fair value hierarchy gives the highest priority, Level 1, to quoted prices in active markets for identical assets or liabilities and the least priority to Level 3, which includes unobservable inputs for the asset and liability (i.e., the company's own data and assumptions). *Please see the table below for a breakdown of the three levels*.

In determining the level of a given fair-value measurement, SFAS 157 indicates that the lowest level input that is *significant* to the fair-value measurement will determine the hierarchy level of that measurement. For example, if a fair-value measure relies significantly on estimated future cash flows (Level 3 input), then the fair-value measurement would be at Level 3. According to SFAS 157, the inputs should be consistent with the valuation premise[3] and be based on the assumptions made by hypothetical market participants.

Disclosures

SFAS 157 requires reporting entities to disclose information for each interim and annual period separately for each major category of assets and liabilities. The following details the required disclosures for assets and liabilities measured at fair value on either a recurring or nonrecurring basis: i) the fair-value measurements at the reporting date; and ii) the levels within the fair value hierarchy in which the fair value measurements fall (segregating measurements with Level 1, Level 2, and Level 3 inputs). For assets and liabilities that are measured at fair value on a *nonrecurring* basis using Level 3 inputs, a description of the inputs and the information used to develop the inputs are required as disclosures. Similarly, for assets and liabilities that are measured at fair value on a *recurring* basis using Level 3 inputs, the reporting entity is required to disclose a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to the following: i) total gains or losses for the period, segregating those gains or losses included in earnings (or changes in net assets), and a description of where those gains are reported in the statement of income (or activities); ii) purchases, sales, issuance, and settlements (net); and iii) transfers in and/or out of Level 3. SFAS 157 encourages reporting entities to combine the disclosures set forth in this Statement with the fair value information disclosed under other accounting pronouncements, including SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*, where applicable.

Other Highlights From SFAS 157

• Valuing a Liability – Since market participants would consider nonperformance risks as a factor in determining the fair value of a liability, SFAS 157 requires the reporting entity's credit standing to be considered when a liability is measured at fair value.

• Restricted Stock – When valuing a restricted stock, SFAS 157 requires that it should be valued based on the value of equivalent unrestricted stock, adjusted for the effect of the restriction. For securities with restrictions of less than one year, SFAS 157 requires adjustments in fair-value measurements for the effect of restrictions that terminate within one year. However, no specific guidance on how to value the effect of such restrictions has been established.

• Blockage – SFAS 157 prohibits entities from applying a blockage factor when valuing a large quantity of shares in an unrestricted security since the appropriate unit-of-account is the individual security and not the equity position of the entity.

• Day One Gains – SFAS 157 amends Emerging Issues Task Force 02-3 ("EITF 02-3") by permitting initial gains or losses to be recognized on instruments measured using Level 3 inputs. Previously, EITF 02-3 only allowed initial recognition of unrealized gains or losses when the fair value of the instruments was obtained from Level 1 and Level 2 inputs.

• Bid-Ask Spreads – SFAS 157 allows the use of mid-market pricing or other pricing conventions within the bid-ask spread that are representative of fair value. The previous proposal, *FASB Proposed Statement, June 23, 2004*, only allowed bid prices to be used for long positions and ask prices to be used for short positions.

Implications Of SFAS 157

The framework for measuring fair value outlined in SFAS 157 builds on current practices and requirements. In order to comply with the requirements set forth in SFAS 157, some entities may need to change some aspects of their current fair-value measurement techniques and as a result, may incur incremental costs. As companies prepare for adoption in the coming year, more clarity will arise among practitioners regarding the implementation of the new fair-value measurement guidelines.

Hierarchy of Inputs in Fair-Value Measurement

Reliability Level	*Input*
1	• Quoted prices in active markets for identical assets or liabilities.
2	• Observable prices in active markets for similar assets or liabilities.
	• Prices for identical or similar assets or liabilities in markets that are not active.
	• Directly observable market inputs for the asset or liability, e.g., interest rates and yield curves at commonly quoted intervals, volatility, prepayment speeds, default rates, and credit spreads.
	• Market inputs that are not directly observable but are derived from or corroborated by observable market data.
3	• Unobservable inputs based on the reporting entity's own assumptions related to market participants, including inputs derived from extrapolation and interpolation that are not corroborated by observable market data.

[1] *A principal market is a market with the greatest level of activity that the reporting entity uses to sell the asset or transfer the liability at the price that maximizes the net amount received for the asset or minimizes the net amount paid to transfer the liability.*

[2] *Since the highest and best use of the asset is determined by market participants, the fair-value measurement considers the assumptions that market participants would use in pricing the asset.*

[3] *According to SFAS 157, a valuation premise is an assumption about how market participants would use an asset. SFAS 157 requires reporting entities to establish the valuation premise based on the asset's highest and best use whether under an in-use premise or an in-exchange premise.*