



Financial Technologies Forum
Hedge Fund Operations &
Technology
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*Current Valuation
Practices and Preparing
for
FASB 157*

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FAS 157: Fair Value Measurements

Reasons for Issuing SFAS 157

- Consolidate Definition of Fair Value
 - 67 FASB Pronouncements Require or Allow Fair Value Measurements (“FVM”)
 - Guidance on Measuring Fair Value Dispersed and Inconsistent
- Establish a Framework for Measuring Fair Value
- Enhance Disclosures about FVM

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FAS 157: Fair Value Measurements

Reasons for Issuing FAS 157: Pervasiveness of Fair Value Estimates

Leasing (13)	Debt and Equity (115)	Long Lived Assets (144)
Non-monetary transactions (APB 29)	Derivatives (133)	Exit and Disposal Costs (146)
Troubled debt restructurings (15)	Transfers of Assets (140)	Liabilities and Equity (150)
Pension accounting (35,87,106)	Business Combinations (141)	Hybrid Financial Instruments (155)
Mortgage Banking (65)	Goodwill and Intangibles (142)	Servicing (156)
Financial Instruments (107)	Asset Retirement Obligations (143)	Guarantees (FIN 45)

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FAS 157: Fair Value Measurements

Scope

- Applies broadly to financial and nonfinancial assets and liabilities measured at fair value, except those relating to:
 - Share-based payment transactions (e.g., APB 25, FAS 123, FAS 123(R), FTB 97-1)
- Clarifies that is not applicable for:
 - Standards permitting practicability exceptions to fair value (e.g., SOP 97-2, SOP 98-9, EITF 00-21, FIN 45, EITF 85-40, EITF 99-17)
 - Inventory pricing (ARB 43, Chapter 4)

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Definition of Fair Value in FAS 157

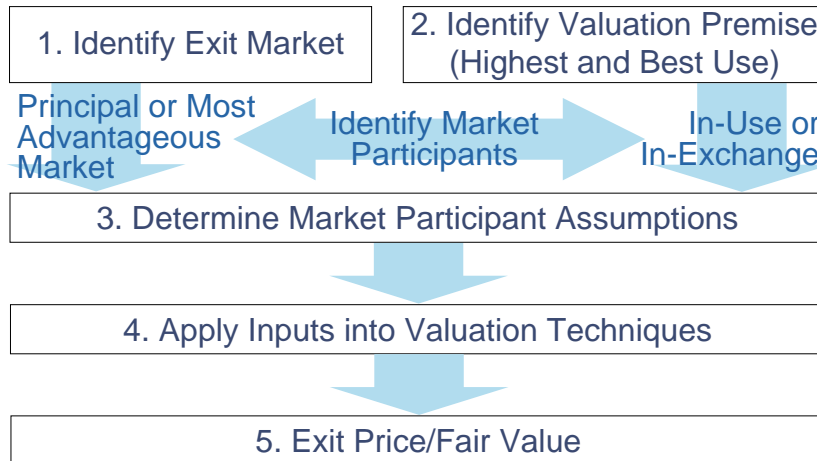
*Fair value is the price that would be received to **sell** an asset or **paid to transfer** a liability in an **orderly transaction** between **market participants** at the measurement date.*

(Emphasis Added)

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Fair Value Framework



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Definition of Fair Value in FAS 157: Exit Price

- The definition retains the exchange price notion in earlier definitions of fair value.
- However, it clarifies that the exchange price is an *exit price* considered from the perspective of a market participant (seller) that holds the asset or owes the liability (transferor).
- The exit price objective applies regardless of a reporting entity's intent and/or ability to sell the asset or transfer the liability.
- Prior to FAS 157, transaction price or entry price was assumed to represent fair value at initial recognition.

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Definition of Fair Value in FAS 157: Market Participants

Market Participants: Buyers or sellers in the principal (or most advantageous) market for the asset or liability, that are:

- Independent of the reporting entity;
- Knowledgeable;
- Able to transact for the asset or liability;
- Willing to transact for the asset or liability; and
- May be hypothetical.

Market participants may be either financial or strategic buyers. Disposal is assumed to be undertaken in an orderly manner.

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Definition of Fair Value in FAS 157: Transaction/Transportation Costs

- Transaction costs are **NOT** included in the fair value estimate. They are incremental costs to sell an asset and not an attribute of the asset.
- Transportation costs should be considered in fair value if location is an attribute of the asset or liability (e.g. commodities).
- Concept: If the cost can be directly transferred to a 3rd party, it should be included in FV.

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Definition of Fair Value in FAS 157: Applicability to Assets

Fair value assumes the **highest and best use** for an asset.
(Valuation Concept)

Highest and Best Use:

- Should maximize the value of the asset
- Use must be physically possible and legally and financially feasible
- Market participant perspective

Reporting entities to determine if highest and best use for an asset is **in-use** or **in-exchange** (valuation basis) regardless of management's intended use for the asset.

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Measurement of Fair Value: Initial Measurement

Transaction Price (Entry Price) may not equal Exit Price.

Factors to Consider

- Whether the transaction occurred between related parties or under duress/forced liquidation.
- Whether the unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value.
- Whether the market in which the transaction occurs is different from the principal (most advantageous) market for the reporting entity.

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Measurement of Fair Value: Subsequent Measurement of Fair Value

Factors to Consider-

- Fresh valuation performed each time.
- Subsequent valuation shall consider changes in the market and other relevant factors since the previous measurement (for example, a change in the condition and/or location of the asset or liability).
- Subsequent measurement may be recurring (i.e. financial instruments) or nonrecurring (i.e. impairment of a non-financial asset).

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Valuation Techniques

SFAS 157 provides guidance on valuation techniques to be used for initial and subsequent measurement and sets out three accepted methodologies:

- Market Approach,
- Income Approach, and/or
- Cost Approach.

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Valuation Techniques

- Use of multiple valuations will produce a range of values
- Selection of a point within the range requires judgment and should consider:
 - Reliability and subjectivity of inputs
 - Relevance of the methodologies chosen
 - Width of the range

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Fair Value Inputs

Inputs are market participant assumptions that go into valuation models.

- **Observable Inputs**

Developed based on *market data* obtained from sources *independent* of the reporting entity.

- **Unobservable Inputs**

Reflect the reporting entity's *own assumptions* about market inputs developed *based on its own data*. Must be consistent with market participant assumptions.

Valuation techniques used to measure fair value should maximize the use of observable inputs (i.e. highest priority to Level 1 inputs and lowest to Level 3).

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Fair Value Hierarchy

Fair Value Hierarchy prioritizes the **inputs** to valuation techniques used to measure fair value into three broad levels:

- Level 1 Inputs
- Level 2 Inputs
- Level 3 Inputs

The significance of an input to the measurement of fair value determines the level in which a fair value estimate is categorized.

This categorization drives financial statement disclosures.

The FV Hierarchy does not prioritize the valuation techniques themselves.

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Fair Value Hierarchy: Level 1

- Level 1 inputs are **observable** inputs that reflect **quoted** prices for **identical** assets or liabilities in active markets. The reporting entity must have the ability to access at the measurement date.
- The quoted price for an identical asset or liability in an active market is assumed to be the most reliable evidence of fair value and shall be used to measure fair value whenever available.

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Fair Value Hierarchy: Level 1

- Quoted prices in an active market might be available but not readily accessible for each of the assets or liabilities (e.g. from pricing services or individual broker-dealers).
- Fair values may be measured using an alternative pricing method (e.g., matrix pricing) as a practical expedient, provided that the method is demonstrated to replicate actual prices. (However the use of an alternative pricing method makes it a Level 2 measurement.)

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Fair Value Hierarchy: Level 1

- After-market events occurring before the measurement date such as announcements or brokered trades may render the closing quoted price stale. These events should not be ignored by a reporting entity.
- The reporting entity should consistently apply a policy for determining how those events affect fair value measurement.

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Fair Value Hierarchy: Level 1

Blockage Reserves: Adjustment to fair value for the risk of a large position in a financial instrument.

- Not allowed for “Level 1” positions.
- P x Q
- Broker-Dealers and Investment Companies are scoped into this requirement.
- Requires limited retroactive application upon adoption with cumulative effect recorded through retained earnings.

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Fair Value Hierarchy: Level 2

- Directly or indirectly **observable** inputs other than those included in Level 1 that the entity has the ability to access at the measurement date.
- The input must be observable for substantially the full term of the asset or liability.

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Fair Value Hierarchy: Level 2

Level 2 inputs include:

- Quoted prices for similar assets.
- Quoted prices for identical assets in illiquid markets.
- Inputs other than quoted prices that are observable for the asset or liability (e.g. interest rates, yield curves, volatilities, etc. observable at commonly quoted intervals).
- Inputs that are derived principally from or corroborated by other observable market data through correlation or by other means (i.e., a bank's prime rate derived through extrapolation and corroborated by observable interest rates).

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Fair Value Hierarchy: Level 3

- **Unobservable** market inputs that reflect the reporting entity's own assumptions about market participant assumptions used in pricing an asset.
- Shall be used if observable market inputs are not available.
- Reporting entity's assumptions should be adjusted if they become aware that market participants would use different assumptions.
- The risk and uncertainty inherent in the inputs should be included.

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Fair Value Hierarchy: Example

Valuing a portfolio company of a private equity fund.

Significant valuation inputs:

- Entity Cash Flows (EBITDA)
- Market Multiple

What level would each of those inputs be classified?

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Fair Value Hierarchy: Example

<u>Input</u>	<u>Level</u>	<u>Reason</u>
EBITDA	Level 3	Cash flows are not corroborated by observable market public data
Market Multiple	Level 2	If derived from observed transactions for comparable businesses

As EBITDA is a significant input – Private company valuations would typically be Level 3 estimates.

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Special Considerations: Restricted Assets

- Restrictions, including their nature and duration, should be considered in the fair value if they would transfer to market participants (i.e. they attach to the asset—SEC Rule 144).
- Restrictions on a specific personal or business use of the asset would not be factored into the valuation unless the restriction transfers (e.g. charity’s restriction on use of land).
- Restrictions would render an otherwise Level 1 measurement a Level 2.

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Disclosures

For assets and liabilities measured at fair value on a **nonrecurring** basis:

- The fair value measurement recorded during the period and the reasons for the measurement.
- The level within the hierarchy in which they fall.
- For measurements with significant Level 3 inputs, a description of the inputs and the information used to develop the inputs.
- Disclosure of valuation techniques and a discussion of changes to techniques (Annual filings only).

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Disclosures

For assets and liabilities measured at fair value on a **recurring** basis:

- The fair value measurement at the reporting date.
- The level within the hierarchy in which they fall.
- A roll-forward of Level 3 measurements.
- Total unrealized gains or losses in the Level 3 roll-forward that were included in earnings due to assets and liabilities held at the reporting date.
- Disclosure of valuation techniques and a discussion of changes to techniques (Annual filings only).

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Effective Date

- This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years.
- Early adoption available if done before the first interim financial statements are issued for that fiscal year.

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Transition

- The provisions of this Statement are to be applied prospectively as of the beginning of the fiscal year in which the statement is initially applied.
- Limited retrospective application (FV minus CV goes to R/E) required for:
 - Level 1 positions previously valued using a blockage factor.
 - Financial instruments valued using the initial recognition principals of EITF 02-3.
 - Hybrid instruments valued at transaction price under SFAS 155 prior to the adoption of this standard.

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Auditor Interest - Primary Focus is on Financial Statement Presentation and Disclosure

- Appropriateness / reasonableness of valuations
- Alignment with stated valuation policies and procedures
- Completeness and accuracy of additional disclosure requirements
- Consistency of application (changes in valuation technique would be accounted for as a change in estimate)
- Levels and sufficiency of underlying documentation
- Integration within overall control environment
- Prior to adoption - consider disclosure requirements of the impact of recently issued accounting standards (SAB 74)

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Auditor Interest - Particular Interest in Level 3 Valuations (based on unobservable inputs)

- Determination and reasonableness of valuation assumptions
- Monitoring of level 3 activity - gains and losses (realized and unrealized, purchases / sales and transfers)
- Hierarchy characterization / designation - particularly interested in changes in Level 3 designations
- Documentation support for assumptions used and disclosure attribution

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Auditor Interest - Board Valued Securities (“Fair Valued”)

- Reasonableness of methodologies used and assumptions applied
- Alignment of security valuation with Board approved processes and techniques
- Consistency of application
- Designation / characterization for disclosure purposes
- Documentation of criteria considered and process applied in determining valuation

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Auditor Focus - Use of Pricing Service Provider

- Designation as Level 1, 2 or 3 input – determination criteria (likely to be primarily levels 1 and 2)
- Detail of information provided by / requested of service provider (at a minimum will likely be valuation methodologies by major asset class)
- Particular interest in international security valuations, quotes based on matrix pricing and valuations based on level 3 inputs, if any
- Consistency of application and use / reliance on service provider input
- Documentation of service provider input / reliance, valuation methodologies and level designation

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