



Risk Management Update October 28, 2008

SFAS 157 – Fair Value Measurements

Valuation practices are an important aspect of any business, and in times of economic strain, regulators have an increased incentive to ensure that users of financial statements are able to rely on fair value measurements as consistent and comparable. In 2006, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards No. 157 (“SFAS 157” or the “Statement”), which became effective for financial statements issued for fiscal years beginning after November 15, 2007. The Statement defines fair value and establishes a framework for measuring fair value in accordance with generally accepted accounting principals (“GAAP”). In addition, the Statement also expands disclosures about fair value measurements which will enable users of those valuations to assess their reliability.

DEFINITION OF FAIR VALUE

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.”¹ This definition assumes transactions take place in the market which would be “the most advantageous for the asset or liability.”² Although the Statement defines fair value, it does not provide specific guidance on how to apply it. The focus of the Statement is on a transaction to sell the asset or transfer the liability in an orderly transaction between market participants in the market which would be the most advantageous for the asset or liability. The definition is targeted towards an exit price of an asset sold or a liability purchased and not on an entry price for the acquisition of an asset or payment received to assume a liability.

SFAS 157 highlights that fair value is a market-based measurement, not an entity-specific measurement. SFAS 157 states “because the highest and best use is determined based on its use by market participants, the fair value measurement considers the assumptions that market participants would use in pricing the asset, whether using an in-use or an in-exchange valuation premise.”³ The Statement provides that the highest and best use is in-exchange if the asset would provide maximum value to market participants principally on a stand-alone basis. If the highest and best use of a financial asset is on a stand-alone basis, then the fair value is measured using an in-exchange premise, such as the price that would be received in a current sale. If the highest and best use for an asset would be in combination with other assets, then the fair value would be measured with an in-use premise. The valuation could be based on the principal market or the most advantageous market in which the entity would sell the asset or transfer the liability. The principal market would be defined as the one with the greatest volume and level of activity for the asset or liability. The most advantageous market is one that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to

¹ FAIR VALUE MEASUREMENTS, Statement of Fin. Accounting Standards No. 157 ¶ 5, (Fin. Accounting Standards Bd. 2006).

² *Id.* ¶ 8.

³ *Id.* ¶ 14.

transfer a liability. If there is a principal market, the fair value measurement shall represent the price in that market, even if the price in a different market is potentially more advantageous at the measurement date.

VALUATION TECHNIQUES

The Statement discusses the valuation techniques used to value the acquisition of an asset or the transfer of a liability. The valuation approach includes a market approach, an income approach and/or a cost approach to be used to estimate fair value. The market approach utilizes pricing from market events with the same or similar assets or liabilities. The income approach relies on a present value methodology translating a future payment or a series of future payments, discounted to reflect the time value of money and other factors such as investment risk. The cost approach is concerned with the amount needed to replace the service capacity of an asset. The proper approach to be used should be based on the facts and circumstances of each situation. Either individual or multiple techniques in the valuation process might be necessary. Whichever method is utilized, the approach should be consistent and if a change in methods is necessary, then the new method should be at least as representative as the previous method.

DISCLOSURE OBLIGATIONS

The disclosure rule in SFAS 157 states that the entity is required to report for each interim and annual period for assets and liabilities measured in terms of fair values on a recurring basis, including: fair value measurements; the level in the hierarchy in which these measurements are placed; for unobservable inputs a reconciliation of beginning and ending balances showing realized and unrealized gains and losses, purchases, sales, issuances and settlements; gains and losses included in earnings due to changes in the unrealized gains and losses in the assets and liabilities in question; and for annual periods, the valuation techniques used and a discussion of any changes in those techniques.⁴ The objective of these disclosures is to allow users of the valuation of assets and liabilities to assess the relative reliability of fair value measures utilized and are meant to provide additional transparency regarding the effect of fair value measurements on earnings.

In March 2008, the Division of Corporation Finance sent an illustrative letter to certain public companies identifying a number of disclosure issues they may wish to consider in preparing Management's Discussion and Analysis ("MD&A") in their quarterly reports on Form 10Q.⁵ The correspondence suggested the companies provide in the MD&A section of their report a general description of the valuation techniques or models used with regard to material assets or liabilities; to the extent material, a discussion of the extent to which, and how, relevant market indices were used; how the techniques or models utilized were validated as well as several other suggested disclosures.

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⁴ *Id.* ¶ 32.

⁵ SEC Division of Corporate Finance, Sample Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157, available at <http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm>.

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