

FAS 157 (Fair Value Measurements) –

**The New Framework for
Developing Fair Value Estimates**

by

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Presentation to Accounting Firm

Presentation Overview

- ✓ Fair Value – A Brief Retrospective
- ✓ Fair Value – FAS 157 (Fair Value Measurements) – the “Current” Guidance
 - ✓ Objective: Improve and Codify Fair Value Measurement Guidance to Improve Consistency and Comparability
 - ✓ Establishes proper approaches to measurement (i.e., a framework)
 - ✓ Provides for Enhanced Disclosures
 - ✓ Framework – Graphical Representation of New Framework
- ✓ Even more Current Guidance from FASB – FSP FAS 157-3 (October 10, 2008) – Valuing Certain Financial Assets in Inactive Markets

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Fair Value – Pre-FAS 157 Retrospective

- ✓ Fair Value is not a new concept!
- ✓ Fair Value has been used in financial reporting for many decades, principally for financial assets like marketable securities (fair value = fair market value based on market transactions). Some past general guidelines were as follows:
 - ✓ Receivables valued at *present values* less allowance.
 - ✓ Plant and equipment at *replacement cost* for similar capacity asset.
 - ✓ Other assets including Land and natural resources at *appraised value*.
 - ✓ Nonmarketable securities at *appraised value*.
 - ✓ Notes payable and long-term debt at *present value* of amounts to be paid.
- ✓ Remember: If an asset can not be reliably measured, it is not an asset per GAAP – i.e., auditors and users are looking for reliable estimates of value to be presented in the financial statements. Note how subjectivity and judgment is required for most of these fair value calculations.

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Pre-FAS 157 Retrospective - continued

- ✓ Recall the environment for financial reporting and valuation
 - ✓ Private Securities Litigation Reform Act of 1995
 - ✓ Provided some safe harbors for accounting firms, investment bankers and company management that were getting sued for alleged material misrepresentations to investors.
 - ✓ Enron – Mid-2001
 - ✓ On October 17, 2001, Enron announced that its third-quarter results were negative due to one-time charges of over \$1 billion. Enron management claimed the losses were mostly due to investment losses, along with charges such as about \$180 million in money spent restructuring the company's troubled broadband trading unit.
 - ✓ Enron asserted that the broadband unit alone was worth \$35 billion, a claim also mistrusted. "I don't think anyone knows what the broadband operation is worth," said Todd Shipman, an analyst at Standard and Poor's.
- ✓ Sarbanes – Oxley Act of 2002
 - ✓ Introduced major changes to the regulation of financial practice and corporate governance
 - ✓ Addressed the issue of Lack of Auditor Independence with regard to valuation services to clients.

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Statement of Financial Accounting Standard No. 157 (Fair Value Measurement)

- ✓ FAS 157 is the new guidance on the measurement of fair value for assets and liabilities. Most companies adopted FAS 157 in the beginning of 2007.
 - ✓ The Financial Accounting Standards Board (“FASB”) first considered applying fair value to financial assets and liabilities as far back as 1999 (FAS 159).
 - ✓ In 2001, FASB affirmed its ultimate goal of requiring essentially all financial assets and liabilities to be measured at fair value in financial statements.
 - ✓ Fair Value project added to FASB agenda in June 2003
 - ✓ Exposure Draft issued in 2004
 - ✓ 100 Comment Letters Received
 - ✓ Final Statement (FAS 157) issued in September 2006
 - ✓ IASB has exposed FAS 157 for comment with view toward convergence by 2010

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FAS 157 (Fair Value Measurement)

- ✓ Under FAS 157, “Fair Value” is defined as follows:

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.

FAS 141 (June 2001) defined fair value as “the amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

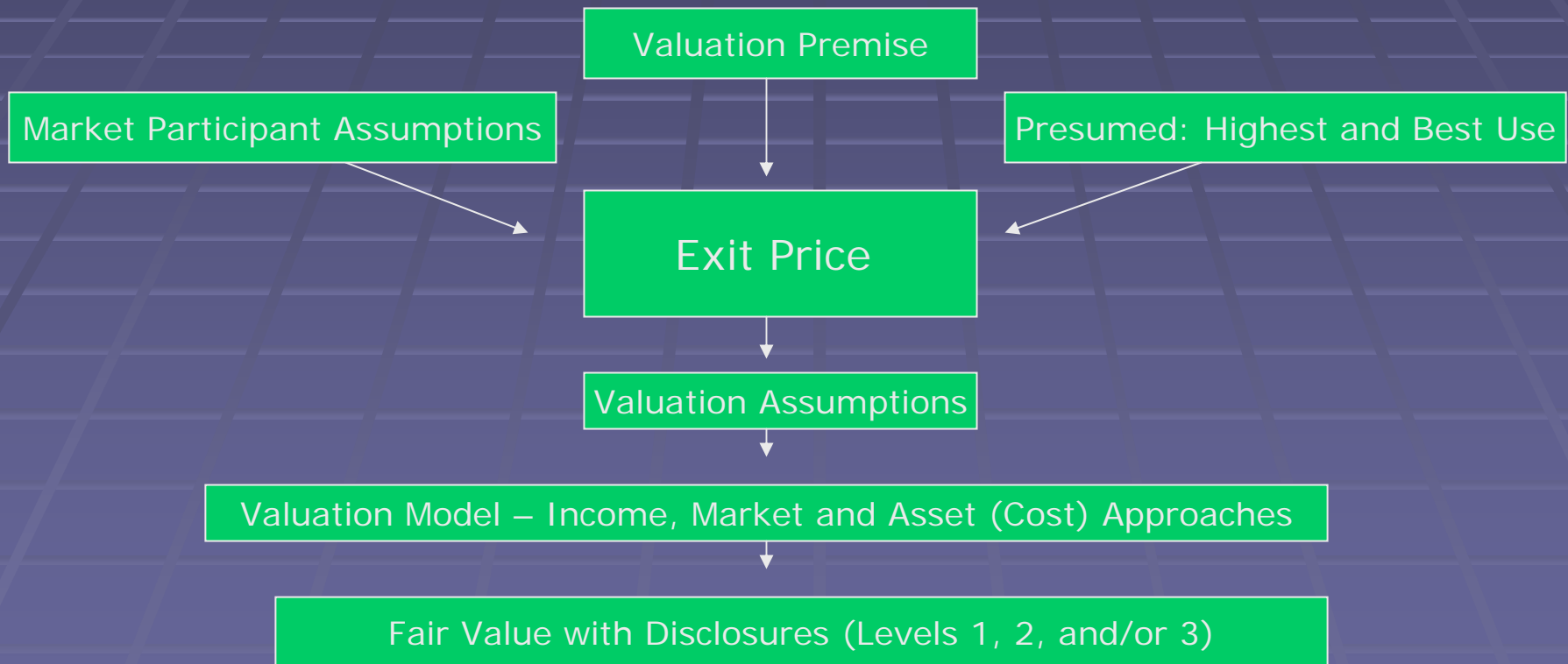
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FAS 157 (Fair Value Measurement)

- ✓ A more granular definition of “fair value” under FAS 157:
 - ✓ The measurement is for *a particular asset or liability* so attributes specific to the asset or liability need to be considered. The particular asset or liability can be a standalone or a group of assets and liabilities.
 - ✓ 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.
 - ✓ *Market Participants* are buyers and sellers in the principal (or most advantageous) market for the asset or liability.
 - ✓ The objective of a fair value measurement is to determine the price that would be received to sell an asset or paid to transfer the liability at the measurement date (an *exit price*).
 - ✓ Transaction costs should not be included

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FAS 157 Framework – Graphical Representation – Exit Price for an Asset or Liability in a Given Market



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FAS 157 (Fair Value Measurement)

- ✓ FAS 157 Disclosures to Improve Quality of Information to Users
 - ✓ Objective: Provide information about the reliability of information (i.e., a disclosure to users about the source of the inputs to valuation techniques used measure fair value)
 - ✓ Highest Priority – Level 1 (Observable) - Quoted prices in active markets.
 - ✓ Next Highest Priority – Level 2 (Somewhat Observable) - Quoted prices in active markets that are directly or indirectly related to the subject asset or liability being measured.
 - ✓ Lowest Level of Priority – Level 3 (Unobservable) – Based on the best information available, these inputs reflect the reporting entity's *own assumptions about the assumptions* that market participants would use in pricing the asset or liability

GRJ Note: Are Level 1 Inputs the most reliable?

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FAS 157 (Fair Value Measurement)

- ✓ FAS 157-3: Valuing Certain Financial Assets in Inactive Markets
 - ✓ Objective: Provide guidance on how to determine fair value when the market for an asset is not active.
 - ✓ Some Issues:
 - ✓ How should the reasonableness of data be judged when relevant observable inputs do not exist?
 - ✓ Observable inputs in a market that is not active...how should that data be considered?
 - ✓ How should broker quotes or pricing services be considered when assessing observable and non-observable inputs?
 - ✓ *General Answer:* Determining fair value in a dislocated market depends on the facts and circumstances and may require the use of significant judgment about whether individual transactions are forced liquidations or distressed sales.
 - ✓ And....disclose...disclose...disclose...the change in balances and the description of inputs and information used to develop those inputs.

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My Opinions/Observations

- ✓ Fair Value is here to stay! No going back now!
- ✓ Greater GAAP guidance has created more disclosures, more valuation information, and, not necessarily, more market volatility.
 - ✓ Subjectivity and judgment will always be required to value assets and liabilities - note that GAAP is principles-based, not rules-based.
- ✓ For users of financial statements, more information is generally better. But more complex financial instruments require greater information about the assumptions (i.e., inputs) and valuation models/methodologies (e.g., Binomial Expansion Technique). See FAS 133 (Hedging Activities).
 - ✓ Users (read: potential investors) and auditors(?) will penalize companies with additional risk premiums if their financial instruments are too complex to reliably measure.

Mr. Donald Young, FASB Board member, dissented from the issuance of FAS 159 because it would not improve financial reporting for the following reason – “While the preparers of financial statements will realize benefits in reduced volatility of reported earnings or reduction in the cost to achieve reduced volatility, those benefits are not justified by the cost that users will incur from increases in complexity and reduction in understandability.”

Example: From Note 3 of AIG’s Form 10-Q for the three months ended March 31, 2008 filed on May 8, 2008 - read AIGFP Super Senior Credit Default Swap Portfolio