

MEMO# 20397

September 22, 2006

FASB Releases Standard on Fair Value Measurements

©2006 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [20397] September 22, 2006 TO: ACCOUNTING/TREASURERS MEMBERS No. 19-06 CLOSED-END INVESTMENT COMPANY MEMBERS No. 43-06 COMPLIANCE ADVISORY COMMITTEE No. 12-06 SEC RULES MEMBERS No. 81-06 SMALL FUNDS MEMBERS No. 66-06 RE: FASB RELEASES STANDARD ON FAIR VALUE MEASUREMENTS The Financial Accounting Standards Board recently released Statement of Financial Accounting Standards No. 157, Fair Value Measurements.¹ FAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The Statement applies to fair value measurements that are already required or permitted by other accounting standards and is intended to increase consistency of those measurements. The Statement applies broadly to securities and other types of assets and liabilities. FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. Existing accounting literature requires investment companies to report their investments at fair value, which is defined as the amount at which the investment could be exchanged in a current transaction between willing parties, other than in a forced liquidation or sale.² While quoted market prices are the best evidence of fair value of a financial instrument, in circumstances where quoted prices in active markets are not available, fair value may be estimated in a variety of ways.³ Consistent with existing literature, FAS 157 relies on observable prices derived from market transactions in valuing identical or comparable assets. FAS 157 also describes valuation techniques and a hierarchy of inputs to 1 Statement of Financial Accounting Standards No. 157, Fair Value Measurements is available at the FASB website: <http://www.fasb.org/st/index.shtml>. 2 See FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, 3 See AICPA Audit and Accounting Guide, Investment Companies (May 1, 2006). 2 be used in those techniques in determining estimates of fair value. We are pleased to report that many of the Institute's comments on the original exposure draft are reflected in the final Statement.⁴ FAS 157 Definition of Fair Value FAS 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. A fair value measurement assumes that the transaction to sell the asset occurs in the principal market for the asset, or in the absence of a principal market, the most advantageous market. The principal market is the market in which the entity would sell the asset with the greatest volume and level of activity for the asset. The price in the principal market used to measure the fair value of the asset should not be adjusted for transaction costs. Market participants are defined in FAS 157 as buyers and sellers in the

principal market for the asset that are: a) independent of the reporting entity; b) knowledgeable, having a reasonable understanding about the asset; c) able to transact for the asset; and d) willing to transact for the asset, but not forced or otherwise compelled to do so. Market participants would obtain available information from public sources and would perform other due-diligence efforts. Valuation Techniques FAS 157 identifies three valuation techniques and indicates that techniques that are appropriate in the circumstances and for which sufficient data are available shall be used to measure fair value. The Statement indicates that use of a single technique is appropriate in certain instances, such as valuing an asset using quoted prices in an active market for identical assets.

- The market approach uses observable prices and other relevant information generated by market transactions involving identical or comparable assets.
- The income approach converts future amounts (for example cash flows or earnings) to a single present value amount. The measurement is based on assumptions market participants would make about those future amounts.
- The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement cost).

Valuation techniques should be consistently applied. A change in the valuation technique should be treated as a change in accounting estimate, not a change in accounting principle.

4 See Accounting/Treasurers Members No. 32-04 [17960] dated September 8, 2004.

3 Fair Value Hierarchy

The Statement establishes a fair value hierarchy, which prioritizes inputs to valuation techniques used to measure fair value. The term “inputs” refers broadly to the assumptions that market participants would use in pricing an asset. Inputs may be based on independent market data (“observable inputs”) or they may be internally developed (“unobservable inputs”). Valuation techniques used to measure fair value should maximize the use of observable inputs and minimize the use of unobservable inputs. The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The hierarchy gives the highest priority to quoted prices in active markets for identical assets (Level 1) and the lowest priority to unobservable inputs (Level 3).

The fair value hierarchy also affects issuers’ disclosure obligations under the Statement, with increased use of lower level inputs necessitating more detailed note disclosures.

Level 1 Inputs

Quoted prices in active markets for identical assets that the entity has the ability to access at the measurement date provide the most reliable evidence of fair value and should be used to measure fair value whenever available. Where a reporting entity holds a large position in an actively traded security the quoted price should not be adjusted because of the size of the holding relative to trading volume. The use of a “blockage factor” is prohibited, even if a market’s normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price. FAS 157 provides two exceptions to the principle that an active market provides the most reliable evidence of fair value. First, where “significant events” take place after the close of a market but prior to the measurement date, an entity should establish and consistently apply a policy for identifying those events that may affect fair value measurements. However, if the quoted price is adjusted for new information, the adjustment renders the fair value measurement a lower level measurement. Second, if the reporting entity holds a large number of debt securities that are required to be measured at fair value, a quoted price may be available but not readily accessible for each of those securities. In that case, a fair value may be measured using an alternative pricing method that does not exclusively rely on quoted prices (for example, matrix pricing) as a practical expedient. However, use of an alternative pricing method renders the fair value measurement a lower level measurement.

Level 2 Inputs

Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset, either directly or indirectly. Level 2 inputs include:

- a) quoted prices for similar assets in active markets;
- b) prices for identical or similar assets in markets that are not active;
- c) observable 4 inputs

other than quoted prices (e.g., interest rates, yield curves, volatilities, prepayment speeds, default rates, credit spreads, etc.); and d) inputs that are not directly observable but are derived from observable market data.

Level 3 Inputs Level 3 inputs are unobservable inputs based on the reporting entity's own assumptions and are to be used to measure fair value to the extent observable inputs are not available. Level 3 inputs enable fair value measurements when there is little, if any, market activity for the asset at the measurement date.

Inputs Based on Bid and Ask Prices If an input used to measure fair value is based on bid and ask prices (for example in a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value, regardless of where in the fair value hierarchy the input falls (Level 1, 2, or 3). The Statement does not preclude the use of mid-market pricing.

Restricted Stock FAS 157 requires restricted stock to be valued based on the quoted price for an otherwise identical unrestricted security of the same issuer that trades in a public market, adjusted to reflect the effect of the restriction. The adjustment would reflect the amount market participants would demand because of the risk relating to the inability to access a public market. The Statement references SEC ASR 113, Statement Regarding Restricted Securities, and notes that it provides related guidance.

Disclosures For assets that are measured at fair value on a recurring basis the reporting entity should disclose the following information for each interim and annual period separately for each major category of assets:⁵

- a. The fair value measurements at the reporting date;
- b. The level of the measurements within the fair value hierarchy based on measurement inputs;
- c. For fair value measurements using significant unobservable inputs a reconciliation of the beginning and ending balances, separately presenting changes attributable to:
 - 1) Total realized and unrealized gains and losses for the period, segregating those gains or losses included in earnings (or changes in net assets), and a description of where those gains or losses are reported,

⁵ Paragraph A34 of the Statement provides an example of the disclosure requirements and lists major categories of assets as: trading securities, available-for-sale securities, derivatives, and venture capital investments.

- 2) Purchases, sales, issuances and settlements,
- 3) Transfers in or out of Level 3 (for example due to changes in observability of inputs).
- d. The amount of the total gains or losses for the period included in earnings (or changes in net assets) attributable to the change in unrealized gains or losses relating to assets still held at the reporting date and a description of where those gains and losses are reported; and
- e. In annual periods only, the valuation technique(s) used to measure fair value and a discussion of changes in valuation techniques during the period, if any.

Effective Date and Transition FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Statement shall be applied prospectively as of the beginning of the fiscal year in which the Statement is initially applied. However, investment companies that applied blockage factors in measuring fair values (i.e., certain unregistered funds) should apply the Statement retrospectively.

Gregory M. Smith Director
Operations/Compliance & Fund Accounting