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FASB PROPOSES ACCOUNTING STANDARD ON FAIR VALUE MEASUREMENT

[17743] July 1, 2004 TO: ACCOUNTING/TREASURERS COMMITTEE No. 22-04 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 23-04 SEC RULES COMMITTEE No. 57-04 UNIT INVESTMENT TRUST COMMITTEE No. 14-04 RE: FASB PROPOSES ACCOUNTING STANDARD ON FAIR VALUE MEASUREMENT The Financial Accounting Standards Board recently issued an exposure draft of a proposed accounting standard entitled Fair Value Measurements.1 If adopted the Exposure Draft would amend generally accepted accounting principles and would apply to all entities that prepare GAAP-based financial statements, including investment companies. The Exposure Draft would apply broadly to financial and non-financial assets and liabilities that are required to be measured at fair value under existing accounting standards. Existing accounting literature defines fair value as the amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.2 Further, quoted market prices in active markets are the best evidence of fair value and should be used if available. In the absence of quoted market prices, the estimate of fair value should consider prices for similar assets and the results of valuation techniques to the extent available.3 The Exposure Draft carries forward and builds on this framework. Comments on the Exposure Draft are due to the FASB by Tuesday, September 7. If you have comments on the Exposure Draft that you would like to be included in the Institute’s comment letter, please contact Greg Smith by phone at 202/326-5851 or email at smith@ici.org by Wednesday, July 28th. Definition of Fair Value The Exposure Draft defines fair value as the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties. Willing parties are presumed to be marketplace participants representing unrelated buyers and sellers 1 Proposed Statement of Financial Accounting Standards, Fair Value Measurement, (June 23, 2004) (the “Exposure Draft”). The Exposure Draft is available from the FASB website http://www.fasb.org/draft/index.shtml. 2 FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities. 3 Valuation techniques identified in FASB Statement No. 133 include the discounted present value of estimated future cash flows, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. 2 that are (a) knowledgeable, having a common level of understanding about factors relevant to the asset and the transaction, and (b) willing and able to transact in the same market(s), having the legal and financial ability to do so. Fair value assumes the absence of compulsion (duress). Accordingly, the amount that forms the basis for the estimate is the price that would be observed in a transaction other than a forced liquidation transaction or distress sale. Valuation Techniques Valuation techniques consistent with the market approach, income approach, and cost approach are to be used

to estimate fair value. The market approach requires observable prices and other information generated by actual transactions involving identical, similar, or otherwise comparable assets or liabilities. The income approach uses valuation techniques to convert future amounts (e.g., cash flows or earnings) to a single discounted present value. The estimate of fair value is based on the value indicated by marketplace expectations about those future amounts. Examples include present value techniques and option pricing models. For an asset, the cost approach considers the amount that currently would be required to replace its service capacity (i.e., current replacement cost). The fair value estimate considers the cost to acquire a substitute asset of comparable utility, adjusted for obsolescence. Fair Value Hierarchy The Exposure Draft establishes a fair value hierarchy that gives highest priority to market inputs that reflect quoted prices in active markets for identical assets and the lowest priority to inputs developed based on an entity’s own internal estimates and assumptions. A. Level 1 Estimates Fair value shall be estimated using quoted prices for identical assets or liabilities in active reference markets. For an identical asset, the Level 1 reference market is the active market to which an entity has immediate access. If the entity has immediate access to multiple active markets with different prices, the Level 1 reference market is the most advantageous market, that is, the market with the price that maximizes the net amount that would be received in a current transaction. Transaction costs shall be accounted for in accordance with other applicable pronouncements, generally in the period incurred (i.e., brokerage commissions that would be incurred on sale need not be deducted from a quoted market price in determining the fair value estimate). Does the Exposure Draft’s requirement to use quoted prices from the most advantageous market create problems for funds valuing securities traded in multiple markets? In an active market, such as the New York Stock Exchange, quoted prices that represent actual, observable transactions are readily and regularly available and should be used to estimate fair value. Readily available means that pricing information is currently accessible, and regularly available means that transactions occur with sufficient frequency to provide pricing information on an ongoing basis. In dealer markets, dealers stand ready to trade for their own account. Typically, bid and asked prices are more readily and regularly available than closing prices. Over-the-counter markets (e.g., NASDAQ, U.S. Treasury securities) are considered to be dealer markets. In active dealer markets where bid and asked prices are more readily and regularly available than 3 closing prices, fair value shall be estimated using bid prices for long positions and asked prices for short positions. This aspect of the Exposure Draft differs from SEC valuation guidance, which permits use of the mean of the bid and ask prices, or the prices of a representative selection of broker-dealers quoting on a particular security.4 Do members believe the mean of the bid and ask, as permitted by ASR 118 is a better measure of value for certain security types? The Exposure Draft indicates that in certain cases significant events may occur after the close of the market but prior to the end of the reporting period and that closing prices may not be representative of fair value. In these instances, an entity should establish and consistently apply a policy for determining how those events affect estimates of fair value. The Exposure Draft does not prescribe specific policies in this circumstance; instead, it indicates that entities should be allowed to use judgment in developing those policies. B. Level 2 Estimates If quoted prices for identical assets in active markets are not available, fair value shall be estimated using quoted prices for similar assets or liabilities in active markets, adjusted as appropriate for differences, whenever that information is available. For a Level 2 estimate, the price effect of the differences must be objectively determinable. Otherwise, the estimate is a Level 3 estimate. C. Level 3 Estimates If quoted prices for identical or similar assets in active markets are not available, or if differences between similar assets are not objectively determinable, fair value shall be estimated using multiple valuation techniques consistent with the market approach, income approach, and cost approach whenever the information necessary to apply those techniques is available without undue cost and effort. If multiple valuation techniques are used, the results of those techniques (i.e., the respective fair value indication) shall be evaluated considering the relevance and reliability of the inputs used. If information necessary to apply multiple valuation techniques is not available without undue cost and effort, the valuation technique that best approximates what an exchange price would be in the circumstances shall be used. Valuation techniques used for Level 3 estimates should emphasize market inputs, including quoted prices, adjusted as appropriate. Block Discounts In the development of the Exposure Draft the FASB considered whether the last sale quoted price of an unrestricted security traded in an active market should be discounted based on the size of the position held and the liquidity of the market. The Board concluded that for blocks, the threshold issue is not whether the measurement should be determined using quoted prices in active markets. Rather, it is one of determining the appropriate unit of account for the measurement, that is, whether the measurement should be based on an individual trading unit (requiring the use of quoted prices) or a block (permitting the use of block discounts). 4 SEC, Codification of Financial Reporting Policies, section 404.03.b.iii. (ASR 118). 4 According to the Exposure Draft, a majority of the Board believes that the appropriate unit of account is a block. However, the Board was unable to define that unit or otherwise establish a threshold criterion for determining when a block exists as a basis for applying a block discount. As to broker-dealers and investment companies, the Exposure Draft maintains current practice as permitted in their respective industry audit and accounting guides.5 Restricted Securities The Exposure Draft explains that restricted securities are securities for which sale is legally restricted by governmental or contractual requirement for a specified period. In estimating the fair value of restricted securities, the quoted price of an otherwise identical unrestricted security shall be adjusted for the effect of the restriction, considering factors such as the nature and duration of the restriction, the volatility of the unrestricted security, and the risk free interest rate. The Exposure Draft incorporates guidance from SEC ASR 113.6 Disclosures The Exposure Draft requires additional financial statement disclosure relating to fair value determinations. For assets that are re-measured at fair value on an ongoing basis throughout the period (e.g., securities), issuers would be required to disclose: 1) the fair value amounts at the end of the period, in total and as a percentage of total assets; 2) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used; 3) the effect of the re-measurements on earnings for the period (unrealized gains or losses) relating to those assets still held at the reporting date. Effective Date and Transition The Exposure Draft will be effective for financial statements issued for fiscal years beginning after June 15, 2005, and interim periods within those fiscal years. The Exposure Draft should be applied prospectively, except that the effect if valuing bid-ask spread traded securities at the bid price should be reported as the cumulative effect of a change in accounting principle. Gregory M. Smith Director - Operations/Compliance & Fund Accounting 5 AICPA Audit and Accounting Guide – Audits of Investment Companies (May 1, 2003). 6 SEC, Codification of Financial Reporting Policies, section 404.04 (ASR 113).
