

# Searching For Insight

## A publication from Navigant Consulting's Finance Function Advisory Practice

Navigant Consulting's Finance Function Advisory practice is strategically focused on providing a broad range of services to companies interested in improving or transforming their finance and risk management functions. We have a proven track record of success assisting clients with:

- » Operations and technology advisory
- » Regulatory advisory services
- » Risk management and internal controls
- » Accounting standard interpretation, policy development and implementation
- » Finance function process improvement
- » Fair value, pricing, modeling, and treasury advisory

### SFAS 157 – Fair Value Measurements

In September 2006, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 157, *Fair Value Measurements* (SFAS 157) which establishes a framework for measuring fair value and expands disclosures about the use of fair value measurements. Although the standard is not required to be implemented until January 1, 2008, it is beginning to impact companies now as they examine their existing fair value methodologies.

### Scope

The new standard has a far reaching scope applying to **all** existing pronouncements under GAAP that require (or permit) the use of fair value with the following exceptions:

- » SFAS 157 does not apply to FASB 123R, *Share-Based Payment*,
- » Continues to allow the practicability exceptions to fair value measurements in accounting pronouncements within scope, and
- » Does not apply to pronouncements that require or permit measurements that are similar to fair value but that are not intended to measure fair value such as ARB No. 43, Chapter 4, *Inventory Pricing*.





## Accounting Guidance

The statement clarifies a number of key considerations with respect to fair value measurement for financial reporting.

- » Fair value is the price to sell an asset or transfer a liability and, therefore, represents an exit rather than an entry price.
- » Although they may be the same in many situations, an exit price for an asset or liability is conceptually different from its transaction (entry) price.
- » Fair value is an exit price in the principal market in which the reporting entity would transact.
- » Fair value is a market-based measurement, not an entity specific measurement.
- » Fair value measures should not be adjusted for transaction costs.
- » Fair value of a liability reflects the risk of nonperformance which includes an entity's credit risk/credit standing.

SFAS 157 establishes a hierarchy of the inputs used in valuation techniques into three levels that drive various disclosure requirements.

- » Level 1 – observable prices in active markets for identical assets and liabilities.
- » Level 2 – observable pricing inputs other than quoted prices in active markets for identical assets and liabilities.
- » Level 3 – unobservable inputs.

In cases for which two or more levels of inputs are used to determine fair value, SFAS 157 states “the level in the fair value hierarchy within which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the measurement in its entirety.”

While SFAS 157 also specifies that the price within the bid-ask spread most representative of fair value in the particular circumstances should be used, it allows the use of mid-point conventions (or other pricing conventions) as a practical expedient.

In applying the fair value hierarchy, SFAS 157 also requires an entity to consider the highest and best use of an asset as well as what the principal or most advantageous market would be for the asset or liability.

## Navigant Consulting's Observations

Key changes from existing practices will include:

- » Not applying a blockage factor to securities for which an active market exists;
- » No deferral of Day 1 gains on derivatives previously accounted for under EITF 02-3; and
- » The “highest and best use” concept may require significant research and consideration especially for fixed assets or real property held for sale, as fair value is determined based on how other market participants would use the asset, even if the intended use by the reporting entity is different;
- » While SFAS 157 specifies that Level 1 inputs are “quoted prices in active markets” and further states that an “active market for the asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis,” it does not clarify how a company should determine whether sufficient frequency and volume exist;
- » Many financial services companies have focused their evaluation of this standard narrowly, concentrating on the “hot topics” such as the guidance prohibiting blockage discounts on instruments traded in active markets and the elimination of the deferral of Day 1 gain (EITF 02-3), but have not considered the broader implications of this standard. For example:
  - » SFAS 13 was not within the scope of SFAS 157 in the exposure draft, but is in the scope as issued and as such the write-down of a lease residual due to impairment would require disclosure under the nonrecurring disclosure rules; and
  - » SFAS 114 impaired loans reflected in the balance sheet based on the present value of their estimable cash flows are not within the scope of SFAS 157, but loans measured at observable market prices or at the fair value of collateral are subject to the guidance in SFAS 157.



## Disclosure Requirements

For assets and liabilities that are measured at fair value on a recurring basis (e.g., trading securities) the following must be disclosed for each interim and annual period (except as otherwise specified) separately for each major category of assets and liabilities:

- » The fair value measurements at the reporting date;
- » The level within the fair value hierarchy for which the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3); and
- » For fair value measurements using significant unobservable inputs (Level 3), the effect of measurements on earnings and a reconciliation of the beginning and ending balances, separately presenting the changes during the period attributable to the following:
  - › Total gains or losses for the period (realized and unrealized), segregating those gains or losses included in earnings (or changes in net assets), and a description of where those gains or losses included in earnings (or changes in net assets) are reported in the statement of income (or activities);
  - › Purchases, sales, issuances, and settlements (net) as well as transfers in and/or out of Level 3 balances (e.g., transfers due to changes in the observability of significant inputs);
  - › The amount of the total gains or losses for the period included in earnings (or changes in net assets) that are attributable to the change in unrealized gains or losses relating to those assets and liabilities still held at the reporting date and a description of where those unrealized gains or losses are reported in the statement of income (or activities); and
  - › In annual periods only, the valuation technique(s) used to measure fair value and a discussion of changes in valuation techniques, if any, during the period.

For assets and liabilities that are measured at fair value on a nonrecurring basis in periods after initial recognition (e.g., impaired assets) the following must be disclosed:

- » The fair value measurements recorded during the period and the reasons for the fair value disclosure;
- » The level within the fair value hierarchy the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3);
- » For fair value measurements using significant unobservable inputs (Level 3), a description of the inputs and the information used to develop the inputs; and
- » In annual periods only, the valuation technique(s) used to measure fair value and a discussion of changes, if any, in the valuation technique(s) used to measure similar assets and/or liabilities in prior periods.

### *Navigant Consulting's Observations*

- » *Disclosures, especially the "rollforward" of balances for items remeasured on a nonrecurring basis using Level 3 inputs, may be particularly onerous to compile and may require new processes to be developed to gather and ensure the integrity and completion of the information.*
- » *As companies will first be adopting SFAS 157 in an interim period (Q1 07 or Q1 08), public registrants may need to include all annual disclosures in each 10Q until their next annual report, similar to what is required for SFAS 123R.*
- » *Due to the increased transparency due to the disclosure requirements for unobservable inputs, companies may want to consider how SFAS 157 impacts their current Critical Accounting Estimates disclosure in MD&A as well as existing SFAS 107 Fair Value disclosures.*



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## Effective Date and Transition

- » SFAS 157 is effective for fiscal years beginning after November 15, 2007 with early adoption allowed.
- » The provisions of the statements are to be applied prospectively as of the beginning of the year in which it is adopted except as it relates to a change in accounting principles related to:
  - › Large positions previously accounted for using a block discount; and
  - › Financial instruments (including derivatives and hybrids) that were initially measured at fair value using the transaction price in accordance with guidance in footnote 3 of EITF 02-3 or similar guidance in FASB Statement 155.

For these transactions, differences between the amounts recognized in the statement of financial position prior to the adoption of Statement 157 and the amounts recognized after adoption should be accounted for as a cumulative-effect adjustment to the opening balance of retained earnings for the fiscal year in which SFAS 157 is initially applied.

## Next Steps

- » *In our view, the implementation of SFAS 157 will require significant organizational efforts and although implementation is generally not required until January 1, 2008, companies should develop a project plan and start evaluating the impact of the standard early.*
- » *Companies should develop a cross functional team including front office personnel and valuation experts to inventory assets and liabilities which are within the scope of SFAS 157 to determine the initial impact upon adoption as well as ongoing implications.*
- » *Companies should consider situations where they rely on information from third party vendors to determine fair values of assets or liabilities, and if the third parties currently provide enough information for the company to compile the required disclosures.*
- » *Companies will be required to develop thorough accounting policies and operational controls to insure appropriate ongoing compliance with SFAS 157.*
- » *Along with the adoption of SFAS 157, companies should consider how the FASB's Exposure Draft The Fair Value Option for Financial Assets and Financial Liabilities may impact their inventory of items currently subject to fair value, once finalized and adopted.*