

Searching for Insight

A publication from Navigant Consulting's Finance Function Advisory Practice

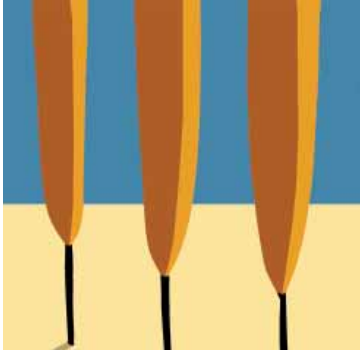
Navigant Consulting's Finance Function Advisory practice is strategically focused on providing a broad range of services to companies interested in improving or transforming their finance and risk management functions. We have a proven track record of success assisting clients with:

- » 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 159 – Fair Value Option for Financial Assets and Financial Liabilities

In February 2007, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 159, *Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159) which permits entities to choose to measure many financial instruments and certain other items at fair value at specific election dates. The intent of this standard is to provide the opportunity to mitigate the volatility of reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Although the standard has an effective date of January 1, 2008 for calendar year end companies, many are currently assessing its potential impact to the accounting for financial assets and liabilities as well as the related reporting issues.





Scope

This Statement applies to all entities, including not-for-profit organizations, although most of the provisions of this Statement apply only to entities that elect the fair value option. However, the standard also amends FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. The amendment to SFAS 115 clarifies that cash flows from purchases, sales and maturities of trading securities shall be classified based on the nature and purpose for which the securities were acquired.

FAIR VALUE OPTION ELIGIBLE ITEMS	FAIR VALUE OPTION NON-ELIGIBLE ITEMS
<ul style="list-style-type: none"> » All recognized financial assets and liabilities (subject to scope exceptions listed in the "non-eligible" section); » Equity investments reporting under the equity method of accounting; » Written loan commitments; » Firm commitments that would otherwise not be recognized at inception involving only financial instruments; » Rights and obligations under insurance contracts and warranties that are not financial instruments (because it requires or permits the insurer to provide goods and services rather than cash) but whose terms permit the settlement through payment to a third party to provide those goods and services; » Host financial instruments resulting from the separation of an embedded nonfinancial derivative instrument from a nonfinancial hybrid instrument, subject to scope exceptions outlined in the following section. 	<ul style="list-style-type: none"> » An investment in a subsidiary that the entity is required to consolidate; » An interest in a variable interest entity that the entity is required to consolidate; » Employers' and plans' obligations (or assets representing net overfunded positions) for pension benefits, other postretirement benefits (including health care and life insurance benefits), postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements; » Financial assets and financial liabilities recognized under leases as defined in FASB Statement No. 13, <i>Accounting for Leases</i>; » Deposit liabilities, withdrawable on demand, of banks, savings and loan associations, credit unions, and other similar depository institutions; » Financial instruments that are, in whole or in part, classified by the issuer as a component of shareholder's equity (including "temporary equity").



Accounting Guidance

Election Dates

The fair value option is exercised on an individual instrument level and is irrevocable (unless a new election date occurs). The election date is established when one of the following occurs:

- » The entity first recognized the eligible item;
- » The entity enters into an eligible firm commitment;
- » Financial assets reported at fair value with unrealized gains and losses included in earnings because of specialized accounting principles cease to qualify for that specialized accounting;
- » The accounting treatment for an investment in another entity changes because (1) the investment becomes subject to the equity method of accounting and, (2) the investor ceases to consolidate a subsidiary or variable interest entity but retains an interest;
- » Events that require remeasurement of eligible items at fair value, initial recognition of eligible items, or both, and thereby create an election date for the fair value option such as business combinations, consolidation or deconsolidation of a subsidiary or significant modifications of debt, as defined in EITF Issue No. 96-19, *“Debtor’s Accounting for a Modification or Exchange of Debt Instruments”*.

Instrument-by-Instrument Application

The fair value option may be primarily applied instrument by instrument and may be elected for a single eligible item without electing it for other identical items with the following exceptions:

- » If multiple advances are made to one borrower pursuant to a single contract (such as a line of credit or a construction loan) and the individual advances lose their identity and become part of a larger

loan balance, the fair value option shall be applied only to the larger balance and not to each advance individually.

- » If the fair value option is applied to an investment that would otherwise be accounted for under the equity method of accounting, it shall be applied to all of the investor’s financial interests in the same entity (equity and debt, including guarantees) that are eligible items.
- » If the fair value option is applied to an eligible insurance or reinsurance contract, it shall be applied to all claims and obligations under the contract.
- » If the fair value option is elected for an insurance contract (base contract) for which integrated or nonintegrated contract features or coverages are issued either concurrently or subsequently, the fair value option also must be applied to those features or coverages.

The fair value option is applied only to entire instruments and not to portions of instruments.

Available-for-Sale and Held-to-Maturity Securities

Available-for-sale and held-to-maturity securities held at the effective date are eligible for the fair value option at that date. If the fair value option is elected for any of those securities at the effective date, cumulative unrealized gains and losses at that date shall be included in the cumulative-effect adjustment. The amount of unrealized gains and losses reclassified from accumulated other comprehensive income (for available-for-sale securities) and the amount of unrealized gains and losses that were previously unrecognized (for held-to-maturity securities) shall be separately disclosed.

If an entity elects the fair value option for a held-to-maturity or available-for-sale security in conjunction with the adoption of this Statement, that security shall be reported as a trading security under Statement 115.



Financial Statement Presentation and Disclosure Requirements

The principal objectives of the disclosures required under SFAS 159 are to facilitate comparisons between:

- » Entities that choose different measurement attributes for similar assets and liabilities and;
- » Assets and liabilities in the financial statements of an entity that selects different measurement attributes for similar assets and liabilities.

FINANCIAL STATEMENT	REQUIRED PRESENTATION*
Statement of Financial Position	Separate those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute. To accomplish that, an entity shall either: <ol style="list-style-type: none"> a. Present the aggregate of fair value and non-fair-value amounts in the same line item in the statement of financial position and parenthetically disclose the amount measured at fair value included in the aggregate amount. b. Present two separate line items to display the fair value and non-fair-value carrying amounts.
Statement of Operations	No guidance provided on the determination and reporting of income and expenses on receivables and payables that are reported at fair value pursuant to the fair value option.
Statement of Cash Flows	Classify cash receipts and cash payments related to items measured at fair value according to their nature and purpose as required by FASB Statement No. 95, <i>Statement of Cash Flows</i> .

PERIOD REQUIRED	REQUIRED DISCLOSURE*
Interim and Annual	<ul style="list-style-type: none"> » Management's reasons for electing fair value option. » Identification and reasons for partial election of eligible items. » Identification of financial statement line items that include eligible items which fair value was elected. » Difference between aggregate fair value (FV) and the aggregate unpaid principal balances (UPB) for loans, long-term receivables and long-term debt that have contractual amounts; » Loans held as assets: <ol style="list-style-type: none"> 1. Loans 90 days or more past due; 2. If the entity's policy is to recognize interest income separately from other changes in fair value, the aggregate fair value of loans in nonaccrual status; 3. The difference between the aggregate FV and the aggregate UPB for loans that are 90 days or more past due, in nonaccrual status, or both. » Investments accounted for under the equity method if the entity had not chosen to apply the fair value option. » Gains/losses from fair value changes included in earnings, and in which line of the income statement these are reported. » Description of how interest and dividends are measured and where they are reported in the income statement.



<p>Interim and Annual <i>(continued)</i></p>	<p>» For loans held as assets, other receivables and liabilities with fair values:</p> <ol style="list-style-type: none"> 1. The estimated amount of gains and losses from fair value changes included in earnings attributable to changes in the instrument-specific credit risk; 2. Qualitative information about the reasons for those changes; 3. How the gains and losses attributable to changes in instrument-specific credit risk were determined.
<p>Annual</p>	<p>» Methods and specific assumptions used to estimate the fair value of items for which the fair value option was elected.</p> <p>» For the period the entity elects the fair value option due to a specified event:</p> <ol style="list-style-type: none"> a) qualitative information about the nature of the event, and b) quantitative information of the effects of initially electing the fair value option by each financial statement line item
<p><i>* Refer to FASB Statement No. 159 for more detail regarding financial statement presentation and disclosure requirements.</i></p>	

Effective Date and Transition

SFAS 159 is effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2007 (i.e., January 1, 2008 for calendar-year companies). Earlier adoption of the Statement is permitted provided:

- » The choice to adopt is made within 120 days after beginning of the fiscal year;
- » No financial statements have been issued prior to the date the entity chooses early adoption; and
- » The entity has adopted all of the requirements of Statement No. 157, *Fair Value Measurement* as of the effective date of adoption or earlier.

In the first interim period and annual financial statements after the adoption of Statement 159, entities are required to disclose the following:

- » A schedule that presents the following by line item in the statement of financial position:
 - › The pretax portion of the cumulative-effect adjustment to retained earnings (or appropriate class or classes of net assets) for items on that line.
 - › The fair value at the effective date of eligible items for which the fair value option is elected and the carrying amount of those same items immediately before electing the fair value option.
- » The net effect on the entity's deferred tax assets and liabilities of electing the fair value option.
- » Management's reasons for electing the fair value option for each existing eligible item or group of similar eligible items.
- » If the fair value option is elected for some but not all eligible items within a group of similar eligible items:
 - › A description of those similar items and the reasons for partial election; and
 - › Information to enable users to understand how the group of similar items relates to individual line items on the statement of financial position.
- » The amount of valuation allowances removed from the statement of financial position because they related to items for which the fair value option was elected.



Navigant Consulting's Observations

Companies should carefully consider the effect of the fair value option being irrevocable. Once an instrument has been classified as held at fair value it can never be transferred out of this category in the future.

The election of fair value option for loans may require careful considerations of the impact to financial metrics such as net interest margin. For example, origination costs which were previously deferred under SFAS 91 will now be immediately expensed for loans for which fair value option is elected. In addition, companies will want to consider whether they will separately recognize interest income/expense. Under fair value accounting, it is common to include changes in accrued interest income/payable through one income statement line item.

Companies should analyze their comfort level with the earnings volatility that may occur once fair option has been elected. Companies should also carefully weigh how fair value option will change their balance sheets in light of any debt covenants or regulatory capital requirements.

Recent remarks by the SEC and other regulatory agencies citing potential abuse by registrants who "cherry-pick" items for which they will elect the fair value option at adoption date should be considered. For example, at adoption, any decrease in value due to the change in fair value of an asset or liability will be recorded as a cumulative catch-up adjustment through retained earnings rather than through current period income. Thus, there is some potential for only selecting fair value option for assets that are underwater, avoiding any income statement impact. While clearly allowed by SFAS 159, companies should consider potential comments or the appearance of abuse and should ensure any other than temporary declines in value are recorded in the appropriate period irrespective of the adoption of SFAS 159.

Given a number of assets and liabilities for which fair value option is available may be considered to be Level 3 in the fair value hierarchy established by SFAS 157, companies should consider the additional disclosure requirements in SFAS 157 pertaining to recurring Level 3 fair value measurements.

While electing the fair value option may decrease the risk inherent in obtaining hedge accounting treatment under SFAS 133, the resulting fair values may not perfectly offset the hedged item, thus resulting in income statement volatility, especially after factoring in the effect of any basis differences, including credit spreads.

If fair value option is elected for loan commitments, companies should consider the interaction between fair value measurement guidance and the guidance in Staff Accounting Bulletin Loan Commitments Accounted for as Derivative Instruments (SAB 105). SAB 105 precludes including expected future cash flows related to the servicing of the loan in measuring the fair value of mortgage loan commitments. It is our understanding this issue is currently being considered by the FASB and the SEC.

The ability to elect the fair value option on a contract-by-contract basis will need to be governed by policies and procedures and due to the inherent judgments used in certain valuation techniques may require a higher level of corporate governance. In adopting SFAS 157 and SFAS 159, companies should consider the need for establishing a fair value

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governance committee which would approve policies, procedures, approve changes in valuation techniques or assumptions and establish a company-wide position on fair value measurements to ensure consistency across business units.

Under SFAS 157, the companies own credit risk must be factored into the valuation of a liability. This concept will apply when the fair value option is elected for liabilities. A point to consider in determining how to apply the company's own risk should be determined on an individual instrument basis. For example, the company credit specific risk relating to a liability that is secured by collateral will have a lesser impact on valuation than a liability that is uncollateralized.

In applying the fair value option to equities or debt issuances, companies should consider their ability to elect the option for the minimum denomination (e.g. the company has the ability to elect to account for only a portion of a debt issuance at fair value). In this example, debt issuance costs would need to be prorated and the portion relating to the debt at fair value would be expensed and not deferred.

The disclosure requirements of SFAS 159 requires that for loans held as assets for which fair value option is elected, a company disclose the estimated amount of gains or losses included in earnings during the period attributable to changes in instrument-specific risk. As many companies do not currently bifurcate changes in fair value due to credit changes versus changes due to interest rates or other factors, consideration should be given to how this disclosure requirement impacts current valuation practices.

Careful consideration should be given to the amendments in SFAS 95, Statement of Cash Flows and SFAS 115, Accounting for Certain Investments in Debt and Equity Securities that require disclosure of cash flows from securities classified as trading to be classified based on "the nature and purpose for which the securities were acquired," rather than classifying them in operating cash flows as required prior to the adoption of SFAS 159. To the extent the fair value option is elected for securities previously classified as held-to-maturity or available-for-sale securities which were reclassified to trading upon election of fair value, cash flows may be more properly classified as investing rather than operating.

The numerous disclosure requirements will require substantial effort to compile and are in addition to the disclosure requirements of SFAS 157, Fair Value Measurements.

