SFAS No. 157

Fair Value Measurements

Bill Godshall
Partner
Frazier & Deeter, LLC
bill.godshall@frazierdeeter.com

SFAS 157 – Overview

• What the standard is
• Scope
• Why the standard was issued
• When the standard is effective
• Key concepts
• Examples
• Recent developments

SFAS 157 – What

• Defines fair value
• Provides a framework for measurement of fair value in GAAP
• Applies to accounting pronouncements that require or permit fair value measurements
• Does not require any new fair value measurements
SFAS 157 – Scope

- Examples of pronouncements affected:
  - SFAS 87, Employers' Accounting for Pensions
  - SFAS 107, Disclosures about Fair Value of Financial Instruments
  - SFAS 115, Accounting for Certain Investments in Debt and Equity Securities
  - SFAS 133, Accounting for Derivative Instruments and Hedging Activities
  - SFAS 141, Business Combinations
  - SFAS 142, Goodwill and Other Intangible Assets
  - SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets

SFAS 157 – Scope, cont’d

- Exclusions to SFAS 157:
  - SFAS 123 (revised 2004), Share-Based Payments
  - Pronouncements that are based on vendor-specific objective evidence (VSOE) of fair value, such as SOP 97-2, Software Revenue Recognition
  - ARB 43, Chapter 4, Inventory Pricing

SFAS 157 – Why

- Previously, there were different definitions of fair value
- Guidance for the application of those definitions was limited
- Dispersed among the many pronouncements that require or permit fair value
- Addressed the need for consistency and comparability of fair value measurements and for expanded disclosures
SFAS 157 – When Effective

- Applicable for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years
- For calendar companies, it will be effective the quarter ended March 31, 2008
- Generally to be applied prospectively, with some limited exceptions that require beginning of the year application.

SFAS 157 – Key Concepts

- Definition of fair value
- Principal (or most advantageous) market
- Market participants
- In-use versus in-exchange
- Valuation
- Fair value hierarchy
- Disclosures
- Examples

Fair Value

“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.”
Fair Value, cont’d

Clarifies several key points:
• Fair value is an exit price whereas the transaction price is an entry price
• An exit price in the principal (or most advantageous) market in which the issuer would transact
• Fair value is a market-based measurement, not an entity-specific measurement
• The exit price objective applies regardless of the issuer’s intent and/or ability
• Fair value contemplates an actual sale of an asset or transfer of a liability, not a transaction to offset risks

Market

• Assumption that the transaction occurs in the principal market for the asset or liability
• If no principal market, then the seller would select the most advantageous market
• Principal market would hold over most advantageous even if that results in lower fair value
• Price shall not be adjusted for transaction costs
• Price would include transport costs

Market

• Market A offers $26 for an asset, less $3 in transaction costs for net $23
• Market B offers $25 for the same asset, less $1 in transaction cost for net $24
• If Market A is the principal market, then fair value is $26.
• If there is no principal market, then fair value is $25 because Market B offers higher value
Market Participants

- Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability
  - They are independent of the issuer
  - They are knowledgeable
  - They are able to transact
  - They are willing to transact

Market Participants, cont’d

- Specific market participants do not need to be identified to apply SFAS 157
- The issuer should be able to identify the characteristics that distinguish market participants for the asset or liability

In-use / In-exchange

- Fair value is based on “highest and best use” of the asset by market participants
- Highest and best use by a market participant may differ from actual or current use of the issuer
- Highest and best use is based on “in-use” or “in-exchange”
In-use / In-exchange, cont’d

In-use considerations:
- Provides maximum value through its use in combination with other assets as a group
- Fair value is based on price to be received assuming that the asset would be used with other assets as a group and that those other assets would be available to market participants

In-use / In-exchange, cont’d

In-exchange considerations:
- Provides maximum value on a stand-alone basis
- Fair value is based on price to be received in a current transaction on a stand-alone basis

<table>
<thead>
<tr>
<th></th>
<th>Strategic buyer</th>
<th>Financial buyer</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(in-use)</td>
<td>(in-exchange)</td>
</tr>
<tr>
<td>Asset A</td>
<td>$360</td>
<td>$300</td>
</tr>
<tr>
<td>Asset B</td>
<td>200</td>
<td>201</td>
</tr>
<tr>
<td>Asset C</td>
<td>30</td>
<td>100</td>
</tr>
<tr>
<td>Total</td>
<td>$690</td>
<td>$601</td>
</tr>
</tbody>
</table>

Sum of highest amounts would suggest a fair value of $720. However, the issuer must select the $650 as in-use represents the highest fair value for asset group.
Valuation techniques shall include:
• Market approach
• Income approach
• Cost approach

Valuation, cont’d

Market approach:
• Uses prices and other relevant information generated by market transactions
• Involves identical or comparable assets or liabilities
• Often uses market multiples derived from a set of comparables

Valuation, cont’d

Income approach:
• Converts future amounts (cash flow or earnings) to a single present amount (present value)
• Measurement shaped by market expectations
• Includes present value techniques, option pricing models and multi-period excess earnings method
Valuation, cont’d

Cost approach:
• Based on current replacement cost
• Requires adjustment for obsolescence
• Obsolescence is more than just depreciation, it includes:
  – Physical deterioration
  – Functional obsolescence
  – Economic obsolescence

Valuation, cont’d

Other considerations for valuation include:
• Fair value measurement is the point within a range that is most representative of fair value
• Valuation techniques shall be consistently applied; revisions shall be accounted for as a change in accounting estimate
• The use of observable inputs shall be maximized and unobservable inputs shall be minimized

Fair Value Hierarchy

<table>
<thead>
<tr>
<th>Level</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level 1</td>
<td>Quoted prices in active markets for identical assets or liabilities (unadjusted); no blockage factors (P x Q)</td>
</tr>
<tr>
<td>Level 2</td>
<td>Other observable input; includes quoted prices for similar assets or liabilities (adjusted) and market-corroborated inputs</td>
</tr>
<tr>
<td>Level 3</td>
<td>Unobservable inputs; entity’s own assumptions about market participant assumptions, including assumptions about risk, developed based on the best information available (subject to cost-benefit constraints); might include issuer’s own data</td>
</tr>
</tbody>
</table>
Fair Value Hierarchy, cont’d

- Prioritizes inputs to valuation techniques used to measure fair value
- Determines the nature of required disclosures
- Level at which measurement is disclosed is based on lowest level of input that is significant to overall fair value measurement

Disclosures

Measurement required on a recurring basis:
- Level of hierarchy used
- Reconciliation of beginning and ending balances for Level 3, including:
  - Total gains and losses in income and OCI
  - Purchases, issuances and settlements
  - Transfers in and out of Level 3
- Amount of total gains and losses recognized in earnings for unrealized gains and losses in Level 3 for assets and liabilities held at reporting date
- Valuation techniques used to measure fair value and any changes from prior period

Disclosures, cont’d

If measurement is performed on a non-recurring basis:
- Level of hierarchy used
- If Level 3, a description of the inputs and the information used to develop the inputs
- Valuation techniques used to measure fair value and any changes from prior period
## Examples

**Fair value measurements by level:**

<table>
<thead>
<tr>
<th>Description</th>
<th>12/31/2008 Level 1</th>
<th>12/31/2008 Level 2</th>
<th>12/31/2008 Level 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trading securities</td>
<td>$115</td>
<td>$105</td>
<td>$10</td>
<td>$ -</td>
</tr>
<tr>
<td>Available-for-sale securities</td>
<td>75</td>
<td>75</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Derivatives</td>
<td>60</td>
<td>25</td>
<td>15</td>
<td>20</td>
</tr>
<tr>
<td>Venture capital investments</td>
<td>10</td>
<td>-</td>
<td>-</td>
<td>10</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$260</strong></td>
<td><strong>$205</strong></td>
<td><strong>$25</strong></td>
<td><strong>$30</strong></td>
</tr>
</tbody>
</table>

## Examples, cont’d

**For recurring fair value measurements using Level 3 inputs:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Level 3 Fair Value Measurements:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Derivatives</td>
</tr>
<tr>
<td>Beginning balance</td>
<td>$14</td>
</tr>
<tr>
<td>Total gains and losses included</td>
<td>-</td>
</tr>
<tr>
<td>in:</td>
<td>-</td>
</tr>
<tr>
<td>Earnings</td>
<td>11</td>
</tr>
<tr>
<td>OCI</td>
<td>4</td>
</tr>
<tr>
<td>Purchases, issuances and</td>
<td>(7)</td>
</tr>
<tr>
<td>settlements</td>
<td>-</td>
</tr>
<tr>
<td>Transfers in/out of Level 3</td>
<td>(2)</td>
</tr>
<tr>
<td>Ending balance</td>
<td>$20</td>
</tr>
<tr>
<td>Change in unrealized gains and</td>
<td>$7</td>
</tr>
<tr>
<td>losses in earnings relating to</td>
<td>-</td>
</tr>
<tr>
<td>assets held</td>
<td>-</td>
</tr>
</tbody>
</table>

## Examples, cont’d

**For non-recurring fair value measurements:**

<table>
<thead>
<tr>
<th>(Dollars in millions)</th>
<th>Year Ended 12/31/2008 Level 3 Fair Value Measurements:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-lived assets held and used</td>
<td>$75</td>
</tr>
<tr>
<td></td>
<td>$ -</td>
</tr>
<tr>
<td></td>
<td>$ -</td>
</tr>
<tr>
<td>Goodwill</td>
<td>30</td>
</tr>
<tr>
<td></td>
<td>30</td>
</tr>
<tr>
<td>Long-lived assets held for sale</td>
<td>26</td>
</tr>
<tr>
<td></td>
<td>26</td>
</tr>
<tr>
<td></td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>(35)</td>
</tr>
<tr>
<td><strong>Total Gains (Losses)</strong></td>
<td>$75</td>
</tr>
<tr>
<td></td>
<td>$75</td>
</tr>
<tr>
<td></td>
<td>$75</td>
</tr>
</tbody>
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Recent Developments

• FASB Staff Position No. FAS 157-1 posted February 14, 2008
• Addresses issues associated with lease classification and measurement under FAS 13
• Scope exception is limited to FAS 13 and does not apply to leases accounted for under FAS 141R

Recent Developments

• FASB Staff Position No. FAS 157-2 posted February 12, 2008
• Provides delayed effective date for certain assets and liabilities.
• Does not apply to entities that have issued interim or annual financial statements that include the application of the measurement and disclosure provisions of FAS 157

Summary

• Establishes a consistent framework for the application of fair value under GAAP
• Provides a market-based definition of fair value
• Creates a fair value hierarchy
• Provides for expanded disclosures
• Effective for fiscal years beginning after December 15, 2007, and interim periods within
<table>
<thead>
<tr>
<th>Questions</th>
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<tr>
<td>???</td>
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