

## **FASB Issues Final Statement of Financial Accounting Standards Number 157, "Fair Value Measurements"**

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The Financial Accounting Standards Board recently issued Statement No. 157, "*Fair Value Measurements*." The Statement does not require any new fair value measurements but the Statement does define fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP) and also expands disclosures about fair value measurements. The Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier adoption is encouraged, provided the reporting entity has not yet issued financial statements for that year, including financial statements for an interim period within that year.

The Statement has been under development for several years and represents the FASB's attempt to develop a framework clarifying fair value measurement objectives and its application under other accounting pronouncements that require fair value accounting.

### **Definition of Fair Value**

Under the Statement, the definition of fair value retains the exchange price notion in earlier definitions of fair value. However, this Statement clarifies that the exchange price is the price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or the liability, that is, the principal or most advantageous market for the asset or liability. The definition focuses on the price that would be received to sell the asset or paid to transfer the liability (the exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price).

The new Statement affirms the requirement of other FASB Statements that the fair value of a position in a financial instrument (including a block) that trades in an active market should be measured as the product of the quoted price for the individual instrument times the quantity held. The quoted price should not be adjusted because of the size of the position relative to trading volume (blockage factor). The Statement extends that requirement to investment companies within the scope of the AICPA Audit and Accounting Guide for that industry.

The Statement also clarifies that market participation assumptions also include assumptions about the effect of a restriction on the sale or use of an asset. A fair value measurement for a restricted asset should consider the effect of the restriction if market participants would consider the effect of the restriction in pricing the asset (as in the case of restricted common shares).

### **Fair Value Hierarchy**

To increase consistency and comparability in fair value measurements and related disclosures, the fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). In some cases, the inputs used to measure fair value might fall into different levels of the fair value hierarchy. The level in the fair value hierarchy in which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety. As such, the fair value hierarchy prioritizes the inputs to the valuation technique and not the valuation techniques.

While Level 1 inputs represent unadjusted quoted prices in an active market, Level 2 inputs include observable inputs such as: (1) quoted prices for similar assets or liabilities in an active market, (2) quoted prices for identical or similar assets or liabilities in markets that are not active, or where the prices are not current or price quotations vary substantially either over time or among market makers, or in which little information is released publicly, (3) inputs other than quoted prices that are observable for the asset or liability (e.g., interest rates and yield curves, etc.) and (4) inputs that are derived principally from or

corroborated by observable market data by correlation or other means. Level 3 inputs are unobservable inputs for the asset or liability and should be used to measure fair value to the extent that observable inputs are not available.

Investment companies that trade exchange-traded securities or instruments will likely use Level 1 quoted prices for those instruments to derive fair value. Level 2 and Level 3 inputs might be used to value securities which are not publicly traded or which are traded in the principal-to-principal markets.

### Disclosures

The new Statement requires reporting entities that carry assets and liabilities at fair value to disclose information, using a tabular format, which enables users of the financial statements to assess the inputs used to develop those measurements and, for fair value measurements using significant Level 3 unobservable inputs, the effect of the measurements on earnings for the period. As such, reporting entities will be required to disclose the following information for each interim and annual period separately for each major class of assets and liabilities:

- the fair value measurements at the reporting date,
- the level within the fair value hierarchy in 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),
- for Level 3 fair value measurements, a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to the following:
  - total gains and losses for the period (realized and unrealized)
  - purchases, sales, issuances and settlements
  - transfers in and/or out of Level 3 (e.g., transfers due to changes in the observability of significant inputs).
- the amount of the total Level 3 gains or losses for the period included in earnings 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, and
- in annual periods only, the valuation techniques used to measure fair value and a discussion of changes in valuation techniques, if any, during the period.

Reporting entities are encouraged, but not required under the new Statement, to combine the fair value information disclosed under this Statement with the fair value information disclosed under other accounting pronouncements in the periods in which those disclosures are required, if practicable.

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