

FAIR VALUE CHANGES AHEAD

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INTRODUCTION

The use of fair value in financial reporting is not new; it is required or permitted under many standards, some of which have been in place for decades. Yet, given its role in the asset write downs and volatility precipitated by the financial crisis, there has been considerable discussion and debate about the use of fair value in financial reporting. As the financial crisis has broadened, the debate has evolved into a global debate that, in addition to the standard setters, the Financial Accounting Standards Board (FASB) and its international counterpart, the International Accounting Standards Board (IASB), involves securities regulators, banking regulators, governmental bodies, and other participants in our global capital markets. Not surprisingly, recent actions to respond to the financial crisis have focused on fair value accounting. Going forward, it will be important for companies to understand the extent of any changes resulting from those actions in preparing for 2009 reporting.

THE FAIR VALUE DEBATE

At the center of the fair value debate is FASB Statement No. 157, *Fair Value Measurements* (FAS 157), which went into effect for financial assets and liabilities just this past year (beginning in 2008). FAS 157 clarifies that when fair value is used under other standards, the measurement should represent a current market price, determined using the fair value hierarchy. The fair value hierarchy prioritizes the inputs used to determine fair value. It gives priority to observable market prices, but allows for the use of other inputs that would be considered by market participants in making pricing decisions. FAS 157 also requires significantly expanded disclosures about the fair values used in financial reporting.

Some, including banking institutions subject to regulatory capital requirements, say that for financial assets that trade in today's distressed markets (for example, mortgage-related securities), the current market price objective in FAS 157 and its emphasis on observable market prices has forced write downs to amounts that do not reflect the true economic values of the assets. They say that the use of fair value has contributed to or exacerbated the market crisis and that fair value accounting should be suspended or modified. Others, however, including many investors, say that fair value accounting enhances the transparency of financial information, which is critical in times of stress. Suspending fair value accounting would weaken investor confidence and add to the instability in the capital markets.

SEC MARK-TO-MARKET STUDY

In response, the Emergency Economic Stabilization Act of 2008 (EESA) required the U.S. Securities and Exchange Commission (SEC) to conduct a study on the use of mark-to-market (fair value) accounting by financial institutions (Section 133). The SEC's findings are set out in its report to Congress entitled, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting*, which was issued in December 2008. In its report, the SEC recommended that fair value accounting be improved, not suspended.

STANDARD SETTER ACTIONS

To date, the standard setters have taken a number of actions to improve fair value accounting.

For 2008 reporting, the SEC issued "Dear CFO" letters to large financial institutions to highlight fair value disclosures to be included in MD&A. The SEC and FASB staffs issued a joint statement to clarify key aspects of FAS 157, and the FASB issued FSP FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active*, to supplement the FAS 157 clarifications included in the joint statement.

For 2009 reporting, the FASB added new fair value (and other) projects to its agenda, largely in response to recommendations contained in the SEC report. Just recently, the FASB completed some of the projects and issued new fair value guidance in FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, and FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*. That guidance will go into effect beginning in the 2nd quarter 2009.

WHAT'S CHANGED?

For 2009 reporting, the key principles in FAS 157 hold. The fair value guidance issued to date clarifies (it does not change) those principles. However, the clarifications emphasize the need for judgments that could change how those principles are being applied in the current environment. Also, more fair value disclosures will be required.

FAS 157 PRINCIPLES

FAS 157 emphasizes that for an asset, fair value should represent the price that would be received in an orderly transaction for the asset at the measurement date (an exit price).

The clarifying guidance affirms the fair value objective in FAS 157. For an asset, that means that fair value is a current market price (the price that would be received today under current market conditions), not a future market price (the price that might be received at some future date under different market conditions). Because fair value is a market-based measurement (not an entity-specific measurement), that current price is determined without regard to whether the entity intends to sell or hold an asset at the valuation date.

The fair value hierarchy in FAS 157 prioritizes the use of observable market prices to determine fair value.

The clarifying guidance affirms the fair value hierarchy approach in FAS 157, but emphasizes that market prices should not be the sole basis for a fair value measurement unless they can be observed in an active market for identical items and result from orderly transactions in that market (Level 1 inputs). In all other cases, the valuations will involve more work and analysis requiring informed judgments (in some cases, significant), but the fair value objective in FAS 157 remains the same.

FAS 157 refers to an active market as one in which transactions are occurring with sufficient frequency and volume to provide ongoing and current pricing information.

The clarifying guidance emphasizes that determining whether the market for an item is (or continues to be) active requires judgment, considering the volume and level of activity for the item in relation to normal levels. For example, the market for an item might not be active if there are few recent transactions; price quotations vary significantly either over time or among market participants; there is a significant increase in the spread between the amount sellers are “asking” and the price that buyers are “bidding;” there is a significant decline or absence of a market for new issuances (a primary market) for the item; or there are relatively few “bidding” parties.¹

FAS 157 refers to an orderly transaction as one that involves a willing buyer/willing seller and allows for sufficient exposure to the market, that is, the seller has had sufficient time to market the asset and undertake marketing activities that are usual and customary for transactions involving other similar items.

The clarifying guidance emphasizes that determining whether a transaction is orderly requires judgment, considering factors specific to the transaction (not the market). For example, a disorderly transaction (a distressed sale or forced transaction where the seller is compelled to transact) might be indicated if the seller is in or near bankruptcy or receivership, the seller was forced to sell to meet regulatory requirements; or the seller was

otherwise forced to sell within a period that did not allow for usual and customary marketing activities under current market conditions. The transaction focus applies even when markets are dislocated. In that case, it is not appropriate to automatically conclude that all market activity represents disorderly transactions. Conversely, it is not appropriate to automatically conclude that all market activity represents orderly transactions that are representative of fair value.

FAS 157 indicates that market prices that are not Level 1 inputs must be evaluated for adjustment.

The clarifying guidance emphasizes that market prices that are not Level 1 inputs are not determinative, especially when there has been a significant decrease in the volume and level of activity for an item in relation to normal levels. Those market prices must be evaluated for adjustment and considered together with the results of valuation techniques using other inputs that are reasonably available in the circumstances. When there are different indications of fair value, determining the point within the range that is most representative of fair value (the price at which market participants would transact under current market conditions) requires judgment, considering the extent to which the inputs used in the valuation techniques are relevant in the circumstances. For example:

- An entity’s estimates of future cash flows and appropriately risk-adjusted discount rates (Level 3 inputs) might be more relevant and weighted more heavily than market prices that can be observed in a market that is not active (Level 2 inputs) if there are significant adjustments to those prices (as illustrated in FSP FAS 157-4).
- Broker quotes determined based on actual market transactions will be more relevant and weighted more heavily than broker quotes determined based on models that use information available only to the broker. Also the nature of the quotes should be considered in the weighting process (for example, whether the quotes are binding offers or indicative bids).
- Information about transactions that are orderly will be more relevant and weighted more heavily than information about transactions that are or might be disorderly, allowing for situations in which the entity is not able to determine whether the transactions are orderly or disorderly based on the information that is reasonably available in the circumstances.

FAIR VALUE DISCLOSURES

For fair value measurements that rely on significant judgments, investors have emphasized that clear and transparent disclosures are critical so that they understand the judgments made and the effect of the judgments on reported amounts. The earlier SEC “Dear CFO” letters expanded the fair value disclosures to be included in MD&A. Going forward, the new FASB guidance requires more fair value disclosures to be included in the financial statements.

¹ In addition, recent decisions in federal court and SEC administrative proceedings, some involving FTI professionals, have established measures of market efficiency that might be helpful in determining whether a market for a financial asset is active.

All entities will need to expand their disclosures under FAS 157 so that the fair values of debt and equity securities are shown by major security type (refer to FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*). They also will need to disclose the valuation technique(s) used to measure fair value and discuss changes, if any, in both interim and annual periods (not just annual periods as currently required under FAS 157).

Public entities only will need to also disclose the fair values of loans and other financial instruments included within the scope of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (FAS 107) that are not subject to the disclosure requirements in FAS 157, and include as part of those disclosures the method(s) and significant assumptions used in the valuations. Those disclosures will be required in both interim and annual periods (not just annual periods as currently required under FAS 107).

WHAT'S STILL IN PROCESS?

Other fair value projects are still in process. They are addressing measurement issues specific to liabilities and interests in alternative investments, such as hedge funds and private equity. Also, more fair value disclosures are under consideration, including disclosures about the sensitivity of fair value measurements to changes in key inputs and about transfers within the fair value hierarchy. The FASB plans to complete those projects and issue more guidance in time for year-end 2009 reporting.

CHALLENGES GOING FORWARD

Determining fair value in the current environment is challenging. The markets for many financial assets that previously were active are no longer active and lack the infrastructure needed to facilitate market pricing. That means that going forward, the valuations will involve more work and analysis requiring informed judgments (in some cases, significant). Provided that the key principles in FAS 157 hold, the focus will be on the valuations, the inputs and the judgments made in using the inputs, and the quality of the disclosures.

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