

Implementation of Fair Value Measurement under FAS 157

What are the issues?

On September 15, 2006, the Financial Accounting Standards Board issued "Statement of Financial Accounting Standards no. 157 (Fair Value Measurements)," better known simply as "FAS 157". Effective for fiscal years beginning after November 15, 2007, FAS 157 defines fair value, establishes a framework for measuring the fair value of assets and liabilities, expands disclosures and enhances the transparency of fair value measurements.

In order to properly rank the inputs used to measure fair value, FAS 157 employs a tri-level hierarchy. Level 1 inputs are observable and reflect quoted prices for identical assets or liabilities in active markets. Level 2 inputs are observable inputs other than quoted prices for identical assets or liabilities in active markets. Level 3 inputs are unobservable, such as inputs generated through valuation techniques that employ uncorroborated assumptions. There is additional disclosure requirements for Level 3.

FAS 157 also applies to other accounting pronouncements that require or permit fair value measurements and may change current practice under those pronouncements.

FAS 157 is "principles-based" guidance which needs to be interpreted and implemented by users. There are significant implementation considerations for investment companies, particularly given their use of and exposure to fair-valued instruments. In addition, there are significant implementation issues for third-party administrators performing outsourced accounting functions for investment advisors.

Background

Prior to FAS 157, there were different definitions of fair value which were dispersed among the many accounting standards that require or allow fair value measurement, resulting in complexity, inconsistency and a lack of comparability.

The FAS 157 definition of fair value clarifies that the exchange price is the price in a hypothetical orderly transaction between market participants to sell an asset or transfer a liability in the principal or the most advantageous-market for the transaction. Since FAS 157 is based on the perspective of the market participant that is selling or transferring an asset or liability, the fair value is considered to be an exit price, being the price you would pay or receive, not what you historically did pay or receive (the entry price).

Under FAS 157, the measurement of fair value is market-based, not entity-specific. Accordingly, the standard establishes a hierarchy for determining fair value that distinguishes between observable inputs (assumptions based on market data obtained from sources independent of the reporting entity) and

unobservable inputs (the reporting entity's own assumptions based on the best information available). The latter is used when a market's limited or nonexistent activity results in insufficient market data. If there is no market or insufficient data, a hypothetical market needs to be constructed, considering the assumptions that market participants would use in pricing the asset/liability. Importantly, FAS 157 affirms the requirement of other FASB statements that the fair value of a position in a financial instrument should not be adjusted because of the size of the position held (i.e. blockage factors are still disallowed if an active market price exists).

FAS 157 expands disclosures about the use of fair value, focusing on the inputs used to measure fair value. There is a bias towards observable inputs, and the fair-valued assets and liabilities must be divided into the prescribed hierarchy (Level 1, Level 2 and Level 3).

Developments in the credit markets during 2007 underscore the need for accurate valuation of assets and liabilities. While FAS 157 can help improve valuation approaches, its implementation presents significant challenges for investment advisors and third-party administrators. The FASB's November 2007 decision to reject a request to defer the implementation of FAS 157 for financial assets and liabilities (while granting a partial one-year deferral for non-financial assets and liabilities) means that investment advisors and third-party administrators must move ahead with implementation.

What is our response?

While many companies have focused on what fair value is, there has been less focus on how companies should implement the standard. Therefore, many investment companies and advisors are seeking guidance on how to address issues encountered when implementing fair value measurement in their operations. These issues include:

For investment companies:

- The requirement to disclose all investments held by the level of the hierarchy can pose considerable process, information technology and system challenges
- The requirement to disclose a rollforward for the year of all Level 3 investments
- FAS 157 redefines fair value as an exit price rather than an entry price, and this will have significant implications on the valuation of illiquid instruments, particularly for hedge fund and private equity fund managers who may have historically used cost (entry price) as the best estimate
- Considerable judgment is needed to determine the appropriate level within the fair valuation hierarchy

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requirements, and it may be unclear at what level certain positions should be ranked, particularly on the Level 2 and 3 distinction

For advisors:

- The standard is very subjective in its application to nontraded financial assets and liabilities
- Forecasting earnings and communicating results to the markets will be more challenging
- The interaction between FAS 157 and numerous other standards is giving rise to additional issues and conflicts
- GAP analysis to identify the measures currently used and modifications needed to existing policies and procedures
- Potential due diligence to gain comfort on pricing service data and broker quotes

PwC has helped clients by:

PwC has worked as an advisor or auditor with many of the early adopters of FAS 157. We have experience in helping these clients achieve their implementation project goals, as efficiently and effectively as possible. We have helped our clients by:

- Performing “healthcheck” reviews on their FAS 157 compliance process and procedures

- Providing technical advice and industry benchmarking on implementation
- Consulting and advising on the implementation project itself
- Assisting in the definition of the functional requirements for Level 3 rollforwards

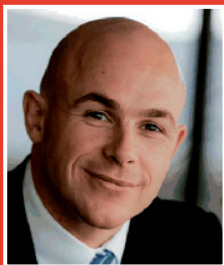
For example, we have identified the 5 key strategic decisions that each company will need to make, which are:

1. How are instruments to be fair valued?
2. What will the disclosure look like in terms of contents, format and level of detail?
3. What is the data collection strategy and unit of account?
4. How will the data be “collected”?
5. How will data be validated, reconciled and analyzed (both from a balance sheet and income statement perspective)?

We have worked with clients throughout their project lifecycle, providing technical and implementation advice as they work through the key decisions above.

This series presents the PricewaterhouseCoopers point of view on a range of issues affecting our clients and our profession.

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