

# Defining Issues<sup>®</sup>

KPMG LLP



## Fair Value Measurements

New Statement 157 establishes a single authoritative definition of fair value, sets out a framework for measuring fair value, and requires additional disclosures about fair-value measurements.<sup>1</sup> The Statement applies only to fair-value measurements that are already required or permitted by other accounting standards and is expected to increase the consistency of those measurements. It will also affect current practices by nullifying the EITF guidance that prohibited recognition of gains or losses at the inception of derivative transactions whose fair value is estimated by applying a model and by eliminating the use of “blockage” factors by brokers, dealers, and investment companies that have been applying AICPA Guides.<sup>2</sup>

### Scope

The Statement applies to fair-value measurements that are already required or permitted by existing standards except for measurements of share-based payments and measurements that are similar to, but not intended to be, fair value.<sup>3</sup> Its applicability is also limited by the practicability exceptions to applying fair value currently found in some standards. The Statement imposes no requirements for additional fair-value measures in financial statements.

### Definition of Fair Value

Statement 157 replaces the different definitions of fair value in the accounting literature with a single definition. It defines fair value as 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. This is an exit-price definition of fair value. Although entry prices may be similar to exit prices in some situations, fair value under Statement 157 is based on an exit price that would result from market participants’ behavior.

Scope	1
Definition of Fair Value	1
Valuation Techniques	2
“Fair Value Hierarchy”	3
Valuing a Liability	3
Restricted Stock	3
Blockage	4
Day One Gains	4
Bid-Ask Spreads	4
Disclosures	4
Effective Date	5

©2001-2006 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. KPMG and the KPMG logo are registered trademarks of KPMG International, a Swiss cooperative. All rights reserved. 24632NYO

Photo: GettyImages/Photodisc Red/Steve Cole BU005048

<sup>1</sup> FASB Statement No. 157, Fair Value Measurements, September 2006, available at [www.fasb.org](http://www.fasb.org).

<sup>2</sup> EITF Issue No. 02-3, Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities, available at [www.fasb.org](http://www.fasb.org); AICPA Audit and Accounting Guide, Brokers and Dealers in Securities, with conforming changes as of May 1, 2005; AICPA Audit and Accounting Guide, Investment Companies, with conforming changes as of May 1, 2004.

<sup>3</sup> FASB Statement No. 123 (revised 2004), Share-Based Payment, December 2004, available at [www.fasb.org](http://www.fasb.org); AICPA Statement of Position 97-2, Software Revenue Recognition, October 1997; EITF Issue No. 00-21, Revenue Arrangements with Multiple Deliverables, available at [www.fasb.org](http://www.fasb.org); and ARB No. 43, Chapter 4, Inventory Pricing, June 1953.

The Statement explains key concepts that are needed to apply the definition, including “market participants,” the markets in which the company would exchange the asset or liability, and the valuation premise that follows from assumptions market participants would make about the use of an asset.

**Market Participants.** For purposes of the definition of fair value, market participants are buyers and sellers in the principal or most advantageous market for the asset or liability who meet four criteria. They must be independent of the reporting entity, have the knowledge needed for a reasonable understanding of the asset or liability and the transaction, have the financial and legal ability to transact for the asset or liability, and be willing to transact without compulsion. Market participants would obtain available information from public sources and would perform other due-diligence efforts.

**Principal or Most Advantageous Market.**

The principal market is the market with the greatest volume and level of activity that the reporting entity uses to sell the asset or transfer the liability. The principal market will therefore depend on the entity’s business activity. For example, a broker-dealer may be able to transact in both the retail and wholesale markets, whereas the broker-dealer’s customer may be able to transact only in the retail market. An entity that has no principal market for the asset or liability would determine its most advantageous market. The most advantageous market is the market in which the reporting entity would sell the asset or transfer the liability at the price that maximizes the net amount that would be received for the asset or minimizes the net amount paid to transfer the liability. Transaction costs are

included in determining the net amount to be received or paid when determining the most advantageous market, but they are excluded from the fair-value measurement.

For example, assume an entity can sell an asset in two different markets and neither is the principal market. The asset can be sold for \$50 in Market A with transaction costs of \$5. The asset can be sold for \$48 in Market B with transaction costs of \$2. Market B would be the most advantageous market because the entity would receive a net of \$46 compared to the net of \$45 available in Market A. However, because transaction costs are not included in the fair-value measurement, the fair value of the asset in this example would be \$48.

**Valuation Premise.** A valuation premise is an assumption about how market participants would use an asset. The Statement directs reporting entities to establish the valuation premise based on the asset’s “highest and best use.” An asset’s highest and best use will result in either an in-use premise (the asset provides maximum value principally from its use in combination with other assets) or an in-exchange premise (the asset provides maximum value principally standing alone, in relative isolation from other assets).

The valuation premise is often an integral part of valuing nonfinancial assets and other assets for which there is no observable market price. If market participants would continue to use an asset as configured as part of an asset group, an in-use valuation premise would be applied in arriving at fair value. When an in-use valuation premise is used, the fair value of the asset reflects synergies that a market participant could realize from using the assets as a group. However, if market partici-

pants would not continue to use an asset as part of an asset group, the asset provides value principally on a standalone basis, or equivalent assets can easily be substituted for the asset, an in-exchange premise would be applied in arriving at fair value. Under an in-exchange valuation premise, the fair value of the assets would be based on their exit price when sold on a stand-alone basis.

## Valuation Techniques

Consistent with valuation practice, the Statement identifies the following three valuation approaches:

- The market approach, which uses observable prices and other relevant information derived from market transactions involving identical or comparable assets or liabilities.
- The income approach, which uses valuation techniques to convert future benefits or costs, usually in the form of cash flows, into a present-value amount. The measurement is based on assumptions market participants would make about those future benefits or costs. Examples of an income approach include the discounted cash flow method, the Black-Scholes-Merton model, and the excess earnings method used to value certain intangible assets.
- The cost approach, which uses estimates of the cost to replace an asset’s service capacity.

Not all techniques will be appropriate or required in all circumstances. Valuation professionals will have to evaluate the merits of the valuation techniques when deciding which to apply or whether to weight the results of different valuation techniques. A change in the valuation technique is a change in accounting estimate, not a change in accounting principle.

## “Fair Value Hierarchy”

The term “fair value hierarchy,” as used in the Statement, refers to the relative reliability of inputs to a valuation technique used in arriving at a fair-value estimate. The three-level hierarchy is essential to the Statement’s disclosure requirements. The lower the level of the input for a fair-value measurement, the more extensive the disclosure requirement. The table summarizes the hierarchy, with Level 1 representing the most reliable inputs, and Level 3 the least.

A fair-value measurement may be based on inputs from more than one level in the hierarchy. For example, the inputs for an income valuation technique may be risk-free interest rates and credit spreads that are observable (Level 1 or 2 inputs) and entity-specific projections of future cash flows to be derived from the use of the asset or asset group (Level 3). In determining the level of the fair-value measurement itself, the lowest-level input that is significant to the fair-value measurement determines the hierarchy level of the measurement. In the

example, the fair-value measurement would be at Level 3 because the estimate of future cash flows (Level 3) is significant to the fair-value measurement.

The lowest-level-significant-input assumption will mean that many fair-value measurements of nonfinancial assets and asset groups or reporting units will be Level 3 measurements because of their reliance on Level 3 inputs, such as forecasts of the reporting unit’s or asset group’s future cash flows. Fair-value measurements of financial instruments, however, may be based entirely on higher level inputs in some situations (e.g., measures of instruments that are traded in active markets or of instruments with contractual cash flows and interest rates that are observable as Level 2 inputs).

In all cases, the inputs should be consistent with the valuation premise and be based on the assumptions that the entity reasonably believes that market participants would use. Thus, if market participants would be

expected to use an asset, the inputs would be based on an in-use valuation premise even if the reporting entity would not plan to use the asset on that basis.

## Valuing a Liability

Statement 157 requires the reporting entity’s credit standing to be considered when a liability is required to be measured at fair value because market participants would consider nonperformance risk in determining its fair value. The entity could record an accounting gain for derivatives and other liabilities that are measured at fair value because the fair value of the liability decreases in response to a credit downgrade if all other inputs remain unchanged.

## Restricted Stock

The Statement requires restricted stock to be valued based on the value of equivalent unrestricted stock, adjusted for the effect of the restriction. The restriction should be evaluated to determine whether it is an attribute of the security or an attribute of the reporting entity. For example, if stock is restricted from sale under SEC Rule 144, the restriction is an attribute of the security and would transfer to a market participant. In that case, the fair value of the unrestricted security would be adjusted to reflect the effects of the restriction. A discount would not be appropriate, however, if the restriction is an attribute of the entity and would not transfer to a market participant (e.g., a contractual prohibition that would not transfer if the instrument were sold).

Statements 115 and 124 required that securities with restrictions of less than one year be measured using the price of similar securities without the restriction.<sup>4</sup> Statement 157 amends

### Hierarchy of Inputs to Valuation Techniques

Reliability Level	Input
1	Quoted prices in active markets for identical assets or liabilities.
2	Observable prices in active markets for similar assets or liabilities. Prices for identical or similar assets or liabilities in markets that are not active.  Directly observable market inputs for substantially the full term of the asset or liability, e.g., interest rates and yield curves at commonly quoted intervals, volatilities, prepayment speeds, default rates, and credit spreads.  Market inputs that are not directly observable but are derived from or corroborated by observable market data.
3	Unobservable inputs based on the reporting entity’s own assumptions about the assumptions that a market participant would use, including inputs derived from extrapolation and interpolation that are not corroborated by observable market data.

<sup>4</sup> FASB Statement Nos. 115, *Accounting for Certain Investments in Debt and Equity Securities*, May 1993, and 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, November 1995; both available at [www.fasb.org](http://www.fasb.org).

that guidance to require adjustments in fair-value measurements for the effect of restrictions that terminate within one year. However, the Statement provides no specific guidance on how to value the effect of the restriction. Additional measurement guidance is available in an SEC release.<sup>5</sup>

### Blockage

Statement 157 prohibits entities from applying a blockage factor when valuing a large position in an unrestricted security. A blockage factor adjusts the price based on the size of the position relative to trading volume. Brokers, dealers, and investment companies that have been applying provisions in the AICPA Guides previously applied blockage factors. The Board, in effect, concluded that the appropriate unit-of-account is the individual security, not the entire position in the securities held by the entity, because the entity holding the security can sell an individual security.

### Day One Gains

EITF 02-3 had prohibited the initial recognition of derivatives at other than the transaction price unless the fair value was based on quoted market prices in an active market or other observable inputs (i.e., Level 1 or Level 2 inputs). As a consequence, EITF 02-3 indicated that “an entity should not recognize an unrealized gain or loss at inception of a derivative instrument unless the fair value of that instrument is obtained from [Level 1 or Level 2 inputs].” Statement 157 amends EITF 02-3 to remove that prohibi-

tion, thereby permitting “day one gains or losses” to be recognized on instruments measured using Level 3 inputs.

### Bid-Ask Spreads

The Statement does not preclude the use of either mid-market pricing or other pricing conventions within the bid-ask spread as practical expedients. This is different from the guidance that had been proposed. The proposal would have required the use of bid prices for long positions and ask prices for short positions.<sup>6</sup> Constituents held that the proposed requirement would result in a major change in practice, especially in light of ASR 118’s requirements.<sup>7</sup> The Board reconsidered the proposed guidance and concluded that the estimate should be based on the price within the bid-ask spread “that is most representative of fair value in the circumstances.”

### Disclosures

The Statement requires the following disclosures, generally in both interim and annual periods. The disclosures should be presented separately for each major category of assets and liabilities.

- For assets and liabilities that are measured at fair value on a recurring basis (for example, trading securities), the fair-value measurements at the reporting date.
- For assets and liabilities that are measured at fair value on a nonrecurring basis (for example, impaired noncurrent assets), the fair-value measurements recorded during the period and the reason or reasons for the measurements.

- For assets and liabilities measured at fair value on either a recurring or nonrecurring basis:
  - The level of the measurements within the fair-value hierarchy based on the measurement inputs, segregating measurements with Level 1, Level 2, and Level 3 inputs, and,
  - *In annual periods only*, the valuation technique or techniques used for the measurements.
- For assets and liabilities that are measured at fair value on a nonrecurring basis using Level 3 inputs, a description of the inputs and the information used to develop the inputs.

Entities are also required to disclose the following for assets and liabilities that are measured at fair value on a recurring basis using Level 3 inputs, for each interim and annual period and separately for each major category of assets and liabilities (except for derivative assets and liabilities, which may be presented net):

- A reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to:
  - Total realized and unrealized gains or losses for the period, segregating those gains or losses included in earnings (or changes in net assets) and a description of where those gains or losses are reported in the income statement (or statement of activities),
  - Purchases, sales, issuances, and settlements (net), and

<sup>5</sup> Accounting Series Release No. 113, Statement Regarding “Restricted Securities,” (FRR 404.04, “Restricted Securities”).

<sup>6</sup> FASB Proposed Statement, Fair Value Measurements, June 23, 2004.

<sup>7</sup> Accounting Series Release No. 118, Accounting, Valuation and Disclosure of Investment Securities (FRR 404.03, Accounting, Valuation and Disclosure of Investment Securities).



This is a publication of KPMG's  
Department of Professional  
Practice—Audit  
212-909-5600

#### Contributing authors:

Paul H. Munter  
Enrique M. Tejerina  
Robert G. Hilbert  
Peter G. Wollmeringer

Earlier editions are available at:  
[www.aro.kpmg.com](http://www.aro.kpmg.com)

Defining Issues® is a registered trademark of KPMG LLP. © 2001-2006 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. KPMG and the KPMG logo are registered trademarks of KPMG International, a Swiss cooperative. All rights reserved. 24632NYO

- Transfers in and/or out of Level 3 in response to changes in the observability of significant inputs.
- The amount of the total gains or losses for the period included in earnings (or changes in net assets) 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 income statement (or statement of activities).

#### Effective Date

The Statement is effective for fair-value measures already required or permitted by other standards for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. Early application is permissible only if no annual or interim financial statements have been issued for the earlier periods. The requirements of the Statement are applied prospectively, except for changes in fair value related to estimating the fair value of a large block position and instruments measured at fair value at initial recognition based on transaction price in accordance with EITF 02-3 or Statement 155.<sup>8</sup> If these exceptions are present, the Statement should be applied by adjusting the opening balance of retained earnings in the period of adoption. The Statement does not require any new fair-value measures.

The descriptive and summary statements above are not intended to substitute for the text of Statement 157 or any other cited, actual, or potential requirements. Nor are any of the provisions necessarily applicable to an entity's specific circumstances. Those measuring fair value for financial reporting and complying with SEC filing requirements should refer to the texts of the applicable documents that set out requirements and consult their accounting and legal advisors.

<sup>8</sup> FASB Statement No. 155, Accounting for Certain Hybrid Financial Instruments, February 2006, available at [www.fasb.org](http://www.fasb.org).