Fair Value – A Troubled Solution

- **Financial Executives International Presentation**

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Accounting Policy

Wholesale Group Controllers

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Objective

The objective of this presentation is to introduce the topic of Fair Value, to review the US GAAP Guidance under FAS 157, to discuss recently issued guidance, and to discuss Fair Value and its impacts in financial reporting.

The views expressed in this presentation are my own and do not represent the positions of the FASB or Wells Fargo.

Positions of the FASB are arrived at only after extensive due process and deliberations.

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Reasons for the FASB's Fair Value Project

- More than 40 FASB Standards require or permit Fair Value
- There are different definitions of fair value
- There is limited guidance for applying the definitions of fair value
- There are user demands for more definitions about fair value

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Statement 157 – Fair Value Measurements

Summary

This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. **Accordingly, this Statement does not require any new fair value measurements.** However, for some entities, the application of this Statement will change current practice.

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Statement 157 – Fair Value Measurements

- Defines fair value for financial reporting
- Provides approach for measuring fair value
- Enhances disclosures about fair value
- Effective for fiscal years beginning after November 15, 2007 (e.g.in 2008 for a calendar year-end entity)
- Applies when other FASB standards require fair value measurements

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Statement 157 – Differences from Prior GAAP

- The definition of fair value retained the exchange price notion in earlier definitions of fair value. 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 liability, that is, **the principal or most advantageous market** for the asset or liability.

- The transaction to sell the asset or transfer the liability is a **hypothetical transaction** at the measurement date, **considered from the perspective of a market participant that holds the asset or owes the liability**. Therefore, the definition focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price).

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Statement 157 – Differences from Prior GAAP

- The Statement emphasized that fair value is a market-based measurement, not an entity-specific measurement, and it is **based on the assumptions that market participants** would use in pricing the asset or liability.
- FAS 157 established a fair value hierarchy that distinguishes between
  - (1) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and
  - (2) the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs).

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Statement 157 – Differences from Prior GAAP

- The notion of unobservable inputs is intended to allow for situations in which there is little, if any, market activity for the asset or liability at the measurement date.
  - In those situations, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the **reporting entity must not ignore information about market participant assumptions that is reasonably available without undue cost and effort.**

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Statement 157 – Differences from Prior GAAP

- The Statement clarifies that market participant assumptions include assumptions about risk,
  - for example, the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and/or the risk inherent in the inputs to the valuation technique.
- A fair value measurement should include an adjustment for risk if market participants would include one in pricing the related asset or liability, even if the adjustment is difficult to determine. **Therefore, a measurement (for example, a “mark-to-model” measurement) that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one in pricing the related asset or liability.**

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Statement 157 – Differences from Prior GAAP

- The Statement clarifies that market participant 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.

- FAS 157 clarifies that a fair value measurement for a liability **reflects its nonperformance risk** (the risk that the obligation will not be fulfilled). Because nonperformance risk includes the reporting entity's credit risk, the reporting entity should consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value under other accounting pronouncements, including FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*

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Statement 157 – Differences from Prior GAAP

- This 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** (within Level 1 of the fair value hierarchy). The quoted price should not be adjusted because of the size of the position relative to trading volume (blockage factor).
    - Extended that requirement to broker-dealers and investment companies within the scope of the AICPA Audit and Accounting Guides for those industries.

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FAS 157 Key Attributes	*FAS 157 Impacts*	*FAS 157 Reliability Level*
Defines Fair Value	**Allows for Early Adoption (01/01/07)**	**Levels rank reliability of prices and market inputs**
Emphasis is on market-based versus entity-specific measurements	**Must be adopted prior to Statement 159** **Fair Value Option**	**<u>Level 1</u> – Quoted prices in active markets (exchange traded)**
Clarifies market participant approach to Fair Value – Example – Restricted Stock	**Increases required disclosures about Fair Value Measurements**	**<u>Level 2</u> – Inputs that are observable, directly or indirectly, for asset or liability (swaps, options)**
Affirms Large Block of Stock is measured as Product of Quoted Price X Quantity (not discounted)	**Nullifies parts of guidance in EITF 02-3, and allows for recognition of Dealer Profit (Day 1 Gains)**	**<u>Level 3</u> – Inputs that are not observable, require entity's own assumptions about market participant assumptions**
Requires a liability be measured reflecting the reporting entity's credit risk	**Provides for a practicability exception to Fair Value**	**Quantitative disclosures with tabular presentation required in interim and annual periods**

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The Asset or Liability

A fair value measurement is for a specific asset or liability.

- The ***unit of account*** establishes the asset or liability that is being measured at fair value for purposes of financial reporting (single asset or liability or groups of assets or liabilities)
- The ***unit of valuation*** establishes whether the asset or liability is measured at fair value within a larger group (i.e.the highest and best use for assets)
- The indicated fair value of the group needs to be attributed to the asset or liability

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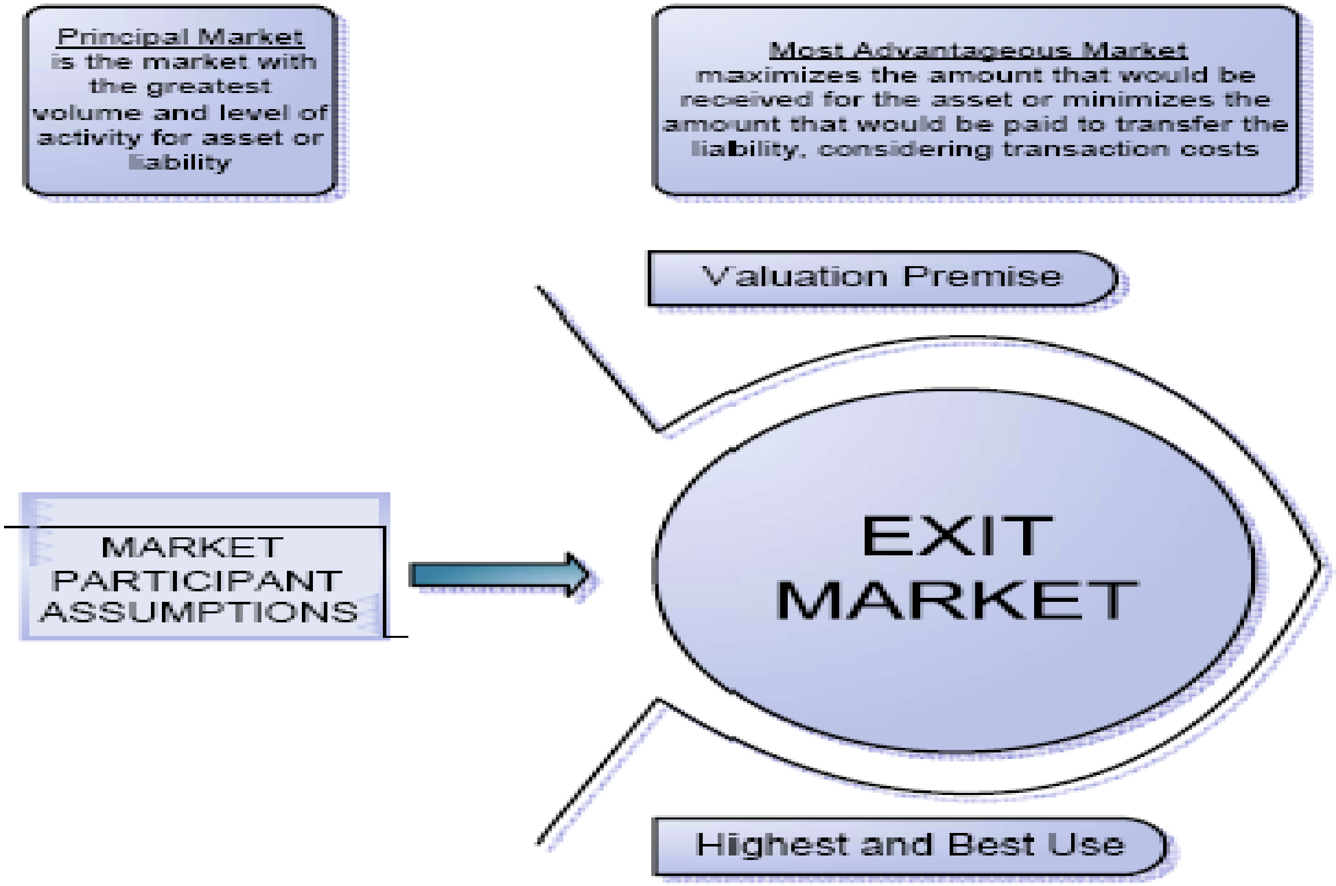
Exit Market –
The market in which the ENTITY would sell the Asset or transfer the Liability



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Market Participant Assumptions

- Fair value measurements should be based on the assumptions that market participants would use in pricing asset or liability (risk, highest and best use of asset, nonperformance risk of liability).
- Fair value can be determined in part based on the use of the asset (in-use can be in combination with other assets) or the value of the exchange (in-exchange is stand alone view)
- Fair value can be determined by the use of market participants that would maximize the value of the asset.

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Market Participant Assumptions

- Observable Inputs – Based on market data obtained from sources independent of the reporting entity
- Unobservable Inputs – Developed based on the best information available in the circumstances, with cost-benefit constraints
- Fair value measurements should maximize their reliance on observable inputs

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LEVEL 3 Dilemma

- The notion that exit price based on market assumptions was better view of fair value than willing buyer / willing seller
- Bids in the market may not reflect true fair value – prolonged distressed pricing in bids is not contemplated in FAS 157
- Efficient markets were assumed to exist (why ban shorts?)
- Volatility and liquidity were assumed to be relatively normal / stable
- Counterparty risk was assumed to be observable
- Mark to Market was assumed to produce reliable fair value measurement. Illiquid market guidance was limited.
- Assumes there is a level of comparability in unobservable inputs
- Mark to Model is sometimes viewed as Mark to Make Believe……

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LEVEL 3 Risk

- Mark-to-Market impacts financial institution's capital, and can undermine Treasury efforts
- American Bankers Association in Nov 25 letter to Treasury Secretary Henry Paulson stated:

  "With market prices continuing to fall well below the actual performance of the bank assets, delay in addressing the failures of the mark-to-market mechanism in fair value reporting will undo much of the work of the Treasury's Capital Purchase Program.
- SEC Chief Accountant Conrad Hewitt suggested that banks go to their regulators and ask for assets in inactive markets to be treated at par for regulatory capital purposes, which would not impact financial reporting. "So, I think that the regulators can have regulatory capital that is not dependent on GAAP. And I think they need to look at that going forward," Hewitt said.

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FAS 157 Issues

- **The OTTI trap - Bright lines in OTTI views cause fair value application. Is the bright line better than a detailed evaluation by management? Should the guidance of EITF 99-20 be trumped by the auditor view?**

- **Observable input trap – Markets that are not active have observable inputs that can significantly influence fair value measurements. The guidance of FAS 157-3 should be pointed to in this situation.**

"Determining fair value in a dislocated market depends on the facts and circumstances and may require significant judgment about whether individual transactions are forced liquidations or distressed sales."

Apply the "market challenge" view to FAS 157-3 example.

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FAS 157 Guidance

➔ **October 2007 –*Center for Audit Quality issues white paper***

➔ **November 2007 –*FAS 157 becomes effective***

➔ **December 2007 –*PCAOB Staff Alert No. 2 is issued***

➔ **July 2008 –*SEC's Compliance Alert contains guidance on municipal bond funds***

➔ **September 2008 - *SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting***

➔ **October 2008 –*FASB issues clarification on FAS 157***

➔ **November 2008-*Mark-to-Market Accounting Roundtable***

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September 2008 - ***SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting***

Q. Can management's internal assumptions (e.g., expected cash flows) be used to measure fair value when relevant market evidence does not exist?

A. Yes. When active market does not exist and management estimates of current market participant expectations of future cash flows include appropriate risk premiums. Level 3 might be more appropriate than Level 2.

Q. How should the use of "market" quotes (e.g., broker quotes or information from a pricing service) be considered when assessing the mix of information available to measure fair value?

A. Broker quotes may be an input when measuring fair value, but are not necessarily determinative if an active market does not exist for the security.

Q. Are transactions that are determined to be disorderly representative of fair value? When is a distressed (disorderly) sale indicative of fair value?

A. The results of disorderly transactions are not determinative when measuring fair value. The concept of a fair value measurement assumes an orderly transaction between market participants. Determining whether a particular transaction is forced or disorderly requires judgment.

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September 2008 - *SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting*

Q. Can transactions in an inactive market affect fair value measurements?

A. Yes. A quoted market price in an active market for the identical asset is most representative of fair value and thus is required to be used (generally without adjustment). Transactions in inactive markets may be inputs when measuring fair value, but would likely not be determinative.

Q. What factors should be considered in determining whether an investment is other-than-temporarily impaired?

A. In general, the greater the decline in value, the greater the period of time until anticipated recovery, and the longer the period of time that a decline has existed, the greater the level of evidence necessary to reach a conclusion that an other-than-temporary decline has not occurred. Consider the following:

- The length of the time and extent which market value has been less than cost;
- The financial condition and near-term prospects of the issuer, including any specific events, which may influence the operations of the issuer
- The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.

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SEC Mark-to-Market Study (report to Congress in 90 days)

The SEC Commission requested public comment related to a study to be conducted by the Commission under the Emergency Economic Stabilization Act of 2008 of "mark-to-market" accounting applicable to financial institutions, including depository institutions. At a minimum, the study was to consider:

(1) the effects of such accounting standards on a financial institution's balance sheet;

(2) the impacts of such accounting on bank failures in 2008;

(3) the impact of such standards on the quality of financial information available to investors;

(4) the process used by the Financial Accounting Standards Board in developing accounting standards;

(5) the advisability and feasibility of modifications to such standards; and

(6) alternative accounting standards to those provided in such Statement Number 157.

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SEC Mark-to-Market Roundtable 11-21-08

The November 21 roundtable concerning mark-to-market accounting was held at the SEC's Washington, D.C., headquarters and had one panel discussion focused on:

- *Usefulness of mark-to-market accounting to investors*
- *The sufficiency of information and the ability to improve the reliability regarding the valuation of assets recognized at fair value that do not currently trade in an active market*
- *Challenges encountered and best practice used by preparers of financial statements related to estimating fair value during the current market conditions*
- *Whether there are aspects of the current fair value measurement accounting standards that are not sufficiently clear, and what are the areas that could be improved and how*
- *Whether there needs to be more education related to fair value measurements*
- *Challenges that auditors have faced and best practice employed in providing assurance regarding fair value accounting*
- *Ways to increase transparency and consistency in the application of impairment models for investments not held for trading purposes*

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SEC Mark-to-Market Roundtable 11-21-08 – Comments

- **Distinguish impairments to debt instruments caused by liquidity problems from those caused by credit problems. Supported by roundtable participant Samuel Ranzilla, KPMG LLP partner in charge of the firm's professional practice, the plan would separate out credit impairment and charge it against equity until sold or the instrument reached maturity, at which point it would be charged against profits or losses. Impairment caused by liquidity problems would be charged against other comprehensive income.**

Approach modifies FAS 115 "triggering events" and preserves guidance of FAS 157

"Credit and liquidity are inextricably linked," said Kevin Spataro, head of accounting and research for the Allstate Corp. "Anybody who thinks they can create a model that separates them has quite a challenge in front of them."

- **SEC Deputy Chief Accountant Paul Beswick said that the current model for other than temporary impairment is difficult for investors to use in practice and might not provide the most beneficial information to them. He said he would like to see more exploration of an impairment model based on credit. The impairment trigger could be an incurred loss, with additional disclosures and liquidity impairments appearing in OCI.**

- **SEC Chairman Christopher Cox noted that many commentators believe that "additional work is needed" to better apply fair value accounting to illiquid markets.**

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FAS 157 In-house Models

- Fair value methodology and pricing needs to have oversight from independent representatives
  - – May be appointed by the Board or comprised of a management valuation committee
- Important to have consistent processes (consistent, reproducible, transparent, verifiable, and preferably simply constructed)
  - May require board notification/approval for changes in processes

Back-testing of fair value determinations would be required

Inputs from Third Party vendors can improve quality of measurement.

Disclosure in the financials with significant details is recommended

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FAS 157 Fair Value Measurement Thoughts

- Liquidity Reserves – Is it possible to create a liquidity reserve as a fair value component across an asset class in illiquid markets?
- Held to Recovery – Is it possible to determine a fair value measurement based on a held to recovery view?
- Reasonable Market Participant – Is it possible to determine a reasonable market participant view as an entity assumption?
- Last trade concept – Is it possible to mark to the last known trade in an active market when there has been no subsequent trades and the market has become illiquid?
- Collect by model – Is it possible to construct a collect by model that indicates the fair value based on reasonable projections of cash flows, which if not received, would require further fair value adjustment?

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"Man who waits for roast duck to fly into mouth must wait very, very long time."

- Chinese proverb

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Thank You For Attending!

QUESTIONS?