FASB Statement No. 157, Fair Value Measurements (FAS 157)

Reference Information
– FASB, Audit Firms, Industry Groups

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FASB STAFF POSITION

No. FAS 157-3

Title: Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active

Date Issued: October 10, 2008

Objective

1. This FASB Staff Position (FSP) clarifies the application of FASB Statement No. 157, Fair Value Measurements, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active.

Background

2. Statement 157 was issued in September 2006, and is effective for financial assets and financial liabilities for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early application was encouraged. FSP FAS 157-2, Effective Date of FASB Statement No. 157, amended Statement 157 to delay the effective date of Statement 157 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years.

3. Statement 157 establishes a single definition of fair value and a framework for measuring fair value in generally accepted accounting principles (GAAP) that result in increased consistency and comparability in fair value measurements. Statement 157 also expands disclosures about fair value measurements, thereby improving the quality of information provided to users of financial statements. Statement 157 does not require any new fair value measurements.
4. The FASB staff obtained extensive input from various constituents, including financial statement users, preparers, and auditors, on determining fair value in accordance with Statement 157. Many of those constituents indicated that the fair value measurement framework in Statement 157 and related disclosures have improved the quality and transparency of financial information.

5. However, certain constituents expressed concerns that Statement 157 does not provide sufficient guidance on how to determine the fair value of financial assets when the market for that asset is not active. Application issues include:

   a. How the reporting entity’s own assumptions (that is, expected cash flows and appropriately risk-adjusted discount rates) should be considered when measuring fair value when relevant observable inputs do not exist

   b. How available observable inputs in a market that is not active should be considered when measuring fair value

   c. How the use of market quotes (for example, broker quotes or pricing services for the same or similar financial assets) should be considered when assessing the relevance of observable and unobservable inputs available to measure fair value.

6. The Office of the Chief Accountant of the SEC and the FASB staff jointly issued a press release on September 30, 2008, that addresses similar Statement 157 application issues. That press release provides financial statement users, preparers, and auditors with additional guidance useful in dealing with those issues. The guidance included in this FSP is consistent with and amplifies the guidance contained in that press release.

   All paragraphs in this FSP have equal authority.
   Paragraphs in bold set out the main principles.

Scope

7. This FSP applies to financial assets within the scope of accounting pronouncements that require or permit fair value measurements in accordance with Statement 157.
8. This FSP clarifies the application of Statement 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active.

9. Key existing principles of Statement 157 illustrated in the example include:

   a. A fair value measurement represents the price at which a transaction would occur between market participants at the measurement date. As discussed in Statement 157, in situations in which there is little, if any, market activity for an asset at the measurement date, the fair value measurement objective remains the same, that is, the price that would be received by the holder of the financial asset in an orderly transaction (an exit price notion) that is not a forced liquidation or distressed sale at the measurement date.\(^1\) Even in times of market dislocation, it is not appropriate to conclude that all market activity represents forced liquidations or distressed sales. However, it is also not appropriate to automatically conclude that any transaction price is determinative of fair value. Determining fair value in a dislocated market depends on the facts and circumstances and may require the use of significant judgment about whether individual transactions are forced liquidations or distressed sales.

   b. In determining fair value for a financial asset, the use of a reporting entity’s own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available. Statement 157 discusses a range of information and valuation techniques that a reporting entity might use to estimate fair value when relevant observable inputs are not available.\(^2\) In some cases an entity may determine that observable inputs (Level 2) require significant adjustment based on unobservable data and thus would be considered a Level 3 fair value measurement. For example, in cases where the volume and level of trading activity in the asset have declined significantly, the available prices vary significantly over time or among market participants, or the prices are not current, the observable inputs might not be relevant and could require significant adjustment. Regardless of the valuation technique used, an entity must include appropriate risk adjustments that market participants would make for nonperformance and liquidity risks.

   c. Broker (or pricing service) quotes may be an appropriate input when measuring fair value, but they are not necessarily determinative if an active market does not exist for the financial asset. In an active market, a broker quote should reflect market information from actual transactions. However, when markets are not active, brokers may rely more on models with inputs based on information available only to the broker. In weighing a broker quote as an input to a fair value measurement, an entity should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighing the available evidence.

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\(^1\)See paragraph 7 of Statement 157.

\(^2\)Paragraph B6 of Statement 157 describes two present value techniques for determining fair value. The present value techniques differ in how they adjust for risk and in the type of cash flows they use.
10. For recurring fair value measurements using significant unobservable inputs (Level 3), paragraph 32 of Statement 157 requires an entity to reconcile the beginning and ending balances, including separately presenting changes that occurred during the period that are attributable to transfers in and/or out of Level 3. For both recurring and nonrecurring fair value measurements using significant unobservable inputs (Level 3), paragraphs 32 and 33 of Statement 157 require an entity to describe the inputs and the information used to develop those inputs.3

**Amendment to Add an Illustrative Example to Statement 157**

11. Statement 157 is amended as follows: [Added text is underlined.]

   a. Paragraphs A32A–A32F and the heading preceding them are added as follows:

      **Example 11—Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active**

      Note: The conclusions reached in this example are based on the assumed facts and circumstances presented. Other approaches to determining fair value may be appropriate. Also, this example assumes that the observable transactions considered in determining fair value were not forced liquidations or distressed transactions.

      A32A. On January 1, 20X8, Entity A invested in a AA-rated tranche of a collateralized debt obligation security. The underlying collateral for the collateralized debt obligation security is unguaranteed nonconforming residential mortgage loans. Prior to June 30, 20X8, Entity A was able to determine the fair value of the collateralized debt obligation security using a market approach valuation technique based on Level 2 inputs that did not require significant adjustment. The Level 2 inputs included:

      a. **Quoted prices in active markets for similar collateralized debt obligation securities with insignificant adjustments for differences between the collateralized debt obligation security that Entity A holds and the similar collateralized debt obligation securities**

      b. **Quoted prices in markets that are not active that represent current transactions for the same or similar collateralized debt obligation securities that do not require significant adjustment based on unobservable inputs.**

   3The Board observes that the SEC’s Division of Corporation Finance issued letters in March 2008 and September 2008 for issuers to consider in enhancing the transparency of disclosures relating to fair value measurements.
A32B. Since June 30, 20X8, the market for collateralized debt obligation securities has become increasingly inactive. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which collateralized debt obligation securities trade and then by a significant decrease in the volume of trades relative to historical levels as well as other relevant factors. At September 30, 20X8 (the measurement date), Entity A determines that the market for its collateralized debt obligation security is not active and that markets for similar collateralized debt obligation securities (such as higher-rated tranches within the same collateralized debt obligation security vehicle) also are not active. That determination was made considering that there are few observable transactions for the collateralized debt obligation security or similar collateralized debt obligation securities, the prices for those transactions that have occurred are not current, and the observable prices for those transactions vary substantially either over time or among market makers, thus reducing the potential relevance of those observations. Consequently, while Entity A appropriately considers those observable inputs, ultimately, Entity A’s collateralized debt obligation security will be classified within Level 3 of the fair value hierarchy because Entity A determines that significant adjustments using unobservable inputs are required to determine fair value at the measurement date.

A32C. Entity A determines that an income approach valuation technique (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs will be equally or more representative of fair value than the market approach valuation technique used at prior measurement dates, which would now require significant adjustments. Specifically, Entity A uses the discount rate adjustment technique described in Appendix B of Statement 157 to determine fair value.

A32D. Entity A determines that the appropriate discount rate used to discount the contractual cash flows of its collateralized debt obligation security is 22 percent after considering the following:

a. The implied rate of return at the last date on which the market was considered active for the collateralized debt obligation security was 15 percent. Based on an analysis of available observable inputs for mortgage-related debt securities, Entity A determines that market rates of return generally have increased in the marketplace since the last date on which the market was considered active for the collateralized debt obligation security. Entity A estimates that credit spreads have widened by approximately 100 basis points and liquidity risk premiums have increased during that period by approximately 400 basis points. Other risks (for example, interest rate risk) have not changed. Using this information, Entity A estimates that an indication of an appropriate rate of return for the collateralized debt obligation security is 20 percent. In making that determination, Entity A considered all available market information that could be obtained without undue cost and effort. For this collateralized debt obligation security, the available market information used in assessing the risks in the security (including nonperformance risk [for example, default risk and collateral value risk] and liquidity risk) included:
(1) Quoted prices that are not current for the same or similar collateralized debt obligation securities
(2) Relevant reports issued by analysts and ratings agencies
(3) The current level of interest rates and any directional movements in relevant indexes, such as credit risk indexes
(4) Information about the performance of the underlying mortgage loans, such as delinquency and foreclosure rates, loss experience, and prepayment rates
(5) Other relevant observable inputs.

b. Two indicative quotes (that is, nonbinding quotes) for the collateralized debt obligation security from brokers imply a rate of return of 23 percent and 27 percent. The indicative quotes are based on proprietary pricing models utilizing significant unobservable inputs (that is, Level 3 inputs), rather than actual transactions.

A32E. Because Entity A has multiple indications of the appropriate rate of return that market participants would consider relevant in estimating fair value, it evaluates and weighs, as appropriate, the respective indications of the appropriate rate of return, considering the reasonableness of the range indicated by the results. Entity A concludes that 22 percent is the point within the range of relevant inputs that is most representative of fair value in the circumstances.

Entity A placed more weight on the 20 percent estimated rate of return (that is, its own estimate) because (a) the indications of an appropriate rate of return provided by the broker quotes were nonbinding quotes based on the brokers’ own models using significant unobservable inputs, and (b) Entity A was able to corroborate some of the inputs, such as default rates, with relevant observable market data, which it used to make significant adjustments to the implied rate of return when the market was last considered active.

A32F. In accordance with the requirements of Statement 157, Entity A determines that the risk-adjusted discount rate appropriately reflects the reporting entity’s estimate of the assumptions that market participants would use to estimate the selling price of the asset at the measurement date. Risks incorporated in the discount rate include nonperformance risk (for example, default risk and collateral value risk) and liquidity risk (that is, the compensation that a market participant receives for buying an asset that is difficult to sell under current market conditions).

\[21a]\text{See paragraphs 20 and 21 of Statement 157.}\]
\[21b]\text{See paragraphs B7–B11 of Statement 157.}\]
\[21c]\text{The discount rate adjustment technique described in paragraphs B7–B11 of Statement 157 would not be appropriate when determining whether the change in fair value results in an impairment and/or necessitates a change in yield under EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets," because that technique uses contractual cash flows rather than cash flows expected by market participants.}\]
\[21d]\text{Calculated as the 15 percent implied rate of return at the last date on which the market was considered active, plus the increase in (a) credit spreads of 100 basis points (1 percent) and (b) liquidity risk premiums of 400 basis points (4 percent).}\]
Effective Date and Transition

12. This FSP shall be effective upon issuance, including prior periods for which financial statements have not been issued. Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate (FASB Statement No. 154, Accounting Changes and Error Corrections, paragraph 19). The disclosure provisions of Statement 154 for a change in accounting estimate are not required for revisions resulting from a change in valuation technique or its application.

| The provisions of this FSP need not be applied to immaterial items. |
Washington, D.C., Sept. 30, 2008 – The current environment has made questions surrounding the determination of fair value particularly challenging for preparers, auditors, and users of financial information. The SEC’s Office of the Chief Accountant and the staff of the FASB have been engaged in extensive consultations with participants in the capital markets, including investors, preparers, and auditors, on the application of fair value measurements in the current market environment.

There are a number of practice issues where there is a need for immediate additional guidance. The SEC’s Office of the Chief Accountant recognizes and supports the productive efforts of the FASB and the IASB on these issues, including the IASB Expert Advisory Panel’s Sept. 16, 2008 draft document, the work of the FASB’s Valuation Resource Group, and the IASB’s upcoming meeting on the credit crisis. To provide additional guidance on these and other issues surrounding fair value measurements, the FASB is preparing to propose additional interpretative guidance on fair value measurement under U.S. GAAP later this week.

While the FASB is preparing to provide additional interpretative guidance, SEC staff and FASB staff are seeking to assist preparers and auditors by providing immediate clarifications. The clarifications SEC staff and FASB staff are jointly providing today, based on the fair value measurement guidance in FASB Statement No. 157, Fair Value Measurements (Statement 157), are intended to help preparers, auditors, and investors address fair value measurement questions that have been cited as most urgent in the current environment.

* * *

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

Yes. When an active market for a security does not exist, the use of management estimates that incorporate current market participant expectations of future cash flows, and include appropriate risk premiums, is acceptable. Statement 157 discusses a range of information and valuation techniques that a reasonable preparer might use to estimate fair value when relevant market data may be unavailable, which may be the case during this period of market uncertainty. This can, in appropriate circumstances, include expected cash flows from an asset. Further, in some cases using unobservable inputs (level 3) might be more appropriate than using observable inputs (level 2); for example, when significant adjustments are required to available observable inputs it may be appropriate to utilize an estimate based primarily on unobservable inputs. The determination of fair
value often requires significant judgment. In some cases, multiple inputs from different sources may collectively provide the best evidence of fair value. In these cases expected cash flows would be considered alongside other relevant information. The weighting of the inputs in the fair value estimate will depend on the extent to which they provide information about the value of an asset or liability and are relevant in developing a reasonable estimate.

**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?**

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. In a liquid market, a broker quote should reflect market information from actual transactions. However, when markets are less active, brokers may rely more on models with inputs based on the information available only to the broker. In weighing a broker quote as an input to fair value, an entity should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote (e.g. whether the quote is an indicative price or a binding offer) should be considered when weighing the available evidence.

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

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. An orderly transaction is one that involves market participants that are willing to transact and allows for adequate exposure to the market. Distressed or forced liquidation sales are not orderly transactions, and thus the fact that a transaction is distressed or forced should be considered when weighing the available evidence. Determining whether a particular transaction is forced or disorderly requires judgment.

**Can transactions in an inactive market affect fair value measurements?**

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. If they are orderly, transactions should be considered in management’s estimate of fair value. However, if prices in an inactive market do not reflect current prices for the same or similar assets, adjustments may be necessary to arrive at fair value.

A significant increase in the spread between the amount sellers are “asking” and the price that buyers are “bidding,” or the presence of a relatively small number of “bidding” parties, are indicators that should be considered in determining whether a market is inactive. The determination of whether a market is active or not requires judgment.
What factors should be considered in determining whether an investment is other-than-temporarily impaired?

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.

Determining whether impairment is other-than-temporary is a matter that often requires the exercise of reasonable judgment based upon the specific facts and circumstances of each investment. This includes an assessment of the nature of the underlying investment (for example, whether the security is debt, equity or a hybrid) which may have an impact on a holder’s ability to assess the probability of recovery.

Existing U.S. GAAP does not provide “bright lines” or “safe harbors” in making a judgment about other-than-temporary impairments. However, “rules of thumb” that consider the nature of the underlying investment can be useful tools for management and auditors in identifying securities that warrant a higher level of evaluation.

To assist in making this judgment, SAB Topic 5M¹ provides a number of factors that should be considered. These factors are not all inclusive of the potential factors that may be considered individually, or in combination with other factors, when considering whether an other-than-temporary impairment exists. Factors to consider include the following:

- The length of the time and the extent to which the 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 such as changes in technology that impair the earnings potential of the investment or the discontinuation of a segment of the business that may affect the future earnings potential; or
- 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.

All available information should be considered in estimating the anticipated recovery period.

* * *

Finally, because fair value measurements and the assessment of impairment may require significant judgments, clear and transparent disclosures are critical to providing investors with an understanding of the judgments made by management. In addition to the disclosures required under existing U.S. GAAP, including Statement 157, the SEC’s Division of Corporation Finance recently issued letters in March and September that are available on the SEC’s Web site to provide real-time guidance for issuers to consider in
enhancing the transparency of fair value measurements to investors. Additionally, the SEC staff and the FASB staff will continue to consult with capital market participants on issues encountered in the application of fair value measurements.

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1 AU 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, of the PCAOB Interim Auditing Standards also provide factors to consider when evaluating whether an impairment is other-than-temporary.
DATALINE 2008-20:
IMPACT OF FAS 157 ON THE MEASUREMENT AND
DISCLOSURE OF PENSION/OPEB PLAN ASSETS

Overview

Key Points

- The FAS 157 framework applies to the valuation of pension plan assets at both the employer and plan level

- The disclosure provisions of FAS 157 apply to the plan's financial statements, but not to the employer's financial statements

- Both the employer and plan management will need to address similar valuation issues in order to comply with the measurement requirements of FAS 157

- Employers and plan management may underestimate the time required to identify, collect and evaluate the necessary information in order meet the employer and plan reporting deadlines

- FAS 157 is generally effective December 31, 2008 for calendar year-end measurement of plan assets and for disclosures in plan financial statements

Main Details

.1 FASB Statement No. 157, *Fair Value Measurements* (FAS 157), will affect the measurement and disclosure of pension and other postretirement benefits (OPEB) plan assets in the employer's financial statements as well as in the separate financial statements of the plan.

.2 This DataLine explores some of the important valuation and disclosure issues that implementation of FAS 157 will present, and emphasizes the importance of why employers and plan management should begin developing their implementation plans now.

Key Provisions

Background

.3 Assets held by a pension or OPEB plan are required to be measured, at least annually, at fair value. Therefore, once adopted, FAS 157 will apply to these assets. Because the accounting and disclosure requirements for pension and OPEB plans for employers and the separate financial statements of the plan differ (FAS 87, FAS 106, FAS 132(R) and FAS 158 apply to employers while plans apply FAS 35 and the AICPA Employee Benefit Plans Audit Guide), the implementation of FAS 157 will, in certain circumstances, also differ.
PwC Observation: FAS 157’s measurement requirements should be applied to plan assets for all kinds of benefit plans, including defined benefit, defined contribution, health and welfare, and post-employment plans accounted for under FAS 112.

The valuation and measurement of plan assets under FAS 157 will generally be the same for purposes of the employer financial statements and the separate plan financial statements. However, the disclosure requirements of FAS 157 only apply to the plan's financial statements.

The FAS 157 disclosures related to the plan's assets must be provided in the separate financial statements of the plan, including providing the information required by the fair value disclosure hierarchy. Such information will include the rollforward of the assets measured using Level 3 inputs, which will require developing estimates of fair value as of both the beginning and end of the plan's fiscal year. However, the FASB has stated that these disclosures are not required in the employer's financial statements, for two primary reasons. First, in the employer's statement of financial position, plan assets measured at fair value are aggregated with benefit liabilities, which are not measured at fair value. Therefore, the net amount presented on the face of the financial statements is not measured at fair value. Second, the requirement in Statement 157 to disclose the realized and unrealized gains or losses recognized in earnings would be difficult to apply to measurements of plan assets due to the provisions of FAS 87 and 106, which allow delayed recognition of gains and losses as components of net periodic benefit cost.

PwC Observation: In March 2008, the FASB staff issued proposed FASB Staff Position (FSP) No. FAS 132(R)-a for public comment. If the FSP is issued as proposed, disclosures about plan assets similar to those required by FAS 157 would be required in the employer's financial statements. As proposed, FSP 132(R)-a would be effective in 2008 for calendar year-end companies, although we expect the FASB to vote soon on a possible extension of that effective date.

Pension and OPEB plan assets generally will be first measured under FAS 157 in the first year-end after adoption (i.e., 12/31/08 for a calendar year-end employer that does not early adopt FAS 157). However, if the employer has an interim remeasurement of plan assets during 2008 (due to a full remeasurement of plan assets and obligations related to a plan amendment, curtailment, or settlement), FAS 157 should be applied to that remeasurement.

Timing

Employers who have not already done so, should begin preparing now for the application of FAS 157 to pension and OPEB plan assets. Typically, separate plan financial statements on Form 11-K for certain defined contribution plans are filed six months after the plan’s year-end. Other plan financial statements on Form 5500 are filed between seven to nine and a half months after the plan's year end. As a result, some may believe that implementation of FAS 157 for plan assets can wait until sometime in 2009. However, it is important to remember that although FAS 157 disclosures are not required in the employer's financial statements, the measurement of the plan assets in the employer's financial statements under FAS 87, 106 and 158, must be in accordance with FAS 157. Accordingly, public companies must determine the impact of applying FAS 157 on plan assets before they file Form 10-K, or the first time financial information is published that includes a balance sheet (e.g., in a press release).

For the employer's financial statements under the requirements of FAS 87, 106 and 158, the same timing applies to the measurement of plan assets for employers that sponsor pension plans in foreign countries, even though they may not have separate plan reporting requirements, or may prepare separate plan financial statements under a basis of accounting other than US GAAP.

PwC Observation: Because many employers and plans may use information provided by third parties as part of their process for developing fair value estimates, it may take additional time to obtain and evaluate the necessary information from those third parties. Because employers and
plan management are ultimately responsible for the valuations (even in a limited-scope ERISA audit), they should develop an understanding of the valuation methodology and practices by those third parties. Employers and plan management should also develop an understanding of the planned approach of their third party information providers to generate the information required to meet the new disclosures, including their methodology for determining Level 1, 2, or 3. See PwC’s guidance regarding the use of information from third party sources in Alert 08/10. Also, the AICPA Employee Benefit Plans Audit Quality Center Advisory, Valuing and Reporting Plan Investments may help plan management understand their responsibilities regarding valuation and reporting of investments.

Fair Value Defined

.9 FAS 157 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." FAS 157 clarifies that the basis for a fair value measure is the price at which a company would sell or otherwise dispose of its assets or pay to settle a liability (i.e., an exit price), not the market price at which a company acquires its assets or assumes a liability (i.e., not an entry price). FAS 157 also introduces a number of new concepts and terms to assist in the determination of an exit price, including the use of principal or most advantageous market, valuation premise, and unit of valuation, among others.

PwC Observation: As a result of the new definition, the fair value of plan assets under FAS 87, FAS 106 and FAS 35 will need to be measured differently than in the past.


Summary of the Impact of FAS 157 on Pension and OPEB Assets

.11 Upon the adoption of FAS 157, the fair value of plan assets must be measured in accordance with its requirements. Significant changes from prior practice are summarized in the following table and discussed in further detail beginning in paragraph .12.

<table>
<thead>
<tr>
<th>Prior Practice under FAS 35 and FAS 87 and FAS 106, as amended</th>
<th>FAS 157</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costs to sell</td>
<td></td>
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<tr>
<td>• Fair value is reduced by brokerage commissions and other costs normally incurred in a sale, if significant</td>
<td>• Carries forward reduction of fair value by costs to sell if those costs are significant</td>
</tr>
<tr>
<td>Valuation of publicly traded equity and debt securities</td>
<td></td>
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<tr>
<td>• Valuation typically based on price times quantity</td>
<td>• Not expected to have a significant impact; however, entities should consider:</td>
</tr>
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<td></td>
<td>- Policy related to bid-ask spread (midpoint pricing convention)</td>
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<td></td>
<td>- No recognition of blockage factors for instruments with Level 1 inputs</td>
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<td>- Change in requirements related to restricted securities</td>
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</tbody>
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CFOdirect Network – http://www.cfodirect.com
| Valuation of alternative investments | • Market prices should be used, if an active market exists for the investment  
• Prices for similar investments may be helpful in estimating fair value  
• If market prices are unavailable, expected cash flows may be considered, discounted at a risk-adjusted rate | • Income, cost, or market valuation technique(s) should be used as appropriate  
• Will require consideration of principal and most advantageous market; determination of market participants may impact conclusions  
• Requires use of market participant assumptions and a determination of highest and best use |
|---|---|
| Disclosures | • Certain disclosures required for plan assets, but no specific requirements regarding the measurement of fair value | • No additional disclosures required by FAS 157 in employer financial statements; however, Proposed FSP No. FAS 132(R)-a would expand employer disclosures of pension and other postretirement benefit plan assets.  
• FAS 157 disclosures are required in the plan financial statements |

**Specific Valuation Considerations**

.12 The valuation concepts described below should be applied to measurements of plan assets for purposes of reporting in employer financial statements as well as in the separate financial statements of the plan.

**Costs to Sell**

.13 FAS 157 states that the fair value of an asset or liability generally should not be adjusted for transaction costs (i.e., costs to sell); however, FAS 157 also states that transaction costs should be accounted for in accordance with the provisions of other accounting pronouncements. Accordingly, FAS 157 does not change the requirements in FAS 35, FAS 87, and FAS 106 that the fair value of plan assets be reduced by brokerage commissions and other costs normally incurred in a sale, if those costs are significant. Therefore, employers and plan sponsors should continue to reduce the fair value of plan assets by such “selling costs” if those costs are significant.

**PwC Observation:** We expect that the implementation of FAS 157 will bring greater attention to this requirement. Employers and plan management will need to consider the impact of selling costs on illiquid investments, as the materiality of these costs to the overall fair value measurement may be significant.

**Publicly-Traded Equity and Debt Securities**

.14 The valuation of plan investments in publicly-traded equity and debt securities is not expected to change as a result of the adoption of FAS 157, as those investments were typically valued using a price times quantity methodology (consistent with the use of Level 1 inputs under FAS 157). However, in valuing these securities, a reporting entity should consider the following FAS 157 requirements:
• **Bid-Ask Spread**: A reporting entity will have to establish a consistent policy for measuring the fair value of plan assets based on a bid-ask spread.

Bid-ask price quoting is common within markets for certain financial instruments and commodities. In these markets, dealers stand ready to buy at the bid price and sell at the ask price. If an input within FAS 157’s fair value hierarchy is based on bid and ask prices, the fair value measurement should represent the price within the bid-ask spread at which market participants would transact on the measurement date. FAS 157 provides a practicability exception to this principle, allowing the use of mid-market pricing or other pricing conventions as a practical expedient for fair value. A reporting entity may also establish a policy to use bid prices for long positions (assets) and ask prices for short positions (liabilities). Once established, a reporting entity should follow its accounting policy consistently.

**PwC Observation**: Many reporting entities currently use or are contemplating the use of the mid-market convention as permitted by FAS 157 because it simplifies some of the necessary calculations and allows use of the same quotes and prices when calculating the fair value of both assets and liabilities.

• **Blockage factor**: FAS 157 precludes the application of a blockage factor in valuing financial instruments traded in active markets.

In accordance with FAS 157, the fair value of a position for a single financial instrument in an active market should be calculated as the product of the quoted price for the individual instrument times the quantity held. When measuring the fair value of a financial instrument that trades in an active market, FAS 157 prohibits the use of a blockage factor (i.e., a discount applied to reflect the inability to trade a block of the security because the market for the security, although an active one, could not absorb the entire block at one time without adversely affecting the quoted market price).

• **Restricted Securities**: If a reporting entity holds a security that has restrictions on its sale or transferability (i.e., a restricted security), the fair value measurement should be adjusted to reflect the discount a market participant would require as a result of the restriction, regardless of the duration of the restriction. As a result of the definition and valuation of restricted securities under FAS 157, previous practice for securities with sale restrictions of less than one year may change.

However, restrictions that arise as a result of side agreements or compliance with statutory requirements imposed on the holder of the security, that are not a direct attribute of the security, should not be included in determining the valuation.

**Real Estate and Other Alternative Investments**

.15 Prior to FAS 157, fair value determined under FAS 35, FAS 87 and FAS 106 were based on market prices, if available, or could be estimated based on market prices for similar securities or a forecast of expected cash flows discounted at a risk-adjusted rate. Fair value calculated in accordance with FAS 157 may result in changes in fair value measurements. As discussed below, employers and plan management may need to reconsider the estimated fair value of illiquid investments, such as real estate and the other assets.

**Real Estate Investments**

.16 The level within the FAS 157 fair value hierarchy for real estate appraisals will vary by type of asset and based on the inputs used. For example, a multi-unit condominium development in which each unit has similar floor plans, features, and few differentiating characteristics, may be measured using an
appraisal based on a market approach that incorporates an observable dollar-per-square-foot multiple. As long as the multiple is observable and unadjusted, the valuation would represent a Level 2 fair value measurement.

However, the valuation of many real estate assets (e.g., office buildings, shopping centers, hospitals, manufacturing facilities, and similar build-to-suit facilities) requires that adjustments be made to market-based valuation inputs to reflect the different characteristics between the assets being measured and the assets on which the observable inputs are based. These adjustments could result in classification as a Level 3 fair value measurement. Real estate assets may also be measured using an income approach based on unobservable cash flows to be received from expected rents and expenses, which would likely also yield a Level 3 fair value measurement.

PwC Observation: In considering information from appraisals, the reporting entity should also ensure that the third-party valuation specialist appropriately evaluated and documented the highest and best use of the asset so that the fair value measurement requirements of FAS 157 are met.

Fund Investments

The net asset value (NAV) of an open-ended fund, whether a registered investment company fund, such as a mutual fund, or certain alternative investment funds, such as a hedge fund, serves as the basis for subscription and redemption transactions for investors in such funds. For investments in funds for which the underlying assets and liabilities are required to be measured at fair value, and where NAV is available, the NAV is generally the most appropriate starting point when determining the fair value measurement for an interest in such fund.

However, when valuing such an investment, the holder must estimate the fair value of the interest held, which at times may be different from a value based solely on the NAV of the fund. The holder should also consider various factors including, but not limited to, the attributes of the interest held, including any restrictions or illiquidity on the disposition of the interest, and the holders' requirements to understand and accept the valuations provided by the fund (or modify them if appropriate), to determine the fair value of the interest itself. Depending on the facts and circumstances, the NAV may need to be adjusted depending upon the rights and obligations of the ownership interest and/or other factors. Furthermore, any adjustments to NAV based on unobservable inputs may result in the fair value measurement being categorized as a Level 3 measurement, if those inputs are significant to the overall fair value measurement.

Open-ended Mutual Funds

An open-ended mutual fund may produce a daily NAV that is validated with a sufficient level of observable activity (i.e., purchases and sales at NAV) to support classification of the fair value measurement as Level 1 or Level 2 in the fair value hierarchy. In this case, the holder may determine that NAV represents the exit value of the security at the measurement date.

Alternative Investment Funds

Alternative investment funds are typically not traded on an exchange and the funds do not stand ready to redeem shares on a daily basis. Instead, depending on the nature and structure of the fund, there may be restrictions on liquidity and transferability that would impact the determination of fair value. Because of the restrictions associated with interests in alternative investment funds, there is generally no secondary market for trading interests in such funds. Instead, the fund’s NAV serves as the basis for the investor’s periodic (e.g., monthly or quarterly) subscription and redemption activity pursuant to the terms of the fund’s governing documents. In effect, the NAV serves as both the entry price (for subscriptions) and, depending on the facts and circumstances, the exit price (for redemptions).
To the extent that there is an adequate level of observable activity (i.e., subscriptions and redemptions at NAV) to support a determination that the NAV represents an exit value of the security at the measurement date, such activity may support classification of the fair value measurement as Level 2 or Level 3 in the fair value hierarchy. For various reasons, certain open-ended alternative investment funds may designate a portion of investor’s capital as not eligible for discretionary redemption (so called “side pocket accounts” or “designated accounts”). The portion of an investor's overall investment allocated to such accounts in an otherwise open-ended alternative investment fund, has characteristics similar to a private equity fund investment and, in certain respects, should be evaluated similarly for purposes of fair value measurements.

Private Equity Funds

Closed-end funds, such as most private equity and private real estate funds, do not have a liquidity feature to provide redemptions to investors. Accordingly, investors are “locked-in” and must wait until the fund can sell its investments in order to convert the investments into cash, which can then be distributed under the terms of the fund's governing documents.

In some situations, a transaction for an interest in a private equity fund may occur in the “secondary market,” whereby an investor purchases a limited partner’s existing interest and remaining commitment in a private equity fund. This often results from the seller’s need for liquidity, inability to fund future commitments, or desire to reduce its exposure to private equity. The seller may sell its investment to the buyer at a discount or, for various reasons, at a premium to the fund’s NAV.

Consequently, depending on the facts and circumstances, the sale or transfer price between the parties may or may not be indicative of fair value. Public closed-end funds, such as real estate investment trusts and closed-end mutual funds, generally have active secondary markets for their listed shares, which should serve as the basis for their valuation, as opposed to using the fund’s NAV.

PwC Observation: The value of some plan assets are estimated as of the plan’s measurement date based on financial information available as of an earlier date. This may occur, for example, because financial information related to the investment is not available timely. In these cases, the estimate is “trued-up” in the next beginning-of-year actuarial valuation. Typically, the difference between the estimated values and the fair value are not material. However, if there is a material difference between the estimate and the fair value, it may indicate an error in the prior year's end-of-year measurement, and should be assessed under FASB Statement No. 154, Accounting Changes and Error Corrections. See PwC DataLine 2007-09, Accounting for Pension and OPEB Measurements Using Rollforward Techniques for further discussion.

Other Investment Arrangements

There are certain investment arrangements common to plans such as investments in master trusts or separate (not pooled) accounts which may appear to operate as a fund vehicle, but the plan’s trust actually owns the underlying investments of the vehicle. For such arrangements, the fair value of the underlying investments would be the appropriate starting point when determining the fair value measurement. In these investments, employers and plan management need to carefully consider the terms of the investment arrangement to understand whether they have an interest in the underlying assets or in a pooled fund vehicle.

Insurance Contracts

FAS 87, paragraph 62, addresses the fair value of investment contracts with insurance companies as follows:

Insurance contracts that are in substance equivalent to the purchase of annuities shall be accounted for as such. Other contracts with insurance companies shall be accounted for as investments and measured at fair value. For some contracts, the best available evidence of fair
value may be contract value. If a contract has a determinable cash surrender value or conversion value, that is presumed to be its fair value.

.28 In accordance with this guidance, certain contracts with insurance companies that are held by pension plans should be accounted for at fair value. FAS 157 does not impact practicability exceptions to fair value measurements provided by other applicable GAAP. The guidance in paragraph 62 of FAS 87 allows a reporting entity, as a practical expedient, to use cash surrender value or conversion value for fair value when available. When measuring the fair value of these contracts, we believe that reporting entities should continue to follow the guidance in paragraph 62 of FAS 87. Paragraph 71 of FAS 106 contains a similar practical expedient.

.29 FAS 35, paragraph 12, requires plan financial statements to present insurance contracts in the same manner as the annual report filed by the plan with governmental agencies pursuant to ERISA, which can be either at fair value or at the amount determined by the insurance enterprise, i.e., the contract value.

.30 FSP SOP 94-4-1 discusses how defined contribution pension and health and welfare plans should report fully benefit-responsive investment contracts at fair value. However, contract value is the relevant measurement attribute for that portion of the net assets available for benefits of a defined-contribution plan attributable to fully benefit-responsive investment contracts.

Questions

.31 Clients of PricewaterhouseCoopers that have questions about this DataLine should contact their engagement partner. Engagement teams that have questions about FAS 157 should contact a member of the Financial Services / Financial Instruments team in the National Professional Services Group (973-236-7803). Engagement teams that have questions about pension accounting and disclosure should contact a member of the Compensation team in the National Professional Services Group (973-236-7802).
Introduction

In September 2006, the Financial Accounting Standards Board (FASB or the “Board”) issued FASB Statement No. 157, *Fair Value Measurements*, (the Statement or Statement 157). Statement 157 establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), clarifies the definition of *fair value* within that framework, and expands disclosures about the use of fair value measurements.

In many of its pronouncements, the FASB has previously concluded that fair value information is relevant to the users of financial statements and has required (or permitted) fair value as a measurement objective. However, prior to the issuance of this Statement, there was limited guidance for applying the fair value measurement objective in GAAP. Guidance was dispersed among the many pronouncements that required (or permitted) fair value measurements, and differences in guidance created inconsistencies in application that added to the complexity in GAAP. Statement 157 provides a framework that clarifies the fair value measurement objective within GAAP and its application under the various pronouncements that require (or permit) fair value measurements. The Statement is intended to increase consistency and comparability among fair value estimates used in financial reporting. As such, this Statement applies to all other accounting pronouncements that require (or permit) fair value measurements, except for the measurement of share-based payments. The Statement does not apply to accounting standards that require (or permit) measurements that are similar to, but not intended to represent, fair value.

This Statement does not require any new fair value measurements in GAAP. The Board has stated it will separately consider issues surrounding “what” to measure at fair value and “when” to measure items at fair value on a project-by-project basis. However, the Board will utilize the framework and the concepts that have been established in Statement 157 in making its future determinations regarding whether to require (or permit) the further use of fair value measurements in financial reporting.

Statement 157 incorporates and builds on existing guidance in Concepts Statement No. 7, *Using Cash Flow Information and Present Values in Accounting Measurements*, as well as accepted financial theory and valuation techniques. Nevertheless, the application of the Statement will result in a number of changes to current practices. Many of these changes stem from the revised definition of fair value and the application of this definition within the framework established by the Statement. Although the revised definition retains the exchange price notion of previous definitions, it clarifies a number of key considerations with respect to fair value as a measurement objective for financial reporting purposes. These clarifications include:
• Fair value is the price to sell an asset or transfer a liability and, therefore, represents an exit price, not an entry price.
• The exit price for an asset or liability is conceptually different from its transaction price (an entry price). While exit and entry price may be identical in many situations, the transaction price is no longer presumed to represent the fair value of an asset or liability on its initial recognition.
• Fair value is an exit price in the principal market (or, lacking a principal market, the most advantageous market) in which the reporting entity would transact.
• Fair value is a market-based measurement, not an entity specific measurement.
• Fair value measures should not be adjusted for transaction costs.

With respect to derivatives and other financial instruments, Statement 157 serves to nullify the existing guidance in paragraph 3 of EITF Issue 02-3, *Issues Involved in Accounting for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities*, as well as the similar guidance in FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*. In addition, the Statement affirms the FASB’s prohibition on the use of blockage factors for financial instruments traded in active markets, and extends this prohibition to broker-dealers and investment companies within the scope of the AICPA Audit and Accounting Guides for those industries.

Statement 157 clarifies that a fair value measurement for a liability should reflect the risk that the obligation will not be fulfilled (i.e., nonperformance risk). A reporting entity’s own credit risk is a component of the nonperformance risk associated with its obligations and, therefore, should be considered in all periods in which a liability is measured at fair value.

The Statement also clarifies that 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. This guidance is applicable for stocks with restrictions that determinate within one year and therefore serves to amend previous guidance in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*.

The Statement expands disclosures about the use of fair value to measure assets and liabilities and the effect of these measurements on earnings. Much of the disclosure is focused on the inputs used to measure fair value, particularly in instances where the measurement uses significant unobservable (Level 3) inputs. This disclosure attempts to give users of the financial statements the ability to assess the reliability of an entity’s fair value measurements.

Statement 157 is effective for fiscal years beginning after November 15, 2007 (i.e., effective January 1, 2008 for calendar year-end entities). Early adoption is allowed, provided that the reporting entity has not yet issued financial statements (including interim financial statements) for the fiscal year in which the Statement is adopted. The provisions of the Statement are to be applied prospectively as of the beginning of the fiscal year in which the Statement is initially applied, except as it pertains to a change in accounting principles related to (i) large positions previously accounted for using a block discount and (ii) financial instruments (including derivatives and hybrids) that were initially measured at fair value using the transaction price in accordance with guidance in footnote 3 of EITF 02-3 or similar guidance in FASB Statement 155. For these transactions, differences between the amounts recognized...
in the statement of financial position prior to the adoption of Statement 157 and the amounts recognized after adoption should be accounted for as a cumulative-effect adjustment to the opening balance of retained earnings for the fiscal year in which the Statement is initially applied.

This publication is organized by paragraph number of the Statement. The shaded sections of the publication are excerpted from the Statement verbatim. The Interpretive Guidance sections following the respective paragraphs summarize our understanding of the paragraph’s requirements. We anticipate issuing additional interpretative guidance on Statement 157 through our E&Y Financial Reporting Developments booklet, *Fair Value Measurements for Financial Reporting*.
### Scope

**Excerpt from Statement 157**

2. This Statement applies under other accounting pronouncements that require or permit fair value measurements, except as follows:

   a. This Statement does not apply under accounting pronouncements that address share-based payment transactions: FASB Statement No. 123 (revised 2004), *Share-Based Payment*, and its related interpretive accounting pronouncements that address share-based payment transactions.

   b. This Statement does not eliminate the practicability exceptions to fair value measurements in accounting pronouncements within the scope of this Statement.

3. This Statement does not apply under accounting pronouncements that require or permit measurements that are similar to fair value but that are not intended to measure fair value, including the following:

   a. Accounting pronouncements that permit measurements that are based on, or otherwise use, vendor-specific objective evidence of fair value.

   b. ARB No. 43, Chapter 4, “Inventory Pricing.”

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**2.1 Scope**

Statement 157 applies to all existing pronouncements under GAAP that require (or permit) the use of fair value, with the exception of FASB Statement No. 123(R), *Share Based Payment* (Statement 123(R)). While certain measurements in Statement 123(R) are conceptually fair value measures, certain share-based payment arrangements entered into with employees are recognized using *fair-value-based* measures. Although these fair-value-based measures may utilize valuation techniques similar to those used in fair value measures, the measurement objective required by Statement 123(R) for share-based payment transactions excludes the effects of: (a) service conditions, performance conditions, and other restrictions that apply only during the requisite service period; (b) reload features that may be included in the terms of the award; and (c) contingent features that may require the employee to return the equity instruments (or the realized gain from the sale of the equity instruments) at some point in the future. These conditions, restrictions, and features would be considered in a true fair value measurement. As such, the Board made a practical decision to exclude Statement 123(R), in its entirety, from the scope of the Statement.

Statement 157 does **not** require any additional fair value measures in financial reporting.

**2.2 Present Value Techniques**

Accounting conventions can differ in their use of present value techniques, and these techniques can be used for purposes other than estimating fair value. While many measurements determined using present value techniques are meant to represent fair value as defined in the Statement (e.g., receivables and payables accounted for under APB Opinion No. 21, *Interest on Receivables and Payables*), other measurements determined using present value techniques are not.
For example, the measurement object for an impaired loan accounted for under FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (Statement 114), is not meant to represent the fair value of the impaired loan, even though impairment is determined using present value techniques. Under Statement 114, a creditor is required to determine impairment based on the present value of the loan’s expected future cash flows discounted at the loan’s *effective* interest rate, not the *market rate* of interest, as would be required under a fair value measure. The effective interest rate of a loan is the rate of return implicit in the loan (i.e., the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the loan) and is used to determine impairment based only on a deterioration of credit quality rather than on changes in other current economic events. Therefore, the present value measurement required for an impaired loan under Statement 114 is conceptually different than that of a present value measurement meant to estimate fair value. However, the guidance in Statement 157 is still applicable as it relates to the practical expedient in Statement 114 that allows for an impaired loan to be measured at an observable market price or at the fair value of its collateral, if the loan is collateral dependent.

### 2.3 Practicability Exceptions

Certain accounting pronouncements within the scope of the Statement permit practicability exceptions to the use of fair value as a measurement objective in specified circumstances. Statement 157 does not eliminate the practicability exceptions in existing standards. The retention of these practicability exceptions will serve to limit the applicability of Statement 157 in certain situations and result in the continuation of some inconsistencies with respect to fair value measures. As discussed by the Board in paragraph 21 of the Basis for Conclusions of Statement 157 (Basis for Conclusions), the practicability exceptions fall primarily into the following categories:

1. The use of transaction price (an entry price) to measure fair value at initial recognition (e.g., FIN 45, *Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*).
2. An exception to the fair value requirement if it is not practicable to measure fair value (e.g., FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*).
3. An exception to the fair value requirement if fair value is not readily determinable (e.g., FASB Statement No. 143, *Accounting for Asset Retirement Obligations*).
4. An exception to the fair value requirement if fair value cannot be measured with sufficient reliability (e.g., FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*).

Certain existing pronouncements require the use of the transaction price as a practical expedient to measure the fair value of an asset or liability on initial recognition. For example, FIN 45 states that, for a guarantee issued in a standalone arm’s-length transaction with an unrelated party, the liability recognized at the inception of the guarantee should be the premium received or receivable by the guarantor. While Statement 157 clarifies that transaction price (an entry price) is no longer presumed to represent fair value at initial recognition (as will be discussed in more detail in section 17.1), the

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Footnote 2 of the Statement identifies existing pronouncements that permit a practicability exception to the use of fair value as a measurement objective.
Statement did not remove the practicability exceptions in the pronouncements that provide for the use of transaction price to measure fair value on initial recognition.

The exceptions related to practicability referred to in item 2 above are focused primarily on cost (i.e., whether excessive cost would be incurred in order for an entity to estimate fair value). This is a dynamic concept, and as such, the determination as to what is excessive may differ from one entity to another. The consideration of cost differs from the exceptions discussed in items 3 and 4 above, which focus primarily on the level of uncertainty in the measurement. In many instances, the pronouncements that allow for these exceptions defer the required use of fair value until such time that the level of uncertainty in the measurement is reduced to an acceptable level. While the individual pronouncements provide guidance as to when the exception should be applied, significant judgment is required in making this determination.

In the Basis for Conclusions, the Board clarifies that FASB Statement No. 141, Business Combinations, does not require the use of fair value as the measurement objective for a number of assets acquired and liabilities assumed in a business combination. The intention of the Board’s clarification was to remind constituents that while the measurement requirements for certain assets and liabilities acquired or assumed in a business combination (e.g., receivables, notes payables, plant and equipment to be used) may use similar concepts (i.e., present value techniques) to those used in fair value measures, fair value is not the measurement objective and, therefore, these measures are not subject to the guidance in Statement 157.

While the Board decided not to eliminate the practicability exceptions discussed above, it did clarify an important point with respect to the inclusion of a risk premium in the determination of a fair value measure. FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements (Concepts Statement 7), states that a fair value estimate should represent the price that market participants would demand for bearing risk and uncertainty, if the amount of a risk adjustment is identifiable, measurable, and significant. Statement 157 serves to elevate and in certain cases expand on the guidance in Concepts Statement 7. The Statement, unlike Concepts Statement 7, requires the inclusion of a risk adjustment in measuring fair value if a market participant would include one in pricing the asset or liability, even if the adjustment is difficult to determine. The exclusion of a risk premium when a market participant would assume one results in a measure that does not faithfully represent fair value and therefore the degree of difficulty in determining a risk adjustment is not a sufficient basis for its exclusion.

**Measurement**

**Excerpt from Statement 157**

5. Fair value is 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.

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2 Statement 157 includes its own undue cost and effort criteria with respect to the determination of market participant assumptions related to unobservable (Level 3) inputs. This concept is discussed in section 30.1 of this document.

3 Statement 141 does require certain assets and liabilities acquired in a business combination to be measured at fair value (e.g., intangible assets) and therefore is subject to the guidance in Statement 157.
5.1 Definition of Fair Value

The FASB decided that a singular definition of fair value is a fundamental requirement in the development of a framework for measuring fair value for financial reporting. As such, Statement 157 introduces a revised definition of fair value that replaces all existing definitions in GAAP, and is to be applied consistently across all applicable accounting guidance. While the definition in the Statement maintains the exchange price notion that existed in previous definitions of fair value in the accounting literature, this revised definition (and its application in the fair value framework) provides clarity on a number of key points, including the following:

- Fair value is the price to sell an asset or transfer a liability and therefore represents an exit price, not an entry price.
- The exit price for an asset or liability is conceptually different from its transaction price (an entry price). While exit and entry price may be identical in many situations, the transaction price is no longer presumed to represent the fair value of an asset or liability on its initial recognition.
- Fair value is the exit price in the principal market (or, if lacking a principal market, the most advantageous market) in which the reporting entity would transact. However, the price in the exit market should not be adjusted for transaction costs.
- Fair value is a market-based measurement, not an entity specific measurement, and as such is determined based on the assumptions that market participants would use in pricing the asset or liability.
- The transaction to sell the asset or transfer the liability is a hypothetical transaction as of the measurement date and assumes an appropriate period of exposure to the market, such that the transaction is considered orderly.

Instead of focusing solely on a definition, Statement 157 establishes a framework (or approach) meant to provide guidance with respect to how the revised definition of fair value should be applied in financial reporting. Many of the key concepts used in the fair value measurement framework are connected and their inter-relationships need to be considered in the context of the entire approach.

The following diagram (Diagram 1) summarizes our view regarding the interaction among the various components of the fair value approach as prescribed in the Statement.
The key concepts within the fair value approach are expanded upon in the Statement and are discussed further in the following sections of this document.

**The Asset or Liability**

**Excerpt from Statement 157**

6. A fair value measurement is for a particular asset or liability. Therefore, the measurement should consider attributes specific to the asset or liability, for example, the condition and/or location of the asset or liability and restrictions, if any, on the sale or use of the asset at the measurement date. The asset or liability might be a standalone asset or liability (for example, a financial instrument or an operating asset) or a group of assets and/or liabilities (for example, an asset group, a reporting unit, or a business). Whether the asset or liability is a standalone asset or liability or a group of assets and/or liabilities depends on its unit of account. The unit of account determines what is being measured by reference to the level at which the asset or liability is aggregated (or disaggregated) for purposes of applying other accounting pronouncements. The unit of account for the asset or liability should be determined in accordance with the provisions of other accounting pronouncements, except as provided in paragraph 27.
6.1 Attributes Specific to an Asset or Liability

The Statement clarifies that fair value is the price to sell an asset or transfer a liability. This clarification serves to distinguish the fair value of a particular asset or liability from the price to merely offset certain risks associated with the same asset or liability. This can be an important distinction, particularly in the valuation of certain financial instruments (e.g., derivatives) that are typically not “exited” through a sale or transfer.

In addition, the Statement clarifies that a fair value measurement should consider attributes that are specific to the asset or liability. For example, age and miles flown would be considered attributes of an aircraft that would need to be considered in determining a fair value measure for this asset.

6.2 Unit of Account

The unit of account serves to define what is being measured for financial reporting purposes. It is an accounting consideration that determines the level at which an asset or liability is aggregated or disaggregated for purposes of applying this Statement, as well as other accounting pronouncements. The specification of exactly what asset or liability is being measured, while basic, is fundamental to determining its fair value.

It can be easy to confuse the concept of “unit of account” with that of “valuation premise” because both concepts deal with determining the appropriate aggregation or disaggregation of assets and liabilities. However, to appropriately apply the Statement the distinction between these two concepts must be understood. Unit of account is an accounting consideration that, as it pertains to the application of Statement 157, primarily drives the level of aggregation (or disaggregation) for presentation and disclosure purposes (e.g., whether disclosure requirements are made at the individual asset level or for a group of assets). Valuation premise is a valuation consideration that determines how the asset or liability is measured (i.e., based on the value it derives on a standalone basis or the value it derives in conjunction with other assets and liabilities).

The distinction between these two concepts becomes clear in a situation where the unit of account for an asset differs from its valuation premise. For example, consider an asset, such as customized machinery, that was acquired outside of a business combination, along with other assets as part of an operating line. Although the unit of account for the customized machinery may be as a standalone asset (i.e., it is recorded for accounting purposes at the individual asset level), the determination of the value of the machinery is derived from use with other assets in the operating line.

Except for requiring financial instruments with quoted prices in active markets to be measured as individual instruments, Statement 157 does not prescribe the unit of account to be used for assets and liabilities required (or permitted) to be measured at fair value. Instead, the Statement notes that the unit of account should be determined in accordance with the provisions of other accounting pronouncements.

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4 The concept of valuation premise is discussed in more detail in section 12.1 Highest and Best Use.
The Price

Excerpt from Statement 157

7. A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale). 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 objective of a fair value measurement is to determine the price that would be received to sell the asset or paid to transfer the liability at the measurement date (an exit price).

7.1 Orderly Transaction

The concept of an orderly transaction in the definition of fair value is meant to distinguish a fair value measure from the exit price in a distressed sale or a forced liquidation, which would not represent fair value. As such, an orderly transaction assumes that the asset or liability is exposed to the market prior to the measurement date for a period that is usual and customary to allow for information dissemination and marketing.

The transaction to sell an asset or transfer a liability as of the measurement date is, by definition, a hypothetical transaction for the particular asset or liability being measured at fair value in that the transaction has not yet occurred. If the asset had actually been sold or the liability actually transferred as of the measurement date, there would be no asset or liability to measure at fair value. However, the concept of a hypothetical transaction is not meant to suggest that pricing information from actual transactions for identical or similar assets and liabilities, as of the measurement date, is not required to be considered in the determination of fair value. In fact, the Statement establishes a fair value hierarchy (discussed in section 22.1) to prioritize the inputs used to measure fair value based on the relative reliability of the inputs.

The concept of a hypothetical transaction clarifies that the transaction between market participants does not consider management’s intent to actually sell the asset or transfer the liability at the measurement date, and it does not consider the reporting entity’s ability to enter into the transaction on the measurement date. Consider a hypothetical transaction to sell a security that is restricted from sale as of the measurement date. While the restriction may impact the determination of a fair value amount for the asset or liability, it does not preclude the consideration of a hypothetical transaction to sell the restricted security.
The Principal (or Most Advantageous) Market

Excerpt from Statement 157

8. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The principal market is the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability. The most advantageous market is the market in which the reporting entity would sell the asset or transfer the liability with the price that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability, considering transaction costs in the respective market(s). In either case, the principal (or most advantageous) market (and thus, market participants) should be considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities. If there is a principal market for the asset or liability, the fair value measurement shall represent the price in that market (whether that price is directly observable or otherwise determined using a valuation technique), even if the price in a different market is potentially more advantageous at the measurement date.

9. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. Transaction costs represent the incremental direct costs to sell the asset or transfer the liability in the principal (or most advantageous) market for the asset or liability. Transaction costs are not an attribute of the asset or liability; rather, they are specific to the transaction and will differ depending on how the reporting entity transacts. However, transaction costs do not include the costs that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market. If location is an attribute of the asset or liability (as might be the case for a commodity), the price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall be adjusted for the costs, if any, that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market.

8.1 Principal Market

In addition to being an orderly transaction, a fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability. The Statement describes the principal market as the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity. The determination of the principal market (and as a result the market participants in the principal market) is made from the perspective of the reporting entity. This is an important clarification in the Statement in that it acknowledges that different reporting entities may sell assets or transfer liabilities in different markets depending on their activities. For example, a securities dealer may exit a financial instrument by selling in the inter-dealer market, while a manufacturing company would sell a financial instrument in the retail market. The term “would sell or transfer” in the description of the principal market is meant to imply that the reporting entity has access to the market in question. As such, it would not be appropriate for a manufacturing company to assume that it would transact in the inter-dealer market.
(even when considering a hypothetical transaction), because the company does not have access to this market.

The recognition in Statement 157 that different entities may sell identical instruments in different markets (and therefore at different exit prices) has important implications, particularly with respect to the initial recognition of certain financial instruments, such as derivatives. Under the framework established by the Statement, a “Day 1” gain recognized by a dealer on a derivative instrument would not imply that the retail counterparty to this transaction has an offsetting loss at initial recognition, as the dealer and the retail counterparty would exit the transaction in different principal markets and therefore at different exit prices (fair values).

### 8.2 Most Advantageous Market

The Statement specifies that if there is a principal market for the asset or liability being measured, the fair value measure for that asset or liability should represent the price in that market, even if the price in a different market is more advantageous at the measurement date. In other words, the most advantageous market concept is applied only in situations where the reporting entity determines there is no principal market for the asset or liability being measured.

The most advantageous market concept is based on the assumption that the goal of most entities is to maximize profits or net assets, which is an assumption that the Board concluded was reasonable and that embodies normal economic behavior. However, the Board agreed that prioritizing the principal market over the most advantageous market provided a more practical approach in that it would not require an entity to continuously assess prices across all possible markets to determine the most advantageous price for the asset or liability being measured. In addition, the Board stated its belief that the principal market generally represents the most advantageous market.

### 9.1 Transaction Costs

The Statement clarifies that the price in the principal (or most advantageous) market used to measure fair value should not be adjusted for transaction costs (i.e., commissions, certain due diligence costs, etc.). Transaction costs represent incremental direct costs to transact in the principal (or most advantageous) market and are not an attribute of the asset or liability being measured. Therefore, they should not be included in the fair value measurement of the asset or liability. Statement 157 does not provide any specific guidance as to when transaction costs should be recognized or where they should be reported, but simply states that these costs should be accounted for in accordance with the provisions of other accounting pronouncements.

Although transaction costs are not included in the fair value measure of an asset or liability, they should be considered when a reporting entity assesses its most advantageous market. The most advantageous market for an asset or liability is the market that maximizes the net amount that will be received for an asset or minimizes the net amount that will be paid to transfer a liability.

The following example from Appendix A of Statement 157 highlights how an entity would consider transaction costs in determining its most advantageous market.
Excerpt from Statement 157

Example:

A financial asset is traded on two different exchanges with different prices. The reporting entity transacts in both markets and has the ability to access the price in those markets for the asset at the measurement date. In Market A, the price that would be received is $26, and transaction costs in that market are $3 (the net amount that would be received is $23). In Market B, the price that would be received is $25, and transaction costs in that market are $1 (the net amount that would be received in Market B is $24).

The most advantageous market is the market in which the reporting entity would sell the asset with the price that maximizes the amount that would be received for the asset, considering transaction costs in the respective markets (that is, the net amount that would be received in the respective markets). Because the price in Market B adjusted for transaction costs would maximize the net amount that would be received for the asset ($24), the fair value of the asset would be measured using the price in that market ($25). Although transaction costs are considered in determining the most advantageous market, the price in that market used to measure the fair value of the asset is not adjusted for those costs.

9.2 Transportation Costs

The Statement clarifies that transportation costs are different than transaction costs in that they represent costs that would be incurred to transport an asset or liability to (or from) the principal (or most advantageous) market. If location is an attribute of the asset or liability being measured (as might be the case with a commodity), then the price in the principal (or most advantageous) market should be adjusted to include transportation costs. For example, consider an entity (Entity A) which holds a physical commodity measured at fair value in its warehouse in New York. The primary market in which entity A would sell this commodity is the London Exchange. The exchange price for the asset is $25, however the contracts traded on the exchange for this commodity require delivery in London. Assume that it would cost Entity A $5 to transport the physical commodity to London. Assume also that Entity A would pay a broker commission of $3 to transact on the exchange. The fair value of the physical commodity would be $20, the price in the principal market for the asset ($25) less transportation costs ($5). The $3 broker commission represents a transaction cost that would not adjust the price in the principal market.

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5 Extract from Example 6 in Appendix A of Statement 157.
Market Participants

Excerpt from Statement 157

10. Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that are:

   a. Independent of the reporting entity; that is, they are not related parties.
   b. Knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary.
   c. Able to transact for the asset or liability.
   d. Willing to transact for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so.

11. The fair value of the asset or liability shall be determined based on the assumptions that market participants would use in pricing the asset or liability. In developing those assumptions, the reporting entity need not identify specific market participants. Rather, the reporting entity should identify characteristics that distinguish market participants generally, considering factors specific to (a) the asset or liability, (b) the principal (or most advantageous) market for the asset or liability, and (c) market participants with whom the reporting entity would transact in that market.

10.1 Characteristics of Market Participants

The Statement defines market participants as the buyers and sellers of an asset or liability in the principal market. In determining potential market participants, certain characteristics should be considered, including the legal capability and the operating and/or financial capacity of an entity to purchase the subject asset or assume the subject liability. Market participants must have both the willingness and the ability to transact at fair value. For example, in the valuation of a reporting unit under FASB Statement No. 142, Goodwill and Other Intangible Assets, the market participants considered in the analysis should be in both a financial and operating position to purchase the subject reporting unit. Determining the characteristics of market participants within the principal (or most advantageous) market of the reporting entity requires significant judgment.

Market participants in the principal (or most advantageous) market should have the knowledge of the asset or liability necessary to appropriately benefit from the asset or cure the liability. The appropriate level of knowledge may not be obtainable solely from public observations, but could be obtained in the course of a normal due diligence process.

As previously noted, the principal (or most advantageous) market is determined from the perspective of the reporting entity (or operating unit within a reporting entity). As a result, other entities within the same industry in which the reporting entity operates will most likely be considered as market participants. However, market participants may be outside of the reporting entity’s industry, especially when considering the fair value of assets on a standalone basis. For instance, a residential real estate development entity may be considered a market participant in measuring the fair value of land held by
a manufacturing company, if the highest and best use\(^6\) of the land is deemed to be residential real estate development.

### 11.1 Market Participant Assumptions

Statement 157 specifies that fair value is not the value specific to one entity, but rather is meant to be a market-based measurement. If market participants would consider adjustments for the inherent risk of the asset or liability, or consider the risk in the valuation technique used to measure fair value, then such risk adjustments should be considered in the fair value assumptions.

Fair value is not the value specific to the reporting entity, and it is not the specific value to one market participant whose risk assessment may differ from other market participants. The reporting entity should consider those factors that market participants, in general, would consider. As such, individual market participants do not need to be identified, nor should fair value be measured by the specific intent or use of the asset or the underlying assumptions of a single market participant. For instance, if a single market participant, Market Participant A, is willing to pay a higher price for an asset than the remaining market participants due to specific synergies that only Market Participant A could achieve, fair value would not be measured as the price that Market Participant A would be willing to pay for the asset. Instead, fair value would be the price that the remaining market participants would pay for the asset.

The characteristics of market participants and the factors that market participants would consider determine the assumptions utilized in the measurement of fair value for the asset or liability. In situations where market observable data is not available, the reporting entity is allowed to use its own data as a basis for its assumptions in determining fair value. However, adjustments should be made to the entity’s own data if readily available market data indicates that market participant assumptions would differ from the assumptions specific to that reporting entity. (See section 30.1 on Level 3 inputs for further discussion of this point.)

The intended use and risk assumptions for an asset or asset group may differ among market participants transacting in the principal market for the asset. For example, the principal market in which the reporting entity would transact may contain both strategic and financial buyers. Both types of buyers may have the characteristics of a market participant; however, the value measurement of an asset may differ among these two types of market participants.

The following example from Appendix A of Statement 157 illustrates this point.

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\(^6\) The concept of highest and best use is discussed in section 12.1 of this document.
### Excerpt from Statement 157

**Example 7:**

The reporting entity, a strategic buyer, acquires a group of assets (Assets A, B, and C) in a business combination. Asset C is billing software developed by the acquired entity for its own use in conjunction with Assets A and B (related assets). The reporting entity measures the fair value of each of the assets individually, consistent with the specified unit of account for the assets. The reporting entity determines that each asset would provide maximum value to market participants principally through its use in combination with other assets as a group (highest and best use is in-use).

In this instance, the market in which the reporting entity would sell the assets is the market in which it initially acquired the assets (that is, the “entry” and “exit” markets from the perspective of the reporting entity are the same). Market participant buyers with whom the reporting entity would transact in that market have characteristics that are generally representative of both financial buyers and strategic buyers and include those buyers that initially bid for the assets. As discussed below, differences between the indicated fair values of the individual assets relate principally to the use of the assets by those market participants within different asset groups:

a. **Strategic buyer asset group.** The reporting entity, a strategic buyer, determines that strategic buyers have related assets that would enhance the value of the group within which the assets would be used (market participant synergies). Those assets include a substitute asset for Asset C (the billing software), which would be used for only a limited transition period and could not be sold standalone at the end of that period. Because strategic buyers have substitute assets, Asset C would not be used for its full remaining economic life. The indicated fair values of Assets A, B, and C within the strategic buyer asset group (reflecting the synergies resulting from the use of the assets within that group) are $360, $260, and $30, respectively. The indicated fair value of the assets as a group within the strategic buyer asset group is $650.

b. **Financial buyer asset group.** The reporting entity determines that financial buyers do not have related or substitute assets that would enhance the value of the group within which the assets would be used. Because financial buyers do not have substitute assets, Asset C (the billing software) would be used for its full remaining economic life. The indicated fair values of Assets A, B, and C within the financial buyer asset group are $300, $200, and $100, respectively. The indicated fair value of the assets as a group within the financial buyer asset group is $600.

The fair values of Assets A, B, and C would be determined based on the use of the assets as a group within the strategic buyer group ($360, $260, and $30). Although the use of the assets within the strategic buyer group does not maximize the fair value of each of the assets individually, it maximizes the fair value of the assets as a group ($650).

In the example above, there is a determination that the underlying assets would provide maximum value in the exit market through the use of the assets in combination with each other (the asset

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7 Example 1 in Appendix A of Statement 157.
grouping) and in combination with other assets held by market participants. In addition, it is determined that the principal market (the exit market) for the asset group includes both strategic and financial buyers. When there are two or more different types of market participants for the asset or the asset group, a separate fair value estimate of the assets should be performed for each type of market participant in order to identify which type should be considered in the fair value measurement.

To determine the appropriate market participants (and the appropriate related assumptions) within the exit market, a separate fair value measurement is prepared for each asset from the perspective of the two types of market participants (in the example, one from the standpoint of the strategic buyers, and the other from the standpoint of the financial buyers). In each of those analyses, the intended use of the asset and any resulting market participant synergies are considered. These include synergies among the assets in the asset grouping and synergies in combination with other assets held by the market participants. The selection of the appropriate market participants is based on the aggregate value measurement from the type of market participants that generates the maximum value for the asset group. In the example, this is the $650 value to the strategic asset buyers. Consequently, the fair value of the individual assets within the asset grouping would be estimated based on the indicated values related to the market participants with the highest overall value for the asset grouping. In other words, once the assets are appropriately grouped, they should be valued using a consistent set of assumptions (i.e., the assumptions for the same type of market participants and the same related use).

As shown in the example, this is true even though the value measurement of a specific asset, asset C in the example, is deemed to be higher for the financial buyer.

The above example highlights the interdependence of key concepts outlined in the Statement, which is also illustrated by Diagram 1 in section 5.1 of this document. The interrelated concepts are the iterative determination of the appropriate Market Participants (see sections 10.1 and 11.1), Valuation Premise (see sections 13.1 and 13.2), Highest and Best Use (see section 12.1) and Exit Market (see sections 8.0, 8.1 and 8.2).

In addition, the above example further highlights the difference between the unit of account and the asset grouping for valuation purposes. The unit of account, or what is being measured and presented for financial reporting purposes, is the individual assets (i.e., Asset A, separate from Asset B and Asset C). The asset grouping for valuation purposes, or the unit of valuation, which forms the basis of how the assets are to be valued, as a group or on a standalone basis, is the asset group comprised of Asset A, Asset B and Asset C.

The indicated value for the unit of valuation (or grouping of assets for valuation purposes) is determined by the premise of value and related market participant assumptions that maximize the value of the unit of valuation, (i.e., the strategic buyers in the above example). Once the indicated value for the unit of valuation is established, this value is then attributed to the asset or asset group based on their unit of account, resulting in the fair value measurement used for financial reporting purposes.
Application to Assets

Excerpt from Statement 157

12. A fair value measurement assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. In broad terms, highest and best use refers to the use of an asset by market participants that would maximize the value of the asset or the group of assets within which the asset would be used. Highest and best use is determined based on the use of the asset by market participants, even if the intended use of the asset by the reporting entity is different.

13. The highest and best use of the asset establishes the valuation premise used to measure the fair value of the asset. Specifically:

a. **In-use.** The highest and best use of the asset is in-use if the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (as installed or otherwise configured for use). For example, that might be the case for certain nonfinancial assets. If the highest and best use of the asset is in-use, the fair value of the asset shall be measured using an in-use valuation premise. When using an in-use valuation premise, the fair value of the asset is determined based on the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets as a group and that those assets would be available to market participants. Generally, assumptions about the highest and best use of the asset should be consistent for all of the assets of the group within which it would be used.

b. **In-exchange.** The highest and best use of the asset is in-exchange if the asset would provide maximum value to market participants principally on a standalone basis. For example, that might be the case for a financial asset. If the highest and best use of the asset is in-exchange, the fair value of the asset shall be measured using an in-exchange valuation premise. When using an in-exchange valuation premise, the fair value of the asset is determined based on the price that would be received in a current transaction to sell the asset standalone.

14. Because the highest and best use of the asset is determined based on its use by market participants, the fair value measurement considers the assumptions that market participants would use in pricing the asset, whether using an in-use or an in-exchange valuation premise.

12.1 Highest and Best Use

Highest and best use is a valuation concept that establishes the premise of value based upon the use of an asset by market participants that would maximize the benefit, or value, of the asset or the group of assets to market participants. The highest and best use of the asset will establish either an in-use premise of value or an in-exchange premise of value. If the asset provides the maximum benefit when used in combination with other assets, or as an asset group, then the premise is in-use. If the maximum benefit from the asset is on a standalone basis, then the premise is in-exchange. Whether the highest and best use of the asset or asset group is value in-exchange or value in-use, fair value is measured as the exit price in a hypothetical transaction.
The reporting entity’s intended use of the asset might not be the highest and best use of the asset. Statement 157 specifies that the intended use of the asset by the reporting entity should not determine the premise of value. Rather, Statement 157 stipulates that market participant assumptions regarding the maximum value of the asset should be used to determine the highest and best use of the asset or asset group. For example, land that is being used in connection with other operating assets (e.g., as a site for a manufacturing facility), but may have an alternative use that would maximize the benefit, or value, to the holder of the land (e.g., as a site for residential housing), may be valued at its alternative use. Even if the intended use of the asset or asset group by the reporting entity is the same as the highest and best use of the asset or asset group, the underlying assumptions used to value the asset should consider market participant assumptions, not entity-specific assumptions. Anticipated synergies from market participants should be considered in the determination of the highest and best use of an asset. Entity-specific synergies, if they would differ from market participant synergies, should not be considered in the determination of highest and best use.

Highest and best use of an asset or asset group should be determined based on market participants’ expectations of the highest and best use of the asset or group of assets. We would expect the reporting entity to consider alternative uses of an asset (e.g., land) in the analysis of fair value, but not necessarily all possible alternatives.

As noted earlier, there is an interdependence of several concepts within Statement 157. The highest and best use of an asset will determine its valuation premise (in-use versus in-exchange) and is often important to the identification of the appropriate market participants. On the other hand, the determination of the principal (or most advantageous) market (in which marketplace participants participate) can be important in determining the highest and best use of an asset. As such, while the analyses of the components to the fair value approach may be straightforward in many situations, in others, the process may need to be iterative to ensure that all of the concepts are consistently applied. For example, if there are multiple marketplace participants (as was the case in the example from section 11.1), several potential uses must be considered before selecting the highest and best use.

To further illustrate this point, consider the following example from Appendix A of Statement 157 that demonstrates how the determination of the highest and best use of an asset may require consideration of both value in-use and value in-exchange.
Excerpt from Statement 157

Example 8:

The reporting entity acquires land in a business combination. The land is currently developed for industrial use as a site for a manufacturing facility. The current use of land often is presumed to be its highest and best use. However, nearby sites have recently been developed for residential use as sites for high-rise condominiums. Based on that development and recent zoning and other changes to facilitate that development, the reporting entity determines that the land currently used as a site for a manufacturing facility could be developed as a site for residential use (for high-rise condominiums).

In this instance, the highest and best use of the land would be determined by comparing (a) the fair value of the manufacturing operation, which presumes that the land would continue to be used as currently developed for industrial use (in-use) and (b) the value of the land as a vacant site for residential use, considering the demolition and other costs necessary to convert the land to a vacant site (in-exchange). The highest and best use of the land would be determined based on the higher of those values.

In the above example, the reporting entity may intend to continue to use the land as part of the manufacturing operation and the highest and best use may be in that capacity. However, given the market conditions, the highest and best use of the land may be as a residential development. The reporting entity should consider both the value in-use and the value in-exchange to determine which premise of value for the asset establishes the maximum benefit to the holder of the asset.

Generally, assets in an asset group will all be valued using the same premise of value. For example, if the fair value of a piece of machinery on a manufacturing line is measured based on a value in-use premise, the other assets in the asset group (i.e. the other equipment on the manufacturing line) would most likely be valued using a value in-use premise.

13.1 In Use

The maximum value of an asset or group of assets to market participants may be through the use of the asset in combination with other assets in the asset group. Under this scenario, the highest and best use of the asset would be “in-use” and an in-use valuation premise would be used to value the asset or asset group. To illustrative, assume that the manufacturing facility in the above example included machinery that was customized and installed as part of an operating line. In this case, a fair value measurement under the in-use premise should take into consideration the customization and installation of the asset or asset group and incorporate the value of these attributes. Market participant assumptions should be applied as inputs to the valuation technique in the fair value analysis.

13.2 In Exchange

Where the maximum value of an asset is on a standalone basis, the highest and best use of the asset is “in-exchange”, and an in-exchange premise would be used to value the asset.

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8 Example 2 from Appendix A of Statement 157.
Under an in-exchange valuation premise, the exit price of the asset if sold on a standalone basis establishes the fair value of the asset. Consideration should be given to the attributes of the asset in its current state compared to the attributes required of the asset in order for the asset to be sold on a standalone basis. For example, if land that is developed for a manufacturing facility is to be valued under the premise of value in-exchange, the cost of clearing the land should be considered in the fair value measurement.

When the valuation premise of one asset in an asset group is valued under an in-exchange premise, consideration to this premise of value should be given in the valuation of the other assets in the group. If, in the above example from Appendix A, the land was valued using an in-exchange valuation premise for alternative development, the fair value of the equipment in the manufacturing facility would not equal the fair value in-use at the current facility. As a result, the equipment could be valued under two alternative valuation premises: (1) in-exchange (i.e. the value of the equipment sold on a standalone basis) or (2) in-use at an alternative facility. In addition, the cost of the redeployment of the equipment at the new facility, such as cost for disassembling, transporting, and re-installing the equipment, would need to be considered in determining the fair value measure.

**Application to Liabilities**

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<th>Excerpt from Statement 157</th>
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<td>15. A fair value measurement assumes that the liability is transferred to a market participant at the measurement date (the liability to the counterparty continues; it is not settled) and that the nonperformance risk relating to that liability is the same before and after its transfer. Nonperformance risk refers to the risk that the obligation will not be fulfilled and affects the value at which the liability is transferred. Therefore, the fair value of the liability shall reflect the nonperformance risk relating to that liability. Nonperformance risk includes but may not be limited to the reporting entity’s own credit risk. The reporting entity shall 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. That effect may differ depending on the liability, for example, whether the liability is an obligation to deliver cash (a financial liability) or an obligation to deliver goods or services (a nonfinancial liability), and the terms of credit enhancements related to the liability, if any.</td>
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**15.1 Nonperformance Risk**

Statement 157 elevates and expands the guidance in Concepts Statement 7 with respect to the consideration of an entity’s own credit standing in the fair value measurement of a liability. Statement 157 requires that the fair value of a liability include the nonperformance risk related to the liability being measured. Nonperformance risk refers to the risk that an obligation will not be fulfilled and conceptually represents a broader risk than the entity’s credit risk. While nonperformance risk would include a reporting entity’s credit risk, it may also include other risks such as settlement risk. In the case of non-financial instruments, such as commodities, this could relate to the risk associated with physically extracting and transferring the asset to the point of delivery.

Statement 157 clarifies that for a liability, a fair value measurement assumes that the liability is transferred to a market participant at the measurement date and that the nonperformance risk relating to
that liability is the same before and after its transfer. This implies that the liability is transferred to a market participant of comparable credit standing that would similarly perform (or similarly bear the consequences of not performing) and that the liability to the counterparty continues and is not settled. The clarification that the measurement of a liability at fair value is not based on the price to settle the liability, but rather to transfer it to a market participant of comparable credit standing will have an impact on the assumptions made with respect to the principal (or most advantageous) market for the liability, and the market participants in the exit market. (While IAS 39, Financial Instruments: Recognition and Measurements, has a similar requirement to consider the credit risk related to a liability when measuring it at fair value; the measurement in IFRS is based on the value at which the liability could be settled or repurchased, not transferred. It is currently unclear how this difference could impact the valuation of liabilities at fair value under U.S. GAAP vs. IFRS.)

15.2 Impact of Own Credit Risk on the Fair Value of a Liability

The consideration of a reporting entity’s own credit in the fair value measurement of a liability will represent a change in practice for many that could impact financial results in a way that some may find counterintuitive. An entity that experiences a credit deterioration would recognize an accounting gain on a liability measured at fair value, assuming all other inputs to the valuation remain unchanged. (Alternatively, a reporting entity would recognize an accounting loss if its credit improved.) During the exposure and redeliberation process for this Statement, many constituents expressed concerns about the recognition of an accounting gain when an entity experiences a deterioration in credit, particularly in situations in which the reporting entity is experiencing financial difficulty and may not have the ability to realize these gains. Although certain Board members shared these concerns, the FASB ultimately concluded that these concerns relate to the consideration of whether fair value is an appropriate measure for liabilities in certain situations, not what the fair value measure of a liability should represent. As such, the Board will continue to consider the most appropriate remeasurement objective for liabilities on a project-by-project basis.

As previously noted, the consideration of nonperformance risk in the subsequent measurement of a liability at fair value will be a new concept for many. As such, it is important to clarify that the fair value of a liability is affected not only by a change in the reporting entity’s credit rating (i.e., the entity experiences a downgrade), but also by changes in credit spreads over time. The following example from Appendix A of Statement 157 is meant to highlight how the fair value measurement of a liability can be affected by changes in the reporting entity’s credit standing.

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9 IAS 39 defines *fair value* as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.
Excerpt from Statement 157

Example 10:

On January 1, 2007, Entity A, an investment bank with a AA credit rating, issues a five-year fixed rate note to Entity B. The contractual principal amount to be paid by Entity A at maturity is linked to the S&P 500 index. No credit enhancements are issued in conjunction with or otherwise related to the contract (that is, no collateral is posted and there is no third-party guarantee). Entity A elects to account for the entire note at fair value in accordance with FASB Statement No. 155, Accounting for Certain Hybrid Financial Instruments. The fair value of the note (the obligation of Entity A) during 2007 is measured using an expected present value technique. Changes in fair value are discussed below.

a. Fair value at January 1, 2007. The expected cash flows used in the expected present value technique are discounted at the risk-free rate (using the treasury yield curve at January 1, 2007), plus the current market observable AA corporate bond spread to treasuries adjusted (up or down) for Entity A’s specific credit risk (credit-adjusted risk-free rate). Therefore, the fair value of the obligation of Entity A at initial recognition considers nonperformance risk, including that entity’s credit risk (presumably, reflected in the proceeds).

b. Fair value at March 31, 2007. During March 2007, the credit spread for AA corporate bonds widens, with no changes to the specific credit risk of Entity A. The expected cash flows used in the expected present value technique are discounted at the risk-free rate (using the treasury yield curve at March 31, 2007), plus the current market observable AA corporate bond spread to treasuries, adjusted for Entity A’s specific credit risk (credit-adjusted risk-free rate). Entity A’s specific credit risk is unchanged from initial recognition. Therefore, the fair value of the obligation of Entity A changes due to changes in credit spreads generally. Changes in credit spreads reflect current market participant assumptions about changes in nonperformance risk generally.

c. Fair value at June 30, 2007. As of June 30, 2007, there have been no changes to the AA corporate bond spreads. However, based on structured note issuances corroborated with other qualitative information, Entity A determines that its own specific credit worthiness has strengthened within the AA credit spread. The expected cash flows used in the expected present value technique are discounted at the risk-free rate (using the treasury yield curve at June 30, 2007), plus the current market observable AA corporate bond spread to treasuries (unchanged from March 31, 2007), adjusted for Entity A’s specific credit risk (credit-adjusted risk-free rate). Therefore, the fair value of the obligation of Entity A changes due to the change in its own specific credit risk within the AA corporate bond spread.

As the example above illustrates, even though Entity A remains a AA rated credit throughout both the subsequent measurement periods considered (i.e., March 31 and June 30), the fair value measure of the liability (i.e., the structured note) in both periods must consider Entity A’s specific credit standing as well as credit spreads generally.

Example 10 from Appendix A of Statement 157.
Fair Value at Initial Recognition

Excerpt from Statement 157

16. When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price represents the price paid to acquire the asset or received to assume the liability (an entry price). In contrast, the fair value of the asset or liability represents the price that would be received to sell the asset or paid to transfer the liability (an exit price). Conceptually, entry prices and exit prices are different. Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them.

17. In many cases, the transaction price will equal the exit price and, therefore, represent the fair value of the asset or liability at initial recognition. In determining whether a transaction price represents the fair value of the asset or liability at initial recognition, the reporting entity shall consider factors specific to the transaction and the asset or liability. For example, a transaction price might not represent the fair value of an asset or liability at initial recognition if:

a. The transaction is between related parties.

b. The transaction occurs under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.

c. The unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value. For example, that might be the case if the asset or liability measured at fair value is only one of the elements in the transaction, the transaction includes unstated rights and privileges that should be separately measured, or the transaction price includes transaction costs.

d. The market in which the transaction occurs is different from the market in which the reporting entity would sell the asset or transfer the liability, that is, the principal or most advantageous market. For example, those markets might be different if the reporting entity is a securities dealer that transacts in different markets, depending on whether the counterparty is a retail customer (retail market) or another securities dealer (inter-dealer market).

16.1 Exit Price vs. Entry Price

As previously discussed, Statement 157 defines fair value as the price to sell an asset or transfer a liability – an exit price. A transaction price represents the price paid to acquire an asset or received to assume a liability, and is, by definition, an entry price. Conceptually, an exit price is different from an entry price as entities do not necessarily sell assets (or transfer liabilities) at the prices paid to acquire (or assume) them. The Board’s recognition and articulation of this distinction in Statement 157 is significant and has important implications on the initial recognition of assets and liabilities at fair value.
17.1 Transaction Price not Equal to Fair Value at Initial Recognition

Prior to the issuance of Statement 157, there was a presumption in GAAP that the transaction price represented the fair value of an asset or liability on its initial recognition. While this presumption could be rebutted, it required an entity to obtain persuasive evidence (e.g., observable market data) that the transaction price was not representative of fair value at initial recognition. Statement 157 acknowledges that in many situations transaction price will equal exit price and, therefore, represent fair value at initial recognition, but it does not presume this to be the case.

The Statement provides certain factors that the reporting entity should consider in determining whether transaction price represents the fair value of an asset or liability at initial recognition. For example, transaction price may not represent fair value in a situation where the unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value. This may be the case with a complex financial instrument where the transaction price includes a fee for structuring the transaction. Another factor to consider is whether the market in which the reporting entity acquired the asset (or assumed the liability) is different from the principal (or most advantageous) market in which the entity will dispose of the asset (or transfer the liability). For example, a securities dealer may acquire an asset in the retail market, but dispose of it in the inter-dealer market.

17.2 Day 1 Gains and Losses

The clarification in Statement 157 that transaction price is not presumed to represent fair value required the Board to reconsider existing guidance on fair value measurements at initial recognition. EITF 02-3 required derivative instruments to be initially recognized at their transaction prices (thereby prohibiting the recognition of any Day 1 gains or losses) unless the fair value of the derivative was based on observable market inputs. Statement 155 imposed a similar restriction on the recognition of Day 1 gains or losses related to hybrid instruments. Statement 157 nullifies the guidance with respect to the recognition of Day 1 gains and losses in EITF 02-3 footnote 3 and amends FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, to remove similar guidance prohibiting the recognition of Day 1 gains and losses that had been added by Statement 155.

As a result, the Statement allows for the recognition of Day 1 gains and losses in situations where the transaction price is not deemed to represent the fair value of the asset acquired or liability assumed at initial recognition. Statement 157 does not impose any reliability threshold, thereby allowing for the recognition of Day 1 gains and losses on instruments measured at fair value using valuation models that utilize unobservable (Level 3) inputs. While the statement requires that the valuation techniques used to measure fair value (such as a pricing model) maximize the use of observable inputs and minimize the use of unobservable inputs, unobservable inputs will be used to measure fair value in situations where there is little or no market activity for the asset or liability at the measurement date. The Statement is very clear, however, that in these situations the objective of the fair value measure remains the same – an exit price from the perspective of a market participant that holds the asset or

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11 Refer to paragraphs 7 and 27 in Concepts Statement No. 7 and footnote 3 in EITF 02-3.
12 As discussed in section 2.3 Practicability Exceptions, the transaction price presumption is still assumed under certain accounting pronouncements, such as FIN 45.
13 Level 3 inputs are discussed in section 30.1 of this document.
owes the liability. As such, an entity should not necessarily assume that its model value represents fair value, but should consider whether this value incorporates all the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk (i.e., any risk premium that market participants would require given the inherent risk in the pricing model and/or the unobservability of the inputs used in the pricing model). In certain cases an adjustment to the model value may be required to appropriately capture market participant assumptions regarding the fair value of the asset or liability.

**Valuation Techniques**

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<tr>
<th>Excerpt from Statement 157</th>
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<tr>
<td>18. Valuation techniques consistent with the market approach, income approach, and/or cost approach shall be used to measure fair value. Key aspects of those approaches are summarized below:</td>
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<tr>
<td>19. Valuation techniques that are appropriate in the circumstances and for which sufficient data are available shall be used to measure fair value. In some cases, a single valuation technique will</td>
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</table>
be appropriate (for example, when valuing an asset or liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate (for example, as might be the case when valuing a reporting unit). If multiple valuation techniques are used to measure fair value, the results (respective indications of fair value) shall be evaluated and weighted, as appropriate, considering the reasonableness of the range indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

20. Valuation techniques used to measure fair value shall be consistently applied. However, a change in a valuation technique or its application (for example, a change in its weighting when multiple valuation techniques are used) is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. That might be the case if, for example, new markets develop, new information becomes available, information previously used is no longer available, or valuation techniques improve. Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate (FASB Statement No. 154, Accounting Changes and Error Corrections, paragraph 19). The disclosure provisions of Statement 154 for a change in accounting estimate are not required for revisions resulting from a change in a valuation technique or its application.

18.1 Valuation Techniques

Statement 157 recognizes three valuation techniques to measure fair value: the market approach, income approach, and cost approach. The three approaches described in the Statement are consistent with generally accepted valuation methodologies utilized outside financial reporting.

All three approaches may not be applicable to all assets or liabilities. The reporting entity should measure the fair value of an asset or liability using one or more valuation techniques where appropriate and for which adequate data is available. It should be noted that the fair value hierarchy does not prioritize the valuation techniques to be applied, but rather presents a hierarchy on the inputs used in the application of the valuation techniques. The selection of the valuation method(s) to apply should consider the exit market for the asset or liability and the nature of the asset or liability being valued. The determination of the appropriate technique to be applied requires significant judgment, sufficient knowledge of the asset or liability, and a level of expertise regarding the valuation techniques.

Specific methodologies may differ within the application of each approach. For instance, there are a number of different methodologies within the income approach that may be utilized to value intangible assets, including the multi-period excess earnings method or a relief-from-royalty method as two examples. Valuation professionals who are familiar with the nuances of each valuation methodology should evaluate the appropriateness of the methodologies to be applied in the fair value measurement using their expertise and judgment.

19.1 Reconciliation of Valuation Techniques

As indicated by the Statement, in certain cases, the use of only one valuation technique may be appropriate in measuring the fair value of an asset or liability. This is especially true when the asset or liability is valued using an unadjusted quoted market price from an active market (i.e., Level 1 inputs). However, in many situations more than one valuation technique may be deemed appropriate and
therefore multiple approaches should be applied. In these cases, the results of the each of the multiple techniques must be evaluated in order to determine the fair value of the asset or liability.

Similar to the selection of the valuation techniques, the evaluation of the techniques applied in the analysis requires significant judgment. The merits of each valuation technique applied and the underlying assumptions embedded in each of the techniques should be considered in evaluating and assessing the results of multiple valuation techniques.

Items that may be considered in the evaluation of the valuation techniques include:

- One valuation technique may be more representative of fair value than the other technique(s).
- Inputs utilized for one valuation technique may be more readily observed in the market place or require fewer adjustments.
- The resulting range from one valuation technique may be narrower than the results from other valuation techniques.

Selection, application and reconciliation of the valuation techniques can be complex. The reporting entity should consider the use of a valuation professional to assist in fair value measurements.

20.1 Consistent Methodology

The Board has emphasized that the application of valuation techniques be applied on a consistent basis, among similar assets as well as across reporting periods. However, when a change in the valuation technique (or the change in the relative importance of one technique versus another) results in a more representative fair value measurement, such changes should be implemented.

Some circumstances that may trigger a change in the valuation technique or weighting of valuation techniques include changes in:

- The available or observable market data.
- The exit market for the asset or liability.
- The market participants for the assets or liabilities.
- The highest and best use of the asset.

A change in valuation techniques or the weighting of valuation techniques should be accounted for as a change in an accounting estimate. However, in situations where there was an error in the application of a valuation technique, the change to the correct application of the technique would be accounted for as the correction of an error in accordance with Statement No. 154, Accounting Changes and Error Corrections.
Inputs to Valuation Techniques

Excerpt from Statement 157

21. In this Statement, inputs refer broadly to the assumptions that market participants would use in pricing the asset or liability, including 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. Inputs may be observable or unobservable:

a. Observable inputs are inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity.

b. Unobservable inputs are inputs that reflect the reporting entity’s own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

Valuation techniques used to measure fair value shall maximize the use of observable inputs and minimize the use of unobservable inputs.

21.1 Inputs to Valuation Techniques

The inputs used in determining fair value measures may be observable or unobservable, but they should always attempt to reflect the assumptions that market participants would use in pricing the asset or liability. As such, the term unobservable input is not meant to imply entity-specific assumptions. Although unobservable inputs may be developed using the reporting entity’s own data, these inputs should reflect the reporting entity’s own assumptions about the assumptions market participants would use in pricing the asset or liability. For example, in valuing an intangible asset using unobservable inputs, the assumptions that would be considered by market participants (and therefore the inputs to the valuation technique) should take into account the intended use of the asset by market participants, which could differ from the intended use specific to the reporting entity. In instances where a reporting entity determines that market participant assumptions are consistent with its own assumptions, the entity’s own data would not need to be adjusted.

The Statement clarifies that the term “input” is meant to refer broadly to the assumptions that market participants would use in pricing the asset or liability, as opposed to the more narrow consideration of only actual data entered into a pricing model. This distinction is important because it indicates that adjustments to a model value (e.g., an adjustment for the risk that a pricing model might not replicate a market price considering the complexity of the instrument being measured) represents an input that needs to be evaluated in determining where within the fair value hierarchy a fair value measure falls. For example, when measuring a financial instrument, an adjustment for model risk would be considered an input (most likely a Level 3 input) that if deemed significant14 may render the entire fair value measure a Level 3 measurement.

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14 See discussion on the significance of inputs in section 23.2 below.
Fair Value Hierarchy

Excerpt from Statement 157

22. 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 in different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is significant to the fair value measurement in its entirety. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset or liability.

23. The availability of inputs relevant to the asset or liability and the relative reliability of the inputs might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques. For example, a fair value measurement using a present value technique might fall within Level 2 or Level 3, depending on the inputs that are significant to the measurement in its entirety and the level in the fair value hierarchy within which those inputs fall.

22.1 Fair Value Hierarchy

Statement 157 establishes a fair value hierarchy that prioritizes the use of inputs used in valuation techniques into the following three levels:

1. Level 1 – observable prices in active markets for identical assets and liabilities.
2. Level 2 – observable inputs other than quoted prices in active markets for identical assets and liabilities.
3. Level 3 – unobservable inputs.

The fair value hierarchy is intended to increase consistency and comparability among fair value measures, but also plays a critical role in disclosure where it serves to provide users with a construct for considering the relative reliability of various fair value measurements made by the reporting entity.

23.1 Valuation Techniques

The fair value hierarchy focuses on prioritizing the inputs used in valuation techniques, not the techniques themselves. While the availability of inputs might affect the valuation technique(s) selected to measure fair value, the Statement does not prioritize the use of one technique over another. The determination of the valuation technique(s) to be used requires significant judgment and will be dependent on the specific characteristics of the asset or liability being measured, and the principal (or most advantageous) market in which market participants would transact for the asset or liability. The Statement focuses on the use of all valuation techniques that are appropriate in the circumstances (and for which sufficient data is available), not on determining the preferred technique.
Although the valuation techniques themselves are not subject to the fair value hierarchy, a risk adjustment that market participants would demand for a risk inherent in a particular valuation technique (e.g., a model adjustment) would be considered an input and, therefore, that adjustment would be assessed and classified within the fair value hierarchy. (This concept is discussed in section 21.1 Inputs to Valuation Techniques.)

### 23.2 Significance of Inputs

Statement 157 distinguishes between where in the fair value hierarchy an individual input to a valuation technique may fall as compared to where in the hierarchy the entire measurement should be classified for disclosure purposes. Often an asset or liability that is not traded in an active market with a quoted price will require more than one input to determine its fair value. For example, an OTC equity option measured at fair value using an option pricing model requires the following market-based inputs: (i) expected volatility, (ii) expected dividend yield, and (iii) the risk-free rate of interest. The Statement clarifies that the determination of where in the hierarchy a fair value measurement in its entirety (i.e., the fair value measure for the asset or liability or the group of assets and/or liability depending on the unit account) falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety. In the OTC equity option example, assume that the risk-free interest rate and the dividend yield were determined to be Level 2 inputs, but the expected volatility was determined to be a Level 3 input (as might be the case with a long-dated option). In this case, as volatility would typically be significant to the overall value of the option, the entire measurement would be classified as Level 3.

Statement 157 does not provide any guidance on how an entity should assess or determine the significance of individual inputs. This determination will require significant judgment and consideration of factors specific to the asset or liability (or group of assets and/or liabilities). However, the requirement that the determination of significance should be based on the “fair value measurement in its entirety” would imply that significance be considered from a balance sheet perspective and not an income statement perspective (e.g., significance would not be determined in relation to Day 1 profit or loss but rather the instrument’s fair value).
## Level 1 Inputs

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<tr>
<th>Excerpt from Statement 157</th>
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<tbody>
<tr>
<td>24. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An active market for the asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available, except as discussed in paragraphs 25 and 26.</td>
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<tr>
<td>25. If the reporting entity holds a large number of similar assets or liabilities (for example, debt securities) that are required to be measured at fair value, a quoted price in an active market might be available but not readily accessible for each of those assets or liabilities individually. In that case, fair value may be measured using an alternative pricing method that does not rely exclusively on quoted prices (for example, matrix pricing) as a practical expedient. However, the use of an alternative pricing method renders the fair value measurement a lower level measurement.</td>
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<tr>
<td>26. In some situations, a quoted price in an active market might not represent fair value at the measurement date. That might be the case if, for example, significant events (principal-to-principal transactions, brokered trades, or announcements) occur after the close of a market but before the measurement date. The reporting entity should establish and consistently apply a policy for identifying those events that might affect fair value measurements. However, if the quoted price is adjusted for new information, the adjustment renders the fair value measurement a lower level measurement.</td>
</tr>
<tr>
<td>27. If the reporting entity holds a position in a single financial instrument (including a block) and the instrument is traded in an active market, the fair value of the position shall be measured within Level 1 as the product of the quoted price for the individual instrument times the quantity held. The quoted price shall not be adjusted because of the size of the position relative to trading volume (blockage factor). The use of a blockage factor is prohibited, even if a market’s normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.</td>
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</table>

### 24.1 Use of Level 1 Inputs

As a general principle, Statement 157 mandates the use of quoted prices in active markets for identical assets and liabilities whenever available. Exceptions to this principle are highlighted in paragraphs 25 and 26 of the Statement.

Quoted prices in active markets should not be adjusted when determining the fair value of assets and liabilities that are identical to those for which the quotes pertain, as the Board believes these prices provide the most reliable evidence of fair value.
25.1 Alternate Pricing Methods

There are situations where an entity holds a large number of similar assets and liabilities for which quoted prices exist, but these quoted prices are not easily accessible for each individual asset and liability. In this specific situation, the Statement does allow for the use of alternative pricing methods (e.g., matrix pricing) that do not rely exclusively on quoted prices, as a practical expedient to ease the administrative burden associated with obtaining quoted prices for each individual instrument. However, if an entity elects to use an alternative pricing method as a practical expedient, the fair value measurement determined under this method would not be considered a Level 1 measurement.

26.1 Quoted Prices that are Not Representative of Fair Value

The overriding principle in Statement 157 requiring the use of quoted prices in active markets whenever available was not meant to conflict with guidance issued by the SEC in Accounting Series Release No. 118, which requires the consideration of whether market quotes are readily available and representative of fair value. The Board clarified this point in the Basis for Conclusions (paragraph C68).

Statement 157 recognizes that, in certain situations (primarily related to significant events which occur on the measurement date but after the close of trading), a quoted price in an active market might not faithfully represent the fair value of an asset or liability at the measurement. In these situations, the Statement allows for an adjustment to the quoted price such that the fair value measure reflects this new information. However, if an adjustment is made to the quoted price, the fair value measurement would not be considered a Level 1 measurement.

An entity’s valuation policies and procedures should address how these “after hour” events will be identified. In addition, controls should be put in place to ensure that any adjustments to quoted prices are in accordance with the guidance in the Statement and applied in a consistent manner.

27.1 Block Discounts

Statement 157 affirms the FASB’s prohibition on the use of blockage factors for financial instruments traded in active markets (as per FASB Statements 107 and 133) and serves to extend the prohibition to broker-dealers and investment companies within the scope of the AICPA Audit and Accounting Guides for those industries. As such, it is no longer appropriate for an entity to record an adjustment for concentration risk related to a large position in a financial instrument that trades in an active market (Level 1), even if the entity’s position exceeds the market’s normal daily trading volume.

The Board stated its belief that adjusting the quoted price in an active market for the size of a position introduces management’s intent (i.e., the intent to trade in blocks) into fair value measurement, thereby reducing comparability. The Board concluded that the decision to exchange a large position in a single transaction, at a discount (or premium) to the quoted price for an individual trading unit, is a decision whose consequences should be reported at the time the decision is executed.
Level 2 Inputs

Excerpt from Statement 157

28. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

   a. Quoted prices for similar assets or liabilities in active markets
   b. Quoted prices for identical or similar assets or liabilities in markets that are not active, that is, markets in which there are few transactions for the asset or liability, the prices are not current, or price quotations vary substantially either over time or among market makers (for example, some brokered markets), or in which little information is released publicly (for example, a principal-to-principal market)
   c. Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates)
   d. Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).

29. Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition and/or location of the asset or liability, the extent to which the inputs relate to items that are comparable to the asset or liability, and the volume and level of activity in the markets within which the inputs are observed. An adjustment that is significant to the fair value measurement in its entirety might render the measurement a Level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall.

28.1 Level 2 Inputs

Level 2 inputs include quoted prices (in inactive markets or in active markets for similar assets or liabilities), inputs other than quoted prices that are observable, and inputs that are not directly observable, but that are corroborated by observable market data.

The concept of market-corroborated inputs is significant in that it expands Level 2 of the fair hierarchy beyond inputs that are directly observable for the asset or liability. Inputs that are determined through mathematical or statistical techniques such as extrapolation, correlation, or regression may be categorized as Level 2 if the inputs to and/or the results from these techniques can be corroborated with observable market data. The Statement requires that a Level 2 input be observable (either directly or indirectly through corroboration with market data) for substantially the full contractual term of the asset or liability being measured. Therefore, extrapolating long term inputs from short term observable market data (e.g., extrapolating the 20 year point on a yield curve based on the observable 5, 10 and 15 year points) would not represent a Level 2 input.
29.1 Adjustments to Level 2 Inputs

Given the nature of Level 2 inputs, in many circumstances it may be appropriate for an entity to make adjustments to these inputs. For example, it may be appropriate for an entity to make an adjustment to a quoted price from an inactive market to account for the risk associated with the illiquidity of that market. Similarly, an entity would adjust the quoted price from an active market for a similar asset to account for any differences between the asset to which the quote relates and the actual asset being measured at fair value. If the adjustment is significant to the fair value measurement in its entirety and is based on unobservable data, the entire measurement would be considered a Level 3 input.

Level 3 Inputs

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<tr>
<td>30. Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs shall be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs shall reflect the reporting entity’s own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity’s own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity’s own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.</td>
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30.1 Level 3 Inputs

There are a number of existing pronouncements in U.S. GAAP that require (or permit) the use of fair value measures irrespective of the level of market activity for the asset or liability as of the measurement date (e.g., the remeasurement of derivative instruments under Statement 133 and the initial measurement of intangible assets under Statement 141). As such, Statement 157 allows for the use of unobservable inputs to measure fair value in situations where observable inputs are not available. The Board recognizes that, in many cases, the best information available with which to develop unobservable inputs may be the reporting entity’s own data. This view is consistent with the view expressed by the FASB in paragraph 38 of Concepts Statement 7, which states the following:

“As a practical matter, an entity that uses cash flows in accounting measurements often has little or no information about some or all of the assumptions that marketplace participants would use in assessing the fair value of an asset or a liability. In those situations, the entity must necessarily use the information that is available without undue cost and effort in developing cash flow estimates. The use of an entity’s own assumptions about future cash flows is compatible with an estimate of fair value, as
long as there are no contrary data indicating that marketplace participants would use different assumptions. If such data exist, the entity must adjust its assumptions to incorporate that market information.”

Statement 157 retains the notion of undue cost and effort criteria, clarifying that the reporting entity need not undertake all possible efforts to obtain information about the assumptions that market participants would use in pricing the asset or the liability, nor must the reporting entity establish the absence of contrary data indicating that market participants would use different assumptions. However, the reporting entity cannot ignore information about market participant assumptions that is available within reasonable cost benefit constraints. For example, in measuring the fair value of a reporting unit under Statement 142, we would expect that a reporting entity with a unique tax position (i.e., a low average tax rate) would consider the typical tax rate of market participants in its analysis. While this example is very simple and meant only to illustrate a concept, in actual practice, significant judgment will be required when considering the undue cost and effort criteria as it pertains to the use of inputs that cannot be observed or corroborated with observable market data.

As previously noted, the Statement makes clear a point that was not explicitly expressed in Concepts Statement 7, which is that even in situations where unobservable inputs are used to measure fair value, the objective of the measurement remains the same – an exit price from the perspective of a market participant that holds the asset or owes the liability. This may require an entity to make its own assumptions about the assumptions a market participant would use. For example, if it is reasonable to assume that a market participant would require a risk adjustment (or premium) in pricing an asset or liability, the reporting should include one even if this requires the reporting entity to use its own estimate of what adjustment a market participant would require.

The clarification by the Board that the objective of a fair value measurement is always the same, regardless of whether observable or unobservable inputs are used, is extremely important in that it highlights the Board’s determination that unobservable inputs are different from entity-specific inputs. For example, in valuing an intangible asset using unobservable inputs (e.g., expected cash flows), the assumptions that would be considered by market participants (and therefore the inputs to the valuation technique) should take into account the intended use of the asset by market participants, which could differ from an intended use specific to the reporting entity.

**Bid-Ask Prices**

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<tr>
<td>31. If an input used to measure fair value is based on bid and ask prices (for example, in a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value, regardless of where in the fair value hierarchy the input falls (Level 1, 2, or 3). This Statement does not preclude the use of mid-market pricing or other pricing conventions as a practical expedient for fair value measurements within a bid-ask spread.</td>
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**31.1 Bid-Ask Spread**

Statement 157 allows for, but does not require, the use of bid prices to measure assets and ask prices to measure liabilities. Having provided extensive clarification as to the objective of a fair value
measurement in U.S. GAAP, the Board felt it was appropriate to allow entities to use judgment in meeting that objective. Therefore, the Statement specifies that the price within the bid-ask spread that is most representative of fair value in the circumstances should be used to measure fair value. This approach is applicable in all situations where inputs are determined based on bid and ask prices, regardless of where the inputs fall in the fair value hierarchy. In addition, constituents need to be consistent in their application of this concept (i.e., it would not be appropriate for an entity to measure similar assets at different prices within the bid-ask spread, without evidence indicating that the exit prices for those assets would be at different points within the bid–ask spread).

As a practical expedient, Statement 157 allows for the use of mid-market pricing or other pricing conventions when measuring fair value within the bid-ask spread. It is our understanding that the Board included this consideration in order to enable certain types of investment companies (e.g., mutual funds) to continue their current practice of valuing investments using mid-market prices as allowed for in ASR No. 118.

The Board did not address the inter-relationship between the Statement’s guidance on transaction costs (i.e., transaction costs are not considered an attribute of the asset or liability and therefore are excluded from fair value measurements) and the guidance on the use of prices within the bid-ask spread. Some believe that part of the bid-ask spread represents transaction costs, and as such, measuring an asset at the bid price would include certain future transactions costs in the fair value measurement for the asset. Given the lack of any specific guidance on this issue, we expect there will be diversity in practice with respect to how transaction costs are represented when inputs are based on bid-ask prices. However, we would expect that a consistent approach would be applied within a particular reporting entity.

**Disclosures**

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<tr>
<td>32. For assets and liabilities that are measured at fair value on a recurring basis in periods subsequent to initial recognition (for example, trading securities), the reporting entity shall disclose information that enables users of its financial statements to assess the inputs used to develop those measurements and for recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on earnings (or changes in net assets) for the period. To meet that objective, the reporting entity shall disclose the following information for each interim and annual period (except as otherwise specified) separately for each major category of assets and liabilities:</td>
</tr>
<tr>
<td>a. The fair value measurements at the reporting date</td>
</tr>
<tr>
<td>b. 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)</td>
</tr>
<tr>
<td>c. For fair value measurements using significant unobservable inputs (Level 3), a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to the following:</td>
</tr>
</tbody>
</table>
| (1) Total gains or losses for the period (realized and unrealized), segregating those gains or losses included in earnings (or changes in net assets), and a description of where those
Statement 157 requires expanded disclosures about fair value measurements that are designed to provide users of financial statements with additional transparency regarding (i) the extent to which fair value is used to measure assets and liabilities, (ii) the inputs and assumptions used in measuring fair value, and (iii) the effect of fair value measurements on earnings. However, the Statement’s disclosure requirements focus solely on fair value measures in periods subsequent to initial recognition. The Statement does not require any disclosures with respect to fair value measurements on initial recognition of an asset or liability, and therefore does not mandate the disclosure of unrealized gains or losses recognized by an entity on Day 1, even in situations where the fair value measure is determined using unobservable inputs.

The nature and extent of the disclosure requirements vary depending on whether subsequent fair value measurements are made on a recurring or nonrecurring basis. In either case, the requirements are meant to provide financial statement users with additional insight into the relative reliability of the various fair value measures, thus enhancing their ability to broadly assess the quality of earnings.
32.1 Assets and Liabilities Measured at Fair Value on a Recurring Basis

The Statement requires reporting entities to disclose the level within the fair value hierarchy in which a fair value measurement falls. While this disclosure is presented by major category of asset or liability, it is important to understand that the determination of the hierarchy level in which the fair value measure falls (and therefore the bucket in which it will be disclosed) is based on the fair value measurement for the specific assets or liabilities and is therefore driven by the unit of account for the assets or liabilities. In situations where the unit of account for an asset or liability is standalone, but the valuation premise is in-use (e.g., as part of a portfolio), the value of the asset group may need to be attributed to the individual assets or liabilities or to the various instruments within each level of the fair value hierarchy.

To illustrate, consider an individual derivative transaction that is valued using an in-use premise (i.e., its value is determined in conjunction with other derivative transactions within a portfolio). The indicated value of the portfolio would consider the impact that master netting agreements would have on the credit risk associated with the portfolio. However, in many cases the determination as to the impact of credit risk is only considered at the portfolio level. In this situation, assuming that the portfolio included transactions that would fall into various levels within the fair hierarchy (i.e., Levels 1, 2 and 3), for purposes of disclosure, the portfolio level adjustment to account for credit risk (considering the impact of netting agreements) would need to be attributed to the individual derivative transactions within the portfolio or to the group of transactions that fall within each of the levels of the hierarchy.

The Statement requires a reconciliation of the beginning and ending balances for any recurring fair value measurements that utilize significant unobservable inputs (i.e., Level 3 inputs). Therefore, any asset or liability (measured at fair value on a recurring basis) that was determined to be a Level 3 measurement at either the beginning or the end of a reporting period would need to be considered in the reconciliation. To enhance the information provided in the reconciliation with respect to total gains and losses recognized in earnings, the Statement requires the reporting entity to also disclose the change in unrealized gains and losses recognized in earnings (for the period) for assets and liabilities measured in Level 3 that are still held at the reporting date. Effectively this will require an entity to distinguish its unrealized gains and losses from its realized gains and losses for Level 3 measurements.

33.1 Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

The Statement requires disclosures for assets and liabilities measured at fair value on a nonrecurring basis (e.g., impaired assets) in the period in which the remeasurement at fair value is performed. Certain of the disclosure requirements for nonrecurring measurements are identical to those required for recurring measurements, including the disclosure of fair value amounts by hierarchy level and (on an annual basis) the disclosure of the valuation techniques used to measure fair value and any changes in those techniques. However, for assets and liabilities that are recorded at fair value on a nonrecurring basis, the Statement requires disclosure as to the reason for the fair value measurement during the period.

Unlike with recurring measurements, a reconciliation of beginning and ending balances is not required for Level 3 assets or liabilities measured on a nonrecurring basis. Because of their nonrecurring nature, these measurements do not lend themselves to a reconciliation approach. Instead, for Level 3
nonrecurring measurements, the Statement requires that the reporting entity provide a description of the inputs and the information used to develop the inputs. The Statement did not include a similar requirement for Level 3 recurring measurements, as the Board determined that recurring measurements related primarily to financial instruments and Statement 107 already requires a similar disclosure.

**Effective Date and Transition**

<table>
<thead>
<tr>
<th>Excerpt from Statement 157</th>
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<tbody>
<tr>
<td>36. This Statement shall be effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including any financial statements for an interim period within that fiscal year.</td>
</tr>
</tbody>
</table>
| 37. This Statement shall be applied prospectively as of the beginning of the fiscal year in which this Statement is initially applied, except as follows. This Statement shall be applied retrospectively to the following financial instruments as of the beginning of the fiscal year in which this Statement is initially applied (a limited form of retrospective application):
  a. A position in a financial instrument that trades in an active market held by a broker-dealer or investment company within the scope of the AICPA Audit and Accounting Guides for those industries that was measured at fair value using a blockage factor prior to initial application of this Statement
  b. A financial instrument that was measured at fair value at initial recognition under Statement 133 using the transaction price in accordance with the guidance in footnote 3 of 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,” prior to initial application of this Statement
  c. A hybrid financial instrument that was measured at fair value at initial recognition under Statement 133 (added by FASB Statement No. 155, Accounting for Certain Hybrid Financial Instruments) prior to initial application of this Statement. |
| 38. At the date this Statement is initially applied to the financial instruments in paragraph 37(a)–(c), a difference between the carrying amounts and the fair values of those instruments shall be recognized as a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that fiscal year, presented separately. The disclosure requirements of Statement 154 for a change in accounting principle do not apply. |
| 39. The disclosure requirements of this Statement (paragraphs 32–35), including those disclosures that are required in annual periods only, shall be applied in the first interim period of the fiscal year in which this Statement is initially applied. The disclosure requirements of this Statement need not be applied for financial statements for periods presented prior to initial application of this Statement. |
37.1 Transition

Statement 157 requires two distinct transition approaches. For certain types of financial instruments including (i) positions in active markets (i.e., Level 1) previously measured using a blockage factor, (ii) financial instruments initially measured at their transaction price in accordance with guidance in EITF 02-3, and (iii) hybrid instruments initially measured at their transaction price in accordance with guidance in Statement 155, the Statement requires a limited form of retrospective transition. For these instruments, the Board determined that the application of Statement 157 would result in a change in the method of applying an accounting principle and transition should be applied retroactively. However, in consideration of the practical difficulties associated with applying this change to all prior periods, the Board agreed to a limited form of retroactive transition, whereby the cumulative impact of the change in principle is recognized in the opening balance of retained earnings in the fiscal year in which the Statement is adopted.

All other changes resulting from the application of the Statement should be applied prospectively as of the beginning of the fiscal year in which the Statement is initially applied. Except for the instruments previously discussed above, the Board determined that the change in methods used to measure fair value resulting from the adoption of the Statement would be inseparable from the change in the fair value measurements themselves (i.e., changes based on better insight or judgment) and therefore considered these changes to be similar to changes in estimates.

38.1 Limited Retrospective Transition

The Statement clarifies that a “single-step” approach is required in determining the cumulative-effect adjustment to opening retained earnings for the financial instruments that require limited retrospective transition. For these instruments, no distinction should be made in the treatment of adjustments that specifically relate to the nullification of guidance in EITF 02-3 (or Statement 155) and those adjustments that relate to the application of other guidance in the Statement. To illustrate this point, consider a derivative transaction whose treatment under the guidance in EITF Issue 02-3 resulted in the “deferral” of a Day 1 gain. Assume also that the derivative is a liability at the date Statement 157 is initially applied. The cumulative-effect adjustment reported through retained earnings should include the change in fair value (if any) resulting from the measurement of the instrument based on Level 3 inputs, as well as any change in the fair value of this position related to the consideration of the reporting entity’s own credit risk. This accounting is in contrast with a derivative liability (e.g., a plain vanilla swap) that had no deferral under EITF 02-3, where the adjustment to the fair value of this liability due to the consideration of nonperformance risk would be accounted for on a prospective basis through earnings.
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- **Weekly Update** summarizes FASB deliberations, SEC regulatory pronouncements, and other activities.
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Audit Committee Library

- **Thought Leadership and Guidance** includes best practices, commentary, and discussion of current events.
- **Audit Committee Toolkit** includes reference materials, questionnaires, and other resources to help prepare for meetings with management and independent auditors.

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GAAIT is your single resource for accounting & auditing standards and E&Y interpretive guidance. GAAIT subscriptions options include:

- **United States. EY/AART** includes U.S. authoritative literature, extensive interpretive guidance, and customized online GAAP checklists.
- **International – Global GAAP Comparison.** The comparison provides a side-by-side comparison of major GAAP systems from around the world.
- **International – GAAP & GAAS.** This GAAIT option includes International Financial Reporting Standards from the IASB and the International Auditing Standards issued by IFAC.
- **United Kingdom.** UK and International GAAPplus includes UK GAAP and International Accounting Standards, as well as in-depth guidance from Ernst & Young.
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Fair Value Pricing

2008 Survey Results
Executive Summary and Key Trends and Findings

Executive Summary

The 2008 Fair Value Pricing Survey (2008 Survey) represents our seventh survey on the valuation practices and industry policies and procedures used by asset managers. We have seen many trends over these seven years. Valuation practices have evolved into a mature set of practices, policies and procedures that continue to be refined as the range and complexity of investment types expand and the investment valuation tools improve.

Consistent with our past surveys, our 2008 Survey was designed with two goals in mind:

1. Provide information that will allow survey participants to understand how their practices, policies and procedures compare to other asset managers in the industry; and
2. Identify emerging trends within the industry.

The 2008 Survey was expanded to mine benchmark information from hot topic areas that are not widely available, such as broker pricing, the price challenge process, and Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (the Statement or FAS 157).

Credit crisis

What is now known simply as the credit crisis began when U.S. homeowners began to default on subprime and adjustable interest rate mortgages. Today it has turned into a global financial storm affecting all the global economy and financial markets: investment and retail banks, asset managers, hedge funds, private equity firms, public and private companies, and institutional and retail investors. As a result, asset managers have experienced unprecedented challenges in valuing portfolio securities in the past year. Information needed to value portfolio securities became scarce and third-party pricing vendors were challenged in their ability to provide evaluated prices. Asset managers were left to seek pricing alternatives such as internal modeling and also had to update valuation policies and procedures to address unforeseen events and a dynamic environment.

Valuation guidance

Although the U.S. Securities & Exchange Commission (SEC or the Commission) did not issue its much anticipated guidance during the first half of 2008, as expected, it was active on the valuation front. SEC representatives, such as Buddy Donahue, Director, Division of Investment Management, and Lori Richards, Director, Office of Compliance Inspections and Examinations, made a number of speeches and participated on several panels, highlighting the importance of valuation and the need for fund board involvement to oversee the valuation process as well as their role in understanding third-party pricing vendors. The SEC conducted a sweep examination on difficult-to-value investments, gathering relevant information on the current practices in place at many fund groups. The SEC also held a roundtable on fair value accounting standards on July 9 and, later in the month, issued its second *ComplianceAlerts* letter for Chief Compliance Officers, which contained a section on valuation risks and considerations for funds investing in high-yield municipal bonds. The section also provided recommendations for board oversight, and the Commission’s expectations of board involvement on valuation and other investment company governance matters has been a subject of much discussion during 2008, with many hoping that the SEC will more narrowly redefine the fund board’s overall responsibilities.
The SEC also continued to provide informal comments on the disclosure of fair value securities in the portfolio of investments as part of their mutual fund financial statement reviews. The SEC still prefers that investment companies highlight fair-valued securities in the portfolio of investments, and such disclosure continues to be more prevalent in the industry.

Funds devoted time in 2008 evaluating and preparing for the implementation of Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (the “Statement” or “FAS 157”). The objective of the Statement is to define fair value, to establish a framework for measuring fair value, to expand disclosures about fair value measurement, and, where applicable, to codify existing guidance under generally accepted accounting principles. The Statement specifies that:

“A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale). 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 objective of a fair value measurement is to determine the price that would be received to sell the asset or paid to transfer the liability at the measurement date (an exit price).”

The Statement requires asset managers to categorize and track each investment using a fair value hierarchy (Levels 1-3 based on market activity and inputs used to determine the prices) established in the Statement for financial reporting and disclosure purposes. Industry groups, service providers and third-party pricing vendors actively collaborated and discussed implementations issues related to FAS 157. These collaborations and discussions helped provide some guidance on the determination of hierarchy levels.

The Center for Audit Quality issued *Measurements of Fair Value in Illiquid (or Less Liquid) Markets* in October 2007. The white paper discussed the effects of, illiquid markets, supply and demand for security issues, definitions of forced sales, low volume market transactions and how to correctly apply a fair value for a security under FAS 157. At a time when the industry was uncertain how it should view trades that were occurring at prices far below their intrinsic value as determined by models, the paper suggested that it is not appropriate to assume that all transactions in a relatively illiquid market are forced or distressed unless persuasive evidence exists in establishing that an observable transaction is forced or distressed. It also stressed that valuation models should only be utilized when active market data or “observable inputs” are not available for a security, or similar securities, and should reflect any market data that would be used by a buyer.

Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*, was issued by the Public Accounting Oversight Board (PCAOB) in December of 2007. The Practice Alert discussed the requirements for an auditor to understand and evaluate 1) how management applies fair value measurements for financial instruments, 2) management’s fair value policies and procedures 3) management’s classification of financial instruments within the fair value hierarchy under FAS 157, and 4) pricing services utilized by management and the assumptions considered by such services. The alert also discussed instances where the auditor should evaluate the need to involve specialists. Although the practice alert focuses on the auditor’s responsibilities, it also provides insights as to management’s responsibilities to understand, in detail, the methods and assumptions used by either management or its service providers in developing valuations that are not based on market transactions. The auditor is then responsible for evaluating management’s processes and procedures, often through a review of documentation. Comments made by SEC Staff seem to suggest that the SEC’s view of management’s responsibilities is consistent with those articulated in the Practice Alert.

### 2008 Fair Value Survey results

Industry professionals representing more than 50 asset managers completed the 2008 Survey. Those asset managers advise more than 2,700 funds with assets under management (AUM) exceeding $3.5 trillion. The population of survey participants included those from fund complexes of varying sizes. Funds managed by these asset managers cover the full spectrum of investment types held by registered products.

While we historically noted significant differences in certain policies and procedures between large asset managers and small asset managers (based on AUM), the gaps have continued to narrow or, in some cases, have been eliminated, indicating that a more universal view of fair value exists today and that it can be achieved
by managers of varying sizes and complexities. This transformation is partly due to continued focus on fair value by the small firms, as well as, the prominence of third-party vendors who have emerged and have been engaged by small firms to help level the playing field. Nonetheless, large asset managers continue to devote more resources to investment valuation and are more likely to use these resources to continue to “raise the bar” and perform detailed analyses of certain valuation situations.

FAS 157 has increased the transparency of the valuation process, especially as it relates to the information used and provided by third-party pricing sources. Fund groups are spending more time understanding the inputs used by these sources, and, as a result, fund boards and management are in a better position to understand, evaluate and anticipate future challenges in the valuation process.

Price challenges continue to be on the rise. The rise is not unusual given the volatility and uncertainty in the investment marketplace and the general strengthening of fund policies and procedures. Fund groups are more successfully teaming within their organizations, sometimes on a daily basis, to assess valuations provided by other using traditional and newly-developed internal tools. Portfolio managers and traders have become more proactive in their assessment of the valuation process, and additional relevant information is being considered. However, extra care and controls need to be considered to ensure that changes to valuations are properly scrutinized.

Valuation continues to be an area of increased focus by regulators, such as the SEC and PCAOB in their examinations, standard setters, such as FASB in the development of FAS 157, and ultimately, financial statement users and investors that are making decisions based on the reported valuations. Overlying these demands are the complications resulting from a very volatile and increasingly global investment market that requires an ever increasing amount of financial data to perform a thorough analysis. As widening credit spreads continue to exist and the global markets yet to stabilize, the challenges in the valuation process remain. Differences relating to investment valuation between International Financial Reporting Standards and U.S. GAAP may also require additional thought as global convergence of those two sets of accounting standards occurs over the next few years.

As the results of the 2008 Survey indicate, progress continues to be made by the industry participants in addressing these many demands in a difficult environment that requires appropriate valuation results be determined and disseminated on a daily basis. Specific trends and findings identified in the 2008 Survey are highlighted in the next section.

**Key Trends and Findings**

Specific trends and findings identified in the 2008 Survey are highlighted below.

**Valuation governance considerations**

- Sixty-four percent of survey participants indicated that the board of directors has created a separate Fair Valuation Committee.
- Nineteen percent of survey participants indicated that at least one member of the board's Fair Valuation Committee is involved in fair value decisions on a “real-time” basis (i.e., members participate in the application of the fair value policies and procedures or are notified as those decisions are made). On a related matter, 31 percent of survey respondents in the prior year noted that the Board or its Fair Valuation Committee would approve the use of a new pricing methodology before a fair valuation decision was finalized, compared to 54 percent in the prior year, as many boards have seemingly reached the conclusion that new methodologies are being used more frequently given market conditions and that it is not practical to be involved in evaluating all of them before they are used.
- Thirty-seven percent have added internal controls over valuation as a result of the credit crisis. In addition, 39 percent indicated that the Treasurer's Group is responsible for monitoring controls designed to prevent or detect price overrides or bias in valuation; 27 percent indicated that the Compliance department is responsible.
Thirty-three percent of portfolio managers and traders perform analyses of security prices each day prior to calculating the NAV of the fund, whereas 13 percent perform this monthly.

Chief compliance officers (CCOs) continue to be involved in the valuation process undertaken by the board’s Fair Valuation Committee. Over 60 percent of participants stated their CCOs are involved in the adviser-led Internal Pricing Committee meetings, most commonly in the role of an observer.

Asset managers appear to be employing more resources for their fair valuation processes. Over 46 percent of survey participants stated they have at least two full time resources focused on fair valuation as compared to 29 percent last year.

Deloitte Point of View: The role of the Board has not changed significantly from the prior year, but management’s responsibility has grown into much more of a daily role. Re-evaluating the sufficiency of internal controls over valuation is important, as is ensuring that all knowledgeable parties are active in the identification of fair value situations and in the fair valuation process itself.

Fair valuation policies and procedures

Seventy-four percent of survey participants indicated that they had made changes to their valuation policies and procedures. Of these, 45 percent described their current year changes as minimal, and 53 percent indicated that they were making at least a moderate level of change.

Twenty-nine percent of survey participants reported that they had plans to develop models to supplement the third-party information they obtain in regards to the challenges in obtaining valuation information on hard-to-price securities. Several participants reported that such models had already been developed.

Foreign equities

Eighty-eight percent of asset managers said they use proxies for foreign securities, representing a continued upward trend dating back to 2004.

Sixty percent of participants use one proxy and 40 percent use two or more proxies. Over 20 percent of participants had changed their proxy or the number of proxies used in the past year.

The S&P 500 and the Russell 1000 continue to be the two most frequently used proxies.

More than 90 percent of those with proxies use triggers. Trigger percentages ranged from zero to 300 basis points. Thirteen percent had decreased their trigger levels from the prior year, while 81 percent had kept their trigger levels the same.

In addition to back-testing, several participants indicated that they perform sensitivity analyses in order to test the appropriateness of current trigger levels being used.

Foreign fixed-income securities

Use of proxies to monitor the valuation of foreign fixed-income securities continues to be an uncommon practice, cited by only 4 percent of survey participants.

Significant events-fair valuation adjustments and materiality

Fifty-three percent of survey participants reported that they do not consider materiality before adjusting a price when a significant event occurs, representing only a slight decrease from the prior year.

Monitoring fair valuation decisions

Ninety-six percent of all asset managers employ back-testing to analyze fair value procedures.
There was a decrease in survey participants who reported supplementing back-testing with additional activities (such as evaluating shareholder cash flows or market-timing analysis). Whereas 55 percent stated they had them in place last year, only 41 percent reported having them this year.

Deloitte Point of View: Funds continue to make changes to their policies and procedures, but they are generally more focused on either traditional focus areas like foreign equity valuation or board governance or emerging areas like the credit crisis and new investment types. As always, policies and procedures should be revised throughout the year when the results of back-testing indicate that the current policies and procedures are not as effective as desired or as other circumstances arise, such as the purchase of a new type of investment.

Specific fair value considerations

Domestic fixed-income

- Ninety-one percent of participants indicated that they are asking pricing vendors questions about the prices they are supplying; seventy-nine percent indicated that they are asking brokers questions.
- The survey showed an increase in the use of Trade Reporting and Compliance Engine (TRACE)-related data to assist in valuing traded corporate fixed-income securities. Results show 36 percent of survey participants use TRACE data for comparative purposes in their valuation process, 26 percent ensure that their pricing vendor is factoring TRACE data into their models/calculations and another 4 percent use TRACE as a secondary source.
- For nongovernmental securitized assets (such as mortgage-backed and asset-backed securities), 43 percent of participants generally perform supplemental analysis to assess prices provided by pricing vendors.
- When obtaining broker quotes, more than 50 percent of participants seek more than one quote for non-money market fund securities. A slight majority indicated that such quotes were averaged, although a strong minority indicated that one of the broker sources had been designated as the primary source.
- When performing the mark-to-market testing for money market funds, commonly called “shadow pricing,” only 30 percent of participants seek more than one quote.

Senior loans

- Ninety percent of survey participants use either Loan Pricing Company or Markit Partners as their primary source in pricing senior bank loan holdings. Seven percent were using brokers as their primary source.
- Fifty-five percent of participants are performing additional procedures to corroborate the valuations they obtain from their vendors on senior loans.

Small cap/Micro cap equities

- Thirty-nine percent of survey participants reported that they use the last available market price to value a small cap/micro cap equity security even when they have determined its price to be stale (assuming they determine that such price is representative of fair value), a decrease of about 11 percent from the prior year’s survey results.
- Thirty-eight percent of asset managers monitor trading volume on small cap/micro cap securities to assist in identifying securities with stale prices.
Derivative contracts

- For participants, there is a clear trend in using pricing vendors as the primary source in valuing derivatives that are not traded on an exchange. Whereas we once saw counterparties being the primary source, this year’s survey indicated that over 50 percent of participants were using pricing vendors.

- Thirty-nine percent of survey participants reported that their analyses had detected errors in counterparty quotes for non-exchange traded derivative contracts during the last twelve months, an increase of 13 percent from the prior year.

- Forty-eight percent of survey participants indicated that they consider the effect of significant events on the valuations of derivative contracts provided by counterparties or third-party vendors. This was a decrease from last year, but still a higher percentage than survey results in previous years.

Thinly-traded and illiquid securities

- More than 80 percent of survey participants have procedures in place to detect situations where securities are either illiquid or thinly-traded.

- Based upon their policies and procedures, a majority of participants will use the most recent market quote to value a thinly-traded or illiquid security, assuming that they believe it is representative or fair value.

Restricted securities

- Discount percentages on restricted securities have increased from the prior year. Approximately 80 percent of respondents use a discount percentage in excess of 5 percent, and more than 40 percent use a discount percentage exceeding 10 percent.

- Seventy-one percent of those applying a discount will adjust the discount based upon the remaining term of the restriction.

Warrants and rights

- Thirty-six percent of survey participants indicated that they use a formulaic methodology (most commonly, Black-Scholes) to value warrants and rights, while 38 percent use an intrinsic value methodology.

Deloitte Point of View: Fund groups should pay close attention to the valuation of new investment types, especially those that are thinly-traded or less liquid. If the expertise relating to such investment types does not exist in-house, such as when a fund is managed by a sub-adviser, additional resources might be necessary, and monitoring techniques not previously used may be warranted.

Foreign currency exchange rates

- Seventy-four percent of survey participants reported that they use foreign currency exchange rates at 4 p.m. Eastern, representing a slight increase from the prior year.

Deloitte Point of View: Using a rate as of the close of the New York Stock Exchange (typically 4 p.m. Eastern) is clearly most common. In situations where they are not used, fund groups should have a mechanism to evaluate significant events that could occur between the time the rates are obtained and the time of day that the NAV is calculated.
Index funds

- Among survey participants offering index funds, nearly 80 percent reported that they apply fair valuation override when the closing exchange price is deemed not to be a reasonable estimate of the fair value of the security or securities, consistent with the percentage from prior year. Most offering exchange-traded funds also apply fair valuation techniques.

*Deloitte Point of View:* As ETFs grow in the marketplace, the need for clear disclosure between the differences between the pricing methodology used by an ETF versus the benchmark will increase. ETFs are playing an increasing role in other aspects of the valuation process, especially the determination of fair value adjustments for foreign equities.

Third-party pricing vendors

- Funds continue to conduct internal analysis on valuations supplied by the vendors and that analysis is most likely to occur daily. On-going face-to-face meetings with the pricing vendor most commonly occur annually.
- Ninety percent of survey participants said they use third-party fair value pricing vendors for foreign securities.
- The most common parties who are permitted to challenge prices supplied by the pricing vendor include the pricing group/coordinator, portfolio manager, and the fund accountant.
- Sixty-two percent of participants indicated that they have chosen to change the evaluated price of third-party pricing vendors providing matrix-pricing.
- Fifty-seven percent of participants noted that their third-party fair valuation pricing vendor now provides a SAS 70 or similar type of report.

*Deloitte Point of View:* Due diligence visits of pricing vendors used to be focused on gaining an understanding of the vendor’s organization and an overview of its pricing process. While these discussions are valuable, fund groups should look to raise the bar on their level of inquiries to really understand the key assumption used in models and the expertise of those providing evaluated prices. Fund personnel knowledgeable about the specific investments held by the fund group should attend the meeting.

FAS 157

- Sixty-three percent of participants indicated that FAS 157 has impacted their valuation policies and procedures.
- Eighty-one percent of survey participants indicated that they monitor, or intend to monitor, the appropriateness of the classification of investments at different levels prescribed by FAS 157. Fifteen percent stated they will perform monitoring on a daily basis, 28 percent on a monthly basis and 38 percent on a quarterly basis.

*Deloitte Point of View:* A core message within FAS 157 is that fund groups should understand the key inputs into the valuations produced by others. The industry should use care in determining the classification of investments using the 3-level hierarchy outlined in FAS 157 and should also ensure that they are adequately considering other FAS 157 requirements, including the need to adjust valuations (for financial reporting purposes only) for significant events after the time at which funds calculate their NAVs.

Financial statement disclosure

- Sixty-five percent of participants have updated their financial statement footnote disclosure relating to fair value policies.

*Deloitte Point of View:* Periodically reviewing the adequacy of fair value disclosures in shareholder reports and in regulatory filings continues to be a leading practice.
SEC examinations

- Forty-five percent of respondents indicated that they had been subjected to a sweep examination by the SEC. Of those that were examined, all indicated that the SEC had made certain inquiries relating to valuation, most commonly about the general fair value pricing policies and procedures. There were also focused inquiries on particular types of investments.

We would be pleased to answer any questions you may have about our survey, its results, or other fair value issues. Please feel free to contact Cary Stier, U.S. Practice Leader, Asset Management Services, Paul Kraft, Partner and Fair Value Pricing Survey Leader, or any of the following partners:

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</tr>
</tbody>
</table>
February 5, 2008

TO: ACCOUNTING/TREAURERS MEMBERS No. 3-08

RE: FAS NO. 157 NOTE DISCLOSURES FOR INVESTMENT COMPANIES

Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands required note disclosures about fair value measurements.¹ FAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. A subgroup of the Accounting/Treasurers Committee has developed the attached investment company note disclosures intended to satisfy the requirements of FAS No. 157.

_FAS No. 157 Note Disclosure Requirements_

For assets that are measured at fair value on a recurring basis, FAS No. 157 requires disclosure of the following information for each interim and annual period (except as otherwise specified) separately for each major category of assets:

a. The fair value measurements at the reporting date,

b. 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 (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3),

c. For Level 3 measurements, a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to the following:
   1) Total gains or losses for the period (realized and unrealized), segregating those gains or losses included in earnings (or changes in net assets), and a description of where those gains or losses included in earnings (or changes in net assets) are reported in the income statement
   2) Purchases, sales, issuances, and settlements (net)
   3) Transfers in and/or out of Level 3

¹ See ICI Memorandum to Accounting/Treasurers Members No. 19-06 [20397] dated September 22, 2006.
d. The amount of the total gains or losses for the period in subparagraph c.1. above included in earnings that are attributable to the change in unrealized gains or losses relating to those assets still held at the reporting date and a description of where those unrealized gains or losses are reported in the income statement.

e. 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.

*Sample Note Disclosures*

Attached are two documents intended to facilitate investment company compliance with the note disclosures required by FAS No. 157. The first document is a matrix that is intended to assist funds in determining where securities fall within the fair value hierarchy (i.e., Level 1, Level 2, or Level 3). This document lists various security types and inputs that could be used to value each security. The matrix classifies securities as Level 1, Level 2, or Level 3 based on the inputs used to value the security.

The second document provides sample note disclosures that could be included in financial statements. The sample note disclosures set forth a fact scenario assuming certain holdings, purchases, sales, transfers between levels, and changes in value over the period. The sample note disclosure then provides: 1) a description of the fair value hierarchy and how it is applied to the fund’s investments; 2) a tabular summary of security types broken down by valuation input level; and 3) a tabular reconciliation of the beginning and ending balances of securities that were valued using Level 3 inputs.

The second document also includes additional information intended to illustrate issues related to the Level 3 reconciliation. Among these are how to handle transfers in/out of Level 3 during the reporting period. The document illustrates three alternatives: end of period value, beginning of period value, and intra-period value. Ending of period value uses the fair value of the item at the end of the reporting period as the transfer in or out amount. Beginning of period value uses the fair value of the item at the beginning of the reporting period as the transfer in or out amount. Intra-period value uses the fair value of the item at the date it was transferred in or out of Level 3. Other methods, such as transfer in at beginning of period value combined with transfer out at end of period value, could also be considered. Funds may wish to consult with their accounting system service provider and their independent accountant as they consider implementation the Level 3 reconciliation.

Gregory M. Smith
Director - Operations/Compliance & Fund Accounting

**Attachments**

Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website ([http://members.ici.org](http://members.ici.org)) and search for memo 22189, or call the ICI Library at (202) 326-8304 and request the attachment for memo 22189.
Attachment no. 1 (in .pdf format)
<table>
<thead>
<tr>
<th>Security/Financial Instrument Type</th>
<th>Level One Inputs (A)(B)</th>
<th>Level Two Inputs (A)(B)</th>
<th>Level Three Inputs (B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic Equities (including rights and warrants) including listed ADRs, Exchange Traded Funds, Preferred Stocks, Exchange Traded Options and HOLDRS</td>
<td>Exchange listed price or a broker quote in an active market</td>
<td>Halted security's last trade price or a broker quote in a non-active market. Additionally, securities closely related (e.g. when issued, fungible shares) where the security held is not trading but related security is. <strong>Example:</strong> A security that has halted trading due to a pending news announcement may use the last trade before the halt if deemed reasonable.</td>
<td>Security in which no indications or comparables are available and the use of the company's financials/information or other market indicators are used to calculate valuation. <strong>Example:</strong> Venture capital investments with no market information available.</td>
</tr>
<tr>
<td>Foreign Equities</td>
<td>Exchange listed price or a broker quote in an active market</td>
<td>Halted security's last trade price, a broker quote in a non-active market, exchange listed price that has a fair value adjustment applied due to post market close subsequent events, or the use of local price for foreign shares of the same security. Additionally, securities closely related (e.g. when issued, fungible shares) where the security held is not trading but related security is. <strong>Example:</strong> IPO price may be used if trading in the security has not yet commenced and IPO price is deemed reasonable.</td>
<td>Security in which no indications or comparables are available and the use of the company's financials/information or other market indicators are used to calculate valuation. <strong>Example:</strong> Venture capital investments with no market information available.</td>
</tr>
<tr>
<td>Unlisted ADRs</td>
<td>Broker quote in an active market or indication of price through actual trading volume (e.g. pink sheets or bulletin board)</td>
<td>Evaluated price, broker quote in a non-active market or imputed value derived using the exchange listed last price from the underlying stock, conversion ratio and exchange rate. In addition, the imputed value from the identical security's global depository receipts price if unavailable. <strong>Example:</strong> vendors evaluate unlisted ADRs using primarily observable market data points such as price of underlying local shares, current exchange rates and available trading information.</td>
<td>Security in which no indications or comparables are available and the use of the company's financials/information or other market indicators are used to calculate valuation. <strong>Example:</strong> ADRs where underlying shares also do not trade publicly.</td>
</tr>
<tr>
<td>Unlisted Preferred Equities</td>
<td>Broker quote in active market (if any)</td>
<td>Evaluated price, broker quote in a non-active market or cost price (if new purchase). <strong>Example:</strong> typically unlisted preferred that is not listed and does not trade on an exchange.</td>
<td>Security in which no indications or comparables are available and the use of the company's financials/information or other market indicators are used to calculate valuation. <strong>Example:</strong> Broker quote or vendor evaluated price may not be available.</td>
</tr>
</tbody>
</table>
## FAS 157 Hierarchy Level Matrix

<table>
<thead>
<tr>
<th>Security/Financial Instrument Type</th>
<th>Level One Inputs (A)(B)</th>
<th>Level Two Inputs (A)(B)</th>
<th>Level Three Inputs (B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Convertible Securities</td>
<td>Exchange listed price or a broker quote in an active market</td>
<td>Evaluated price which is based on a compilation of primarily observable market information or value is imputed based on the conversion ratio and other security specific information or a broker quote in a non-active market.</td>
<td>Security in which no indications or comparables are available and the use of the company's financials/information or other market indicators are used to calculate valuation <strong>Example</strong>: Venture capital investments with no market information available.</td>
</tr>
<tr>
<td>Unrated or Non-Investment Grade Municipal Bonds</td>
<td>Broker quote in an active market</td>
<td>Evaluated price which is based on a compilation of primarily observable market information or a broker quote in a non-active market.</td>
<td>Security in which no indications or comparables are available and the use of the company's financials/information or other market indicators are used to calculate valuation <strong>Example</strong>: Distressed or defaulted municipal bond where a broker cannot be located to provide a quote or pricing vendor to provide an evaluated quote.</td>
</tr>
<tr>
<td>Investment Grade Municipal Bonds</td>
<td>Broker quote in an active market</td>
<td>Evaluated price which is based on a compilation of primarily observable market information or a broker quote in a non-active market.</td>
<td>Security in which no indications or comparables are available and the use of the company's financials/information or other market indicators are used to calculate valuation. <strong>Example</strong>: Distressed or defaulted municipal bond where a broker cannot be located to provide a quote or pricing vendor to provide an evaluated quote.</td>
</tr>
<tr>
<td>Mortgage Backed Securities</td>
<td>Broker quote in an active market</td>
<td>Evaluated price which is based on a compilation of primarily observable market information or a broker quote in a non-active market.</td>
<td>Price calculated internally using primarily information not observable in the market place. <strong>Example</strong>: A broker cannot be located to provide a quote or pricing vendor to provide an evaluated quote.</td>
</tr>
<tr>
<td>Asset Backed and CMO Securities</td>
<td>Broker quote in an active market</td>
<td>Evaluated price which is based on a compilation of primarily observable market information or a broker quote in a non-active market.</td>
<td>Price calculated internally using primarily information not observable in the market place. <strong>Example</strong>: A broker cannot be located to provide a quote or pricing vendor to provide an evaluated quote.</td>
</tr>
<tr>
<td>Treasury Securities</td>
<td>Broker quote in an active market</td>
<td>Evaluated price which is based on a compilation of primarily observable market information or a broker quote in a non-active market.</td>
<td>Price calculated internally using primarily information not observable in the market place.</td>
</tr>
<tr>
<td>Security/Financial Instrument Type</td>
<td>Level One Inputs (A)(B)</td>
<td>Level Two Inputs (A)(B)</td>
<td>Level Three Inputs (B)</td>
</tr>
<tr>
<td>-----------------------------------</td>
<td>-------------------------</td>
<td>-------------------------</td>
<td>------------------------</td>
</tr>
<tr>
<td>Agency Securities</td>
<td>Broker quote in an active market</td>
<td>Evaluated price which is based on a compilation of primarily observable market information or a broker quote in a non-active market.</td>
<td>Price calculated internally using primarily information not observable in the market place. Example: A broker cannot be located to provide a quote or pricing vendor to provide evaluated quote.</td>
</tr>
<tr>
<td>U.S. Investment Grade Corporate Bonds</td>
<td>Broker quote in an active market</td>
<td>Evaluated price which is based on a compilation of primarily observable market information or a broker quote in a non-active market.</td>
<td>Security in which no indications or comparables are available and the use of the company's financials/information or other market indicators are used to calculate valuation. Example: Distressed or defaulted bond where a broker cannot be located to provide a quote or pricing vendor to provide an evaluated quote.</td>
</tr>
<tr>
<td>U.S. Non-Investment Grade Corporate Bonds</td>
<td>Broker quote in an active market</td>
<td>Evaluated price which is based on a compilation of primarily observable market information or a broker quote in a non-active market.</td>
<td>Security in which no indications or comparables are available and the use of the company's financials/information or other market indicators are used to calculate valuation. Example: Distressed or defaulted bond where a broker cannot be located to provide a quote or pricing vendor to provide an evaluated quote.</td>
</tr>
<tr>
<td>International Corporate and Government Bonds</td>
<td>Broker quote in an active market</td>
<td>Evaluated price which is based on a compilation of primarily observable market information or a broker quote in a non-active market.</td>
<td>Security in which no indications or comparables are available and the use of the company's financials/information or other market indicators are used to calculate valuation. Example: Distressed or defaulted bond where a broker cannot be located to provide a quote or pricing vendor to provide an evaluated quote.</td>
</tr>
<tr>
<td>Corporate &amp; Bank Loans</td>
<td>Price based on average of broker quoted closing bid quotes in an active market</td>
<td>Evaluated price which is based on a compilation of primarily observable market information or a broker quote in a non-active market.</td>
<td>Security in which no indications or comparables are available and the use of the company's financials/information or other market indicators are used to calculate valuation. Example: Distressed or defaulted loan where a broker cannot be located to provide a quote or pricing vendor to provide broker quotes in active or non active market.</td>
</tr>
<tr>
<td>Currency, Interest Rate, Credit Default, Unfunded Index and Total Return Swaps</td>
<td>Broker quote in an active market.</td>
<td>Evaluated price based on a model which may include end of day net present values, spreads, ratings, credit analysis, industry, and company performance. In addition, broker quotes in a non active market.</td>
<td>Valuation would be dependant on internally developed assumptions from a comparable yield curve (currency/interest rate) or comparable credit curve (credit default).</td>
</tr>
<tr>
<td>Security/Financial Instrument Type</td>
<td>Level One Inputs (A)(B)</td>
<td>Level Two Inputs (A)(B)</td>
<td>Level Three Inputs (B)</td>
</tr>
<tr>
<td>-----------------------------------</td>
<td>-------------------------</td>
<td>-------------------------</td>
<td>------------------------</td>
</tr>
<tr>
<td>Funded Index Swaps</td>
<td>Broker quote in an active market.</td>
<td>Evaluated price which values the security based on a compilation of primarily observable market information. In addition, broker quotes in a non active market.</td>
<td>Price calculated internally using information available via external data sources.</td>
</tr>
<tr>
<td>Short Term Obligations (Non Money Market Funds)</td>
<td>Broker quote in an active market.</td>
<td>Evaluated quote and broker quotes in a non active market. Note amortized cost may be used when the security is 60 days or less to maturity.</td>
<td>Security in which no indications or comparables are available and the use of the company's financials/information or other market indicators are used to calculate valuation.</td>
</tr>
<tr>
<td>Gold Bullion</td>
<td>Broker quote or spot price quoted by an electronic data service (e.g.- Bloomberg).</td>
<td>N/A</td>
<td>Price calculated internally using information available via external data sources.</td>
</tr>
<tr>
<td>Private Equity Securities</td>
<td>N/A</td>
<td>Broker quote in a non active market.</td>
<td>Security in which no indications or comparables are available and the use of the company's financials/information or other market indicators are used to calculate valuation.</td>
</tr>
<tr>
<td>Private Investments in Public Equities “PIPES”</td>
<td>N/A</td>
<td>Exchange price of underlying publicly related security less a discount for risk associated with lockup period, if applicable.</td>
<td>Security in which no indications or comparables are available and the use of the company's financials/information or other market indicators are used to calculate valuation.</td>
</tr>
<tr>
<td>Registered Investment Companies</td>
<td>Exchange listed prices (for exchanged traded RICs) or net asset value for open-end RICs and continuously offered closed-end RICs.</td>
<td>N/A</td>
<td>Security in which no indications or comparables are available and the use of the company's financials/information or other market indicators are used to calculate valuation.</td>
</tr>
<tr>
<td>Exchange Traded, Over the Counter (“OTC”) Options and Credit Default Swap Options</td>
<td>Exchange listed price or broker quote in an active market.</td>
<td>Implied value through primarily observable inputs used as a base point of reference. In addition, a broker quote in a non active market and an evaluated quote provided by an independent pricing vendor.</td>
<td>Value derived on the prior history of volatility of the underlying shares to approximate current value. Example: Options where no broker can be located to provide a quote and or pricing vendor to provide or pricing vendor to provide a price.</td>
</tr>
<tr>
<td>Security/Financial Instrument Type</td>
<td>Level One Inputs (A)(B)</td>
<td>Level Two Inputs (A)(B)</td>
<td>Level Three Inputs (B)</td>
</tr>
<tr>
<td>-----------------------------------</td>
<td>-------------------------</td>
<td>-------------------------</td>
<td>------------------------</td>
</tr>
<tr>
<td>Futures</td>
<td>Exchange listed price or broker quote in an active market.</td>
<td>Broker quote in a non active market.</td>
<td>Price calculated internally using information available via external data sources.</td>
</tr>
<tr>
<td>Foreign forward exchange currency contracts</td>
<td>Market quotes posted by banks and major currency dealers (e.g. retrieved via an electronic data service or other sources) and broker quotes in an active market.</td>
<td>N/A</td>
<td>Price calculated internally using information available via external data sources.</td>
</tr>
<tr>
<td>Money Market instruments valued at amortized cost pursuant to Rule 2a-7</td>
<td>Interpretation of FAS 157 suggests amortized cost is a Level 2 input. Due to the risk-limiting provisions and shadow pricing requirements included in Rule 2a-7, consideration should be given regarding whether securities held in Rule 2a-7 money market funds that are valued at amortized cost should be considered Level 1 inputs.</td>
<td>Use of amortized cost to the extent that periodic mark-to-market calculations indicate that the use of amortized cost approximates market value (see comments in Level 1 regarding the anticipation that these Rule 2a-7 fund investment should be considered Level 1 inputs).</td>
<td></td>
</tr>
</tbody>
</table>

(A) Refer to paragraph 10 of FAS 157 which identifies four requirements to be considered a market participant and paragraph 11 of FAS 157 that discusses characteristics that distinguish market participants. Also, refer to paragraphs 24-30 of FAS 157 for further discussion of Level 1, Level 2 & Level 3 inputs. Refer to paragraph 31 for use of prices within the bid-ask spread (mid-market pricing) if the price is most representative of fair value (regardless of where in the fair value hierarchy the input falls).
(B) Careful consideration should be given to broker quotes received to determine whether or not 1) the quote is representative of fair value, 2) the quote is representative of an active market from a market participant as defined in FAS 157 and 3) whether an “indicative” broker quote is reflective of an “observable” input.

Disclaimer: The above grid represents examples of the classification of the various security types. An examination of the facts and circumstances of a specific security may render a different classification than the examples provided.
Financial Statement Disclosures in response to FAS 157  
February 2008

(Note the italics information throughout this document is for informational purposes. Non-italicized information represents the sample disclosure or examples in supplemental information.)

Scenario: Below is a hypothetical fact scenario for the discussion points and disclosure examples that follow; assumed valuation levels presented are for illustrative purposes only and are not intended to indicate appropriate valuation levels for security types listed.

A Fund holds the following securities and/or other investment instruments and has made additional purchases or sales accordingly:

<table>
<thead>
<tr>
<th>Security Type</th>
<th>Assumed Valuation Level for example</th>
<th>Original Cost @ Purchase</th>
<th>Value at 12/31/X7</th>
<th>Purchase/ Sell Proceeds</th>
<th>Value at 12/31/X8</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic Equity</td>
<td>Level 1</td>
<td>125,000</td>
<td>130,000</td>
<td></td>
<td>140,000</td>
</tr>
<tr>
<td>Foreign Equity: Halted at Period End (Assumes unobservable inputs were utilized to develop a price at 12/31/X8)</td>
<td>Level 3</td>
<td>10,000</td>
<td>15,000</td>
<td></td>
<td>30,000</td>
</tr>
<tr>
<td>Asset Backed Security</td>
<td>Level 2</td>
<td>100,000</td>
<td>98,000</td>
<td></td>
<td>105,000</td>
</tr>
<tr>
<td>Fixed Income Security: No Active Market at Period End</td>
<td>Level 3</td>
<td>87,081</td>
<td>90,000 (Amortized Cost of $ 90,000)</td>
<td></td>
<td>100,000 (Amortized Cost of $ 95,000)</td>
</tr>
<tr>
<td>Private Equity</td>
<td>Level 3</td>
<td>75,000</td>
<td>80,000</td>
<td>Purchase $25,000</td>
<td>115,000</td>
</tr>
<tr>
<td>Security Type</td>
<td>Assumed Valuation Level for example</td>
<td>Original Cost @ Purchase</td>
<td>Value at 12/31/X7</td>
<td>Purchase/ Sell Proceeds</td>
<td>Value at 12/31/X8</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>-------------------------------------</td>
<td>--------------------------</td>
<td>-------------------</td>
<td>------------------------</td>
<td>------------------</td>
</tr>
<tr>
<td>S&amp;P 500 Futures Contract</td>
<td>Level 1 (Actual “cost” and market value)</td>
<td>50,000</td>
<td>55,000</td>
<td></td>
<td>60,000</td>
</tr>
<tr>
<td>Credit Default Swap</td>
<td>Level 3</td>
<td>100,000</td>
<td>95,000</td>
<td>Sell ½ at $45,000 assuming cost of $50,000</td>
<td>35,000</td>
</tr>
</tbody>
</table>

In addition to its investments, a fund should also evaluate whether any of its other assets or other liabilities are required to be carried at fair value and, if so, the impact of such balances on its valuation disclosures.

Sample Hierarchy Disclosure

Included below is suggested disclosure language preceding the presentation of major categories of assets and liabilities and their fair value within the FAS 157 hierarchy. This disclosure could be included as an additional note in the notes to financial statements or could follow the listing of holdings. The Other Financial Instruments values represent the unrealized appreciation/depreciation of these instruments, not the notional contract value.

Various inputs are used in determining the value of the Fund’s investments. These inputs are summarized in the three broad levels listed below:
- Level 1 – quoted prices in active markets for identical securities
- Level 2 – other significant observable inputs (including quoted prices for similar securities, interest rates, prepayment speeds, credit risk, etc.)
- Level 3 – significant unobservable inputs (including the Fund’s own assumptions in determining the fair value of investments)

The inputs or methodology used for valuing securities are not necessarily an indication of the risk associated with investing in those securities. [May want to consider this additional disclosure if a money market fund: For example, money market securities are valued using amortized cost, in accordance with rules under the Investment Company Act of 1940. Generally, amortized cost approximates the current fair value of a security, but since the value is not obtained from a quoted price in an active market, such securities are reflected as Level 2.]
The following is a summary of the inputs used to value the Fund’s net assets as of December 31, 20X8:

<table>
<thead>
<tr>
<th>Valuation Inputs</th>
<th>Investments in Securities</th>
<th>Other Financial Instruments*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level 1 - Quoted Prices</td>
<td>$140,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Level 2 - Other Significant Observable Inputs</td>
<td>$105,000</td>
<td>-</td>
</tr>
<tr>
<td>Level 3 - Significant Unobservable Inputs</td>
<td>$245,000</td>
<td>$(15,000)</td>
</tr>
<tr>
<td>Total</td>
<td>$490,000</td>
<td>$(5,000)</td>
</tr>
</tbody>
</table>

*Other financial instruments are derivative instruments not reflected in the Portfolio of Investments, such as futures, forwards and swap contracts, which are valued at the unrealized appreciation / depreciation on the instrument.

Sample Level 3 Reconciliation Disclosure

Following is suggested disclosure for the reconciliation of the fair value of securities from the beginning to the end of the period for those securities that were considered a Level 3 at either the beginning or ending of the reporting period. Since this is a reporting requirement, we do not believe it is necessary to track securities that have moved to and from Level 3 throughout the period unless the security was a Level 3 at either the beginning or ending of the reporting period; however, intra-period tracking is permitted. Additionally, the reporting period would be considered a year-to-date concept. So, for example, if a security was a Level 3 at the end of quarter 1 and was reported in the N-Q, but was not a Level 3 at the semiannual reporting period, then no disclosure would be required at the semiannual reporting period.

The market value of the Other Financial Instruments in Column 2 represents the unrealized appreciation/depreciation of instruments that are typically considered to be accounted for off-balance sheet. Examples include futures, forward foreign currency exchange contracts, swaps, etc. There was consideration of disclosing the notional contract value of these items, but given the proposed changes to FAS 133, which propose disclosing notional contract value, it appears the intent of the FAS 157 was to reflect the unrealized appreciation/depreciation of the contracts.

Following is a reconciliation of Level 3 assets for which significant unobservable inputs were used to determine fair value (Note: This example assumes transfers in or out of Level 3 occur at the end of period value, as discussed in the Supplemental Reconciliation Examples):
**Investments in Securities** | **Other Financial Instruments**
--- | ---
Balance as of 12/31/X7 | $170,000 | $ (5,000)
Accrued discounts/premiums | 5,000 | -
Realized gain (loss) | 10,000 | -*
Change in unrealized appreciation (depreciation) | 45,000 | (10,000)
Net purchases (sales) | (15,000) | -
Transfers in and/or out of Level 3 | 30,000 | -
Balance as of 12/31/X8 | $245,000 | $ (15,000)

*The realized gain (loss) earned during the fiscal year ended 12/31/X8 for Other Financial Instruments was $(5,000).

As indicated in FAS 157, the provisions of the statement need not be applied to immaterial items. Some fund groups have expressed their intent to omit the Level 3 reconciliation if the reporting fund’s Level 3 holdings at both beginning and end of the reporting period are immaterial relative to the fund’s net assets.
Additional Information Related to Previous Scenario

The following information is intended to illustrate, in more detail, the Level 3 reconciliation for each of those securities that was considered a Level 3 in the previous scenario. (Note: This example assumes the end of period approach for transfers in and out of Level 3 as discussed in the Supplemental Reconciliation Examples.)

**Foreign Equity:** Issue was halted at reporting date and significant unobservable inputs were considered in determining the value.

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Price</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>6/1/X7</td>
<td>Purchase 100 shares @ $100</td>
<td></td>
<td>$10,000</td>
</tr>
<tr>
<td>12/31/X7</td>
<td>Market Close (Level 1): 100 shares @ $150</td>
<td></td>
<td>$15,000</td>
</tr>
<tr>
<td>1/1/X8</td>
<td>Beginning Balance (Level 1)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/X8</td>
<td>Fair Value (Level 3): 100 shares @ $300</td>
<td></td>
<td>$30,000</td>
</tr>
</tbody>
</table>

**Investments in Securities**

<table>
<thead>
<tr>
<th></th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance as of 12/31/X7</td>
<td>$ -</td>
</tr>
<tr>
<td>Transfers in and/or out of Level 3</td>
<td>30,000</td>
</tr>
<tr>
<td>Balance as of 12/31/X8</td>
<td>$ 30,000</td>
</tr>
</tbody>
</table>

**Fixed Income Security:** Issue was valued with significant unobservable inputs. The issue accreted from amortized cost of $90,000 to $95,000 during the period ended 12/31/X8.

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Price</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>6/1/X7</td>
<td>Purchase $100,000 principal at discount</td>
<td></td>
<td>$87,081</td>
</tr>
<tr>
<td>12/31/X7</td>
<td>Fair Value (Level 3): $90</td>
<td></td>
<td>$90,000</td>
</tr>
<tr>
<td>12/31/X7</td>
<td>Amortized Cost</td>
<td></td>
<td>$90,000</td>
</tr>
<tr>
<td>1/1/X8</td>
<td>Beginning Balance (Level 3)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/X8</td>
<td>Fair Value (Level 3): $100</td>
<td></td>
<td>$100,000</td>
</tr>
<tr>
<td>12/31/X8</td>
<td>Amortized Cost</td>
<td></td>
<td>$95,000</td>
</tr>
</tbody>
</table>

**Investments in Securities**

<table>
<thead>
<tr>
<th></th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance as of 12/31/X7</td>
<td>$ 90,000</td>
</tr>
<tr>
<td>Accrued discounts/premiums</td>
<td>5,000</td>
</tr>
<tr>
<td>Change in unrealized appreciation (depreciation)</td>
<td>5,000</td>
</tr>
<tr>
<td>Balance as of 12/31/X8</td>
<td>$ 100,000</td>
</tr>
</tbody>
</table>
Private Equity: Issue is valued daily with significant unobservable inputs.

<table>
<thead>
<tr>
<th>Date</th>
<th>Action</th>
<th>Shares</th>
<th>Price</th>
<th>Cost</th>
<th>Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>6/1/X7</td>
<td>Purchase 750 shares @ $100</td>
<td>750</td>
<td>$100</td>
<td>$75,000</td>
<td></td>
</tr>
<tr>
<td>12/31/X7</td>
<td>Fair Value (Level 3): 750 shares @ $106.667</td>
<td></td>
<td></td>
<td></td>
<td>$80,000</td>
</tr>
<tr>
<td>1/1/X8</td>
<td>Beginning Balance (Level 3)</td>
<td></td>
<td></td>
<td></td>
<td>Market Value = $80,000</td>
</tr>
<tr>
<td>3/1/X8</td>
<td>Purchase 250 shares @ $100</td>
<td>250</td>
<td>$100</td>
<td>$25,000</td>
<td></td>
</tr>
<tr>
<td>7/1/X8</td>
<td>Sold 300 shares @ $133.333</td>
<td>300</td>
<td></td>
<td>$30,000</td>
<td>Realized Gain = $10,000</td>
</tr>
<tr>
<td>12/31/X8</td>
<td>Fair Value (Level 3): 700 shares @ 164.286</td>
<td></td>
<td></td>
<td></td>
<td>$115,000</td>
</tr>
</tbody>
</table>

**Investments in Securities**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance as of 12/31/X7</td>
<td>$80,000</td>
</tr>
<tr>
<td>Realized gain (loss)</td>
<td>10,000</td>
</tr>
<tr>
<td>Change in unrealized appreciation (depreciation)</td>
<td>40,000</td>
</tr>
<tr>
<td>Net purchases (sales)</td>
<td>(15,000)</td>
</tr>
<tr>
<td>Balance as of 12/31/X8</td>
<td>$115,000</td>
</tr>
</tbody>
</table>

Credit Default Swap: Issue is valued daily with significant unobservable inputs.

<table>
<thead>
<tr>
<th>Date</th>
<th>Action</th>
<th>Notional Value</th>
<th>Cost</th>
<th>Ap/Dp</th>
</tr>
</thead>
<tbody>
<tr>
<td>6/1/X7</td>
<td>Purchase $100,000 notional value</td>
<td>$100,000</td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>12/31/X7</td>
<td>Fair Value (Level 3): $95,000</td>
<td></td>
<td></td>
<td>$(5,000)</td>
</tr>
<tr>
<td>1/1/X8</td>
<td>Beginning Balance (Level 3)</td>
<td></td>
<td></td>
<td>$(5,000)</td>
</tr>
<tr>
<td>7/1/X8</td>
<td>Sold $50,000 notional @ $45,000</td>
<td>$50,000</td>
<td>$50,000</td>
<td></td>
</tr>
<tr>
<td>12/31/X8</td>
<td>Fair Value (Level 3): $35,000</td>
<td></td>
<td></td>
<td>$(15,000)</td>
</tr>
</tbody>
</table>

**Other Financial Instruments**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance as of 12/31/X7</td>
<td>$(5,000)</td>
</tr>
<tr>
<td>Realized gain (loss)</td>
<td></td>
</tr>
<tr>
<td>Change in unrealized appreciation (depreciation)</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Balance as of 12/31/X8</td>
<td>$(15,000)</td>
</tr>
</tbody>
</table>

*The realized gain (loss) earned during the fiscal year ended 12/31/X8 for Other Financial Instruments was $(5,000).
Supplemental Level 3 Reconciliation Examples

The following examples are intended to address reporting concerns related to intra-period transfers to and from Level 3. Each scenario has three presentation options in order to facilitate discussion.

The first option assumes the security would be transferred in/out of Level 3 at the market value of the holding at the end of the reporting period, as illustrated in the preceding sample Level 3 reconciliation disclosures. The second option assumes the security would be transferred in/out of Level 3 at the market value at the beginning of the reporting period (i.e., end of the previous reporting period). Both options are based on point-in-time measures and are consistently applied to both transfers in and transfers out. Alternatively, a fund may reflect transfers in/out of Level 3 at the value on the actual date the security moves to/from Level 3 inputs, as presented in the third option. These examples present a limited number of options and other approaches may also be permissible, such as transfers in at the beginning of period value combined with transfers out at end of period value. Funds should consult with their accounting system service provider and their independent auditor as they consider implementation of the Level 3 reconciliation.

Example 1: Security was held in a prior reporting period and valued with observable market inputs (i.e. Level 1 or Level 2). The security was valued with significant unobservable inputs at a point within the current reporting period and at period end (i.e. Level 3).

10/01/X7 Purchase 10 shares @ $110 Cost = $1,100
12/31/X7 Market Close (Level 1) 10 shares @ $100 Market Value $1,000
5/23/X8 Fair Value (Level 3): 10 shares @ $90 Market Value = $900
(moved to Level 3)
12/31/X8 Fair Value (Level 3): 10 shares @ $85 Market Value = $850

Option I – End of Period:

<table>
<thead>
<tr>
<th>Investments in Securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance as of 12/31/X7</td>
</tr>
<tr>
<td>Transfers in and/or out of Level 3</td>
</tr>
<tr>
<td>Balance as of 12/31/X8</td>
</tr>
</tbody>
</table>

Option II – Beginning of Period:

<table>
<thead>
<tr>
<th>Investments in Securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance as of 12/31/X7</td>
</tr>
<tr>
<td>Change in unrealized appreciation (depreciation)</td>
</tr>
<tr>
<td>Transfers in and/or out of Level 3</td>
</tr>
<tr>
<td>Balance as of 12/31/X8</td>
</tr>
</tbody>
</table>
**Option III – Intra-Period:**

<table>
<thead>
<tr>
<th>Investments in Securities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance as of 12/31/X7</td>
<td>$ -</td>
</tr>
<tr>
<td>Change in unrealized appreciation (depreciation)</td>
<td>(50)</td>
</tr>
<tr>
<td>Transfers in and/or out of Level 3</td>
<td>900</td>
</tr>
<tr>
<td>Balance as of 12/31/X8</td>
<td>$ 850</td>
</tr>
</tbody>
</table>

**Example 2:** Security was held in a prior reporting period and valued with significant unobservable inputs (i.e. Level 3). The unobservable inputs were used for a period of time in the current reporting period. The security was subsequently valued with observable market inputs at a point within the current reporting period and at period end (i.e. Level 1 or 2).

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Quantity</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>10/1/X7</td>
<td>Purchase 10 shares @ $110</td>
<td>10</td>
<td>$1,100</td>
</tr>
<tr>
<td>12/31/X7</td>
<td>Fair Value (Level 3) 10 shares @ $100</td>
<td>10</td>
<td>Market Value $1,000</td>
</tr>
<tr>
<td>5/23/X8</td>
<td>Market Close (Level 1): 10 shares @ $90</td>
<td>10</td>
<td>Market Value = $900 (moved to Level 1)</td>
</tr>
<tr>
<td>12/31/X8</td>
<td>Market Close (Level 1): 10 shares @ $85</td>
<td>10</td>
<td>Market Value = $850</td>
</tr>
</tbody>
</table>

**Option I – End of Period:**

<table>
<thead>
<tr>
<th>Investments in Securities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance as of 12/31/X7</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Change in unrealized appreciation (depreciation)</td>
<td>(150)</td>
</tr>
<tr>
<td>Transfers in and/or out of Level 3</td>
<td>(850)</td>
</tr>
<tr>
<td>Balance as of 12/31/X8</td>
<td>$ -</td>
</tr>
</tbody>
</table>

**Option II – Beginning of Period:**

<table>
<thead>
<tr>
<th>Investments in Securities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance as of 12/31/X7</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Change in unrealized appreciation (depreciation)</td>
<td>-</td>
</tr>
<tr>
<td>Transfers in and/or out of Level 3</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Balance as of 12/31/X8</td>
<td>$ -</td>
</tr>
</tbody>
</table>
Option III – Intra-Period:

<table>
<thead>
<tr>
<th>Investments in Securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance as of 12/31/X7</td>
</tr>
<tr>
<td>Change in unrealized appreciation (depreciation)</td>
</tr>
<tr>
<td>Transfers in and/or out of Level 3</td>
</tr>
<tr>
<td>Balance as of 12/31/X8</td>
</tr>
</tbody>
</table>

*Since this is a reporting requirement, we do not believe it is necessary to track securities that have moved to and from Level 3 throughout the period unless the security was a Level 3 at the beginning or end of the reporting period. In accordance with this position, we do not believe it is necessary to separately track the gain/loss activity of a Level 3 security for intra-period transfers, however, intra-period tracking is permitted.*