

CHAPTER 1

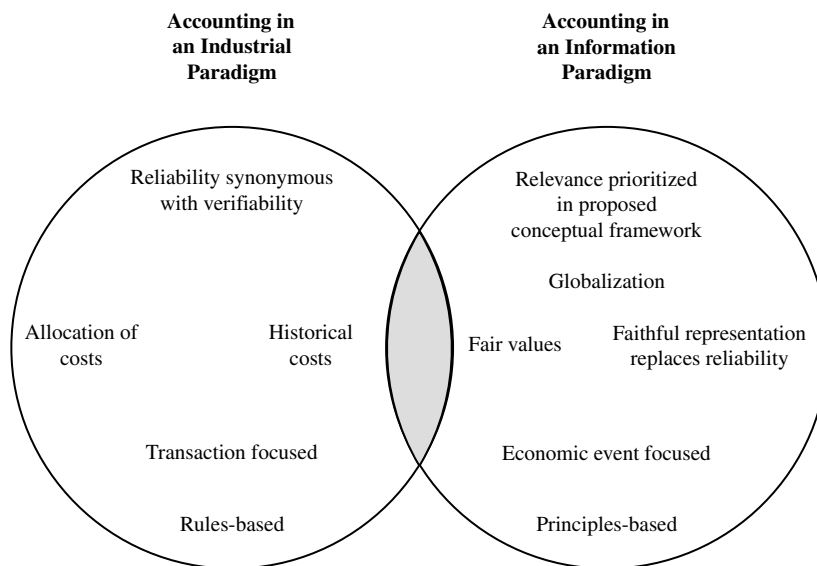
Fair Value Measurements and Financial Reporting

Financial Reporting and the Current Environment

Fair value is here to stay and fair value measurements are becoming a pillar of accounting and auditing. The accounting model has changed. No longer is accounting based solely on historical cost; in fact, it never was. It has always been a mixed-attribute system; a little historical cost here and a little fair value there. The more pronounced change, however, has been from hierarchal guidance that was predominantly rules-based to principles-based guidance. Accounting has always been regulatory driven. Until now, professionals could cite a specific rule to document compliance, a “one size fits all.” Now, though, the citations must be principles driven—“do what’s right given the circumstances.”

Financial accounting and reporting are in the midst of one of the most significant revolutionary changes in modern history. ... We are moving from an accounting paradigm that existed in the age of an industrial economy to an accounting paradigm that fits the economy in an information age. This redirection has resulted in the following: a change in the conceptualization and application of relevance and reliability, an increased use of fair value versus historical cost measurements, a renewed emphasis on principles versus rules, and an evaluation of the composition of the basic financial statements.¹

In the paper *Understanding the Changes in Accounting Thought*, Professors of Accountancy Rebecca Toppe Shortridge and Pamela A. Smith state:

**EXHIBIT 1.1 Paradigms Depicted**

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Currently, accounting is undergoing a revolutionary change in thought regarding the core fundamentals upon which financial accounting is based. The catalysts for the transformation can be attributed to the movement from an industrial economy to an information economy, increased globalization, improvements in data availability, and increased information processing capabilities.

We refer to the change in accounting fundamentals as a paradigm shift. The old paradigm, hereafter referred to as the industrial paradigm, existed during the industrial economy and was based on the FASB's (Financial Accounting Standards Board's) original conceptual framework. It emphasized historical cost measurements, was rules-based, and was focused on transactions and allocations [Exhibit 1.1]. This paradigm reflected rules that allowed estimates and judgments but thrived on the certainty and precision garnered from historical cost measurements. The application of industrial age accounting practices in the new economy resulted in several anomalies in financial reporting that spurred significant changes in accounting thought. As a result of these developments, a new financial reporting paradigm emerged.

The fundamentals of the new paradigm, hereafter referred to as the information paradigm, exists in an information economy and is based on the proposed conceptual framework. Further, the new paradigm is principles-based, emphasizes fair value, and focuses on economic events [see Exhibit 1.1]. It is important to note that although the change from historical cost to fair value measurements currently has high visibility, this change alone is not what we are conceptualizing as a paradigm shift. All of the factors presented in the diagram are part of the paradigm shift. In the information model, the FASB (2006a) has proposed that the notion of reliability be replaced with faithful representation. The new terminology is indicative of the FASB's movement to emphasize the substance of economic events over their form. This new focus leads to an increased emphasis on principles versus rules and fair value versus historical cost measures. [Exhibit 1.1] highlights the overlap that is occurring as the financial reporting environment moves from an industrial age to an information age. The shift in accounting paradigms is not complete, and therefore the standards issued during the transition period have characteristics from each paradigm.²

Professors Shortridge and Smith continue their thought analysis by offering their views of a new hierarchy of accounting qualities. The old hierarchy's tension between relevance and reliability is replaced with a sequential process of relevance, faithful representation, comparability, and understandability. As the professors state:

[Exhibit 1.2] depicts the authors' interpretation of the hierarchy of accounting qualities in the proposed conceptual framework currently being deliberated by the FASB (FASB, 2006a). In this hierarchy, decision-useful information is information that is relevant, faithfully represented, comparable, and understandable. These characteristics are applied sequentially when determining what information is reported, because the application of the characteristics follows a logical sequence (numbered 1, 2, 3, and 4 in [Exhibit 1.2]). The first and most important characteristic is relevance (FASB, 2006a, QC43). Relevance helps "identify which economic phenomena" need to be reported (FASB, 2006a, QC43). Relevant information has predictive and confirmatory value and is timely. Once the relevant information is identified, the second qualitative characteristic requires it to be faithfully represented. This means that the information depicts the economic phenomena in a faithful manner (FASB, 2006a, QC16). Faithfully represented information is verifiable, neutral, and complete. In the 1980 conceptual framework, faithful representation was a component of reliability; in the proposed conceptual framework it stands alone and replaces the term reliability.

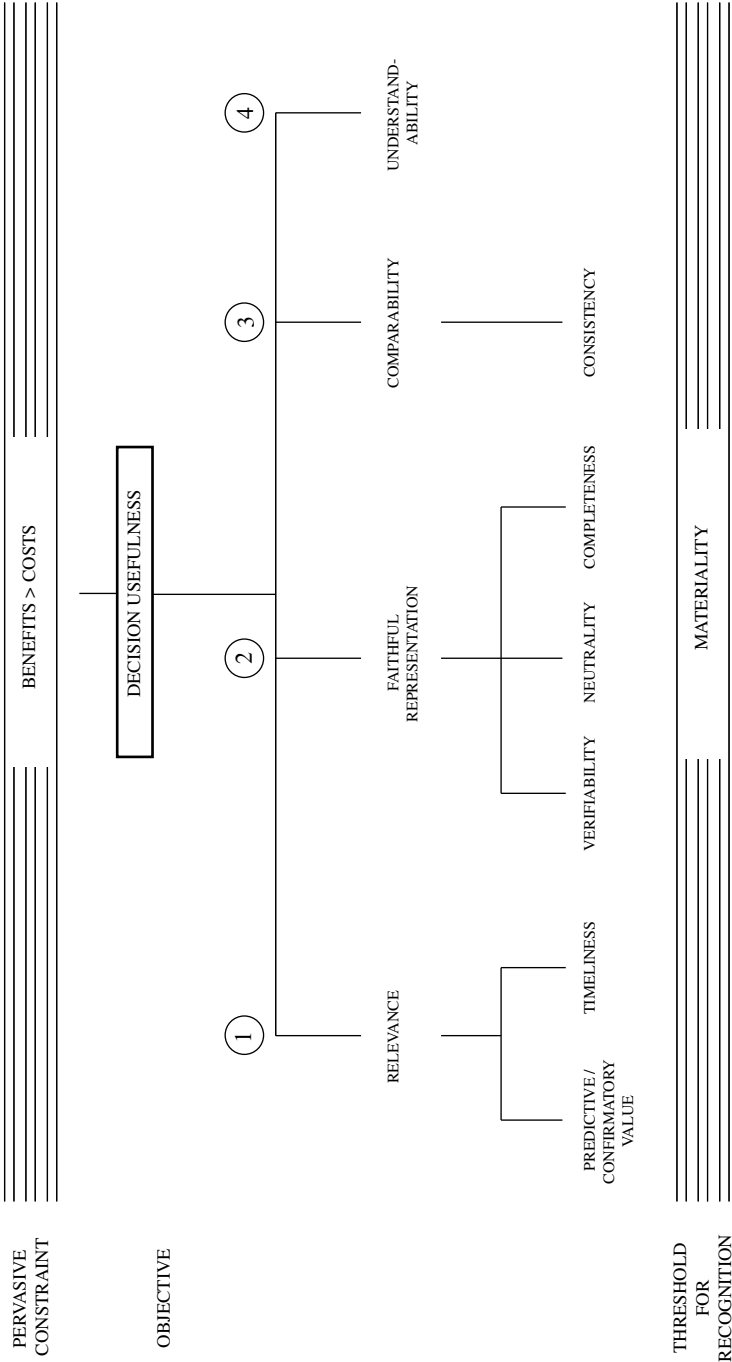


EXHIBIT 1.2 Information Paradigm Proposed Conceptual Framework

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Characteristics three and four of the proposed conceptual framework are comparability and understandability. Once it is determined that the information is relevant and faithfully represented, that information must be comparable. "Comparability is the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena" (FASB, 2006a, QC35). This also implies that the same policies are consistently applied through time and across different situations. Finally, the information needs to be understandable. In the 1980 conceptual framework, this characteristic applied to the user of the information. In the proposed conceptual framework, the FASB recognizes that understandable information must be "classified, characterized, and presented clearly and concisely" (FASB, 2006a, QC39).

The transformation of the conceptual framework is just one piece of evidence that there is a paradigm shift. As depicted in [Exhibit 1.1], there are other changes that parallel the changes in the conceptual framework. For example, there is a shift to fair value measurements, an increased emphasis on principles versus rules, and an increased focus on economic events versus transactions. The information economy enables all these changes because there is more information technology, more sophisticated valuation methodology, more globalization, and greater data accessibility.³

Change, of course, brings pain and, in the case of fair value measurement, significant controversy. That controversy flooded the financial press and made its way all the way to the U.S. Congress. In *The Crisis of Fair-Value Accounting: Making Sense of the Recent Debate*, Professor Christian Laux and Professor Christian Leuz state:

The recent financial crisis has led to a vigorous debate about the pros and cons of fair-value accounting (FVA). This debate presents a major challenge for FVA going forward and standard setters' push to extend FVA into other areas. In this article, we highlight four important issues as an attempt to make sense of the debate. First, much of the controversy results from confusion about what is new and different about FVA. Second, while there are legitimate concerns about marking to market (or pure FVA) in times of financial crisis, it is less clear that these problems apply to FVA as stipulated by the accounting standards, be it IFRS or U.S. GAAP. Third, historical cost accounting (HCA) is unlikely to be the remedy. There are a number of concerns about HCA as well and these problems could be larger than those with FVA. Fourth, although it is difficult to fault the FVA standards per se, implementation issues are a potential concern, especially with respect to litigation.⁴

Two of the bigger complaints of fair value measurement are procyclicality (in booms and busts) and contagion (across industries and markets) in financial markets. Put simply, downward adjustments required by fair value measurement lead to further downward metrics . . . a continuous downward spiral. It's interesting, however, that few complaints were heard when the economy was booming . . . only during the recent economic downturn did the objections mount, at certain points rising to a crescendo.

Fair Value Measurements

The FASB is the U.S. accounting standard setter for anyone reporting under generally accepted accounting principles (GAAP). It is the standard setter because the U.S. Securities and Exchange Commission (SEC) effectively recognizes the FASB for establishing GAAP applicable to publicly registered companies (subject to additional SEC requirements). Therefore, the fair value accounting literature issued by the FASB is effectively a regulatory accounting standard.

The FASB continues to move ahead with an agenda that includes fair value accounting. In 2006 it issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157) to take effect for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. In 2009, this statement was incorporated into the FASB's Accounting Standards CodificationTM (ASC or Codification). The changes brought about by SFAS 157 are discussed below.

Scope

The fair value measurement standard establishes a framework for making fair value measurements and requires additional disclosures about the measurements. The pronouncement does not establish any new areas in financial reporting where fair value accounting is required. Rather, it interacts with other accounting literature (in fact, it is woven throughout the ASC) that requires or permits fair value measurements.

Fair Value

For financial reporting, the ASC provides a single authoritative definition of *fair value*:

*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.*⁵

An important distinction with the FASB definition is that fair value may not consider synergies and attributes of a *specific* buyer and a *specific* seller, but may consider synergies available to *market participants*.

Fair value for financial reporting is not quite the same as fair market value as used with the IRS and other purposes. Characteristics of fair value in business combinations under GAAP include:

- Valuation methodologies specified in accounting literature and/or acceptable to the auditors.
- Generally established on an asset-by-asset and a situation-by-situation basis.
- Typically a control value, but more specifically, driven by the unit of account.
- The fair values of individual assets do not include a specific buyer's unique synergies unless such synergies are also those of "market participants."
- The additional purchase price paid in a business combination due to a synergistic component is recorded as goodwill and subsequently is subject to impairment testing.
- In the absence of quoted market prices, the technique used to estimate fair value is the method producing a fair value best approximating quoted market prices.
- Typically includes tax amortization benefits for individual assets in a business combination.
- Transaction costs are not an attribute of the asset or liability and thus purchase price is not adjusted.
- Considers the highest and best use of market participants in the principal (or most advantageous) market to establish the valuation premise (in-use or in-exchange).
- Considers a reporting entity's credit standing, or the credit standing of the creditor in the case of liabilities.
- Requires the use of market participant assumptions in assessing management's prospective financial information (projections).

Fair Value Hierarchy

The FASB has specified a hierarchical approach to determining fair value. The ASC defines a hierarchy⁶ in the development of fair value measurements as follows:

- *Level 1.* Inputs are observable market inputs that reflect quoted prices for identical assets or liabilities in active markets the reporting entity has the ability to access at the measurement date.

- *Level 2.* Inputs are observable market inputs other than quoted prices for identical assets or liabilities in active markets the reporting entity has the ability to access at the measurement date. Level 2 inputs include:
 - Quoted prices for similar assets or liabilities in active markets.
 - Quoted prices for identical or similar assets or liabilities in markets that are not active; that is, a market 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 (e.g., some brokered markets) or in which little information is released publicly (e.g., a principal-to-principal market).
 - Market inputs other than quoted prices that are directly observable for the asset or liability; for example, interest rates, yield curves, volatilities, and default rates that are observable at the commonly quoted intervals.
 - Market inputs that are not directly observable for the asset or liability but that are derived principally from or corroborated by other observable market data through correlation or by other means (market-corroborated inputs); for example, inputs derived through extrapolation or interpolation that are corroborated by other observable market data.
- *Level 3.* Inputs are unobservable market inputs; for example, inputs derived through extrapolation or interpolation that are not able to be corroborated by observable market data. Unobservable market inputs shall be used to measure fair value if observable market inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability. However, the fair value measurement objective remains the same; that is, an exit price from the perspective of a market participant (seller). Therefore, a fair value measurement using unobservable market inputs within Level 3 shall consider the assumptions that market participants would use in pricing the asset or liability, including assumptions about the amount a market participant (buyer) would demand to assume the risk related to the unobservable market inputs used to measure fair value. The reporting entity's own data used to develop the inputs shall be adjusted to exclude factors specific to the reporting entity if information is available that indicates that market participants would use different assumptions.

Level 1 and Level 2 inputs are sometimes called mark-to-market inputs, while Level 3 inputs are sometimes called mark-to-model inputs.

Entry Price versus Exit Price

Fair value is defined from the perspective of an exit (sale) price rather than an entry (purchase) price. The price is determined based on the amount

required to exchange the asset or liability in an orderly transaction between market participants. Exchange means to sell the asset or transfer the liability at the measurement date. An orderly transaction assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary. An exit price is based on a hypothetical transaction from the perspective of a market participant who holds the asset or owes the liability. Therefore, the objective is to determine the price that would be received to sell the asset or paid to transfer the liability at the measurement date, which makes it an exit price.

Although the idea that an exit price can be different from an entry price is something that has featured in deliberations and pronouncements by both FASB and IASB, the experience of the International Valuation Standards Board (IVSB) is that most valuers do not consider this to be a meaningful or valid distinction.⁷ If fair value is supposed to represent the price in a sale or a transfer, that price is simultaneously an exit for the seller and an entry for the buyer. Confusion is sometimes caused by people looking for the supposed difference and imagining unstated assumptions. For example, some consider that “exit” implies a liquidation or break-up; others consider that “entry” implies consideration of entity specific requirements.

Principal (or Most Advantageous) Market

The exit price is to be considered from the perspective of market participants in the principal (or most advantageous) market for the asset or liability.⁸ A fair value measurement is based on a transaction assumed to occur in the principal market for the asset or liability. The principal market is the market with the greatest volume and level of activity for the asset or liability. The most advantageous market is the market that would provide the highest price for an asset and the lowest for a liability. The principal market trumps the most advantageous market and is considered by the FASB to be a more expedient, relevant, and consistent metric for the preparer. If for whatever reason the principal market cannot be defined, the preparer may default to an advantageous market. 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. For more on markets, see the sections “Active Market” and “Efficient Market.”

Transaction Costs

Transaction costs are specific to the transaction and represent the incremental direct costs to sell the asset or transfer the liability; thus, the price should not be adjusted for transaction costs because they are not an attribute of the

asset or liability. However, transportation costs are included in the fair value measurement of an asset measured on an “in-use” basis.⁹

Market Participants

Market participants are defined for purposes of fair value measurements.¹⁰ They are buyers and sellers in the most advantageous market for the asset or liability. Market participants are also:

- Independent of the reporting entity.
- Knowledgeable (having all relevant information, including obtaining information through usual and customary due diligence).
- Able to transact.
- Willing to transact (motivated but not compelled).

Highest and Best Use of an Asset

A fair value measurement of an asset assumes the highest and best use of the asset from the perspective of market participants, regardless of how the company actually intends to use it.¹¹ It also requires considering that the use of the asset is:

- Physically possible
- Legally permissible
- Financially feasible

Highest and best use is based on the use of the asset and generally results in maximizing the value. As such, the valuation premise may be either:

- *In-use*, which would provide maximum value through its use in combination with other assets as a group. As early practice has evolved, the in-use premise most often and may only apply to nonfinancial assets.
- *In-exchange*, which would provide maximum value on a stand-alone basis, such as some financial assets.

As of this writing, the FASB is very near to adopting an Accounting Standards Update (ASU) proposing the elimination of the terms “in-use” and “in-exchange.” Instead of the term “in-use,” the FASB has proposed the term “combination with other assets” or “combination with other assets and liabilities.” Further, the FASB has proposed to use the term “stand-alone basis” instead of in-exchange. Importantly, the fair value of an asset in-use is determined based on the use of the asset together with other assets as a group (consistent with its highest and best use from the perspective of market participants), even if the asset that is the subject of the measurement

is aggregated (or disaggregated) at a different level for purposes of applying other accounting pronouncements. This requirement may result in different aggregation assumptions from those used for impairment analyses.

In the proposed ASU, the FASB specifies that the highest and best use and valuation premise are relevant only when measuring the fair value of nonfinancial assets and are not relevant when measuring the fair value of financial assets or of liabilities. This is because financial assets or liabilities do not have alternative uses and their fair values do not depend on their use within a group of other assets or liabilities. The authors believe this ASU will be adopted.

Applicability to Liabilities

For a liability, a fair value measurement assumes a transfer of the liability to market participants. For the determination of price related to the transfer of a liability, nonperformance risk must be considered and must be the same before and after the assumed transfer. Nonperformance risk is the risk of not fulfilling the obligation and includes (but may not be limited to) the reporting entity's own credit risk.¹²

Initial Recognition

When an asset is acquired or a liability is assumed in an exchange transaction, the transaction price represents an *entry price* to acquire or assume. By contrast, fair value measurement after acquisition or assumption is a function of the hypothetical price to sell the asset or paid to transfer the liability and is thus an *exit price*.¹³

Valuation Approaches: Market, Income, and Cost

Fair value measurement also calls for valuation techniques used to measure fair value that are consistent with the market approach, income approach, and cost approach.¹⁴ The measurement objective is to use a valuation technique (or a combination of techniques) appropriate for the circumstances but maximizing the use of market inputs.¹⁵

Fundamentally, value is a function of economics and is based on the return on assets. The cost approach represents the things owned or borrowed. The income approach quantifies the return these assets can be expected to produce. The market approach merely reflects the market's perceptions of the things owned and borrowed or their expected returns.

For the determination of fair value measurement, the *cost approach* is based on the current replacement cost—the amount that at the measurement date would be required to replace the service capacity of the asset. It is based on the cost to a market participant to acquire or construct a substitute asset of

comparable utility, adjusted for obsolescence whether physical, functional, or economic.

The *income approach* uses valuation techniques to convert future amounts to a single present amount and is based on the value indicated by current market expectations about those future amounts. This approach includes present value techniques such as option-pricing models, binomial models, and the multiperiod excess earnings method.¹⁶ Importantly, present value techniques originally presented by the FASB in Statement of Financial Accounting Concepts No. 7 are now Level A GAAP.¹⁷ These techniques include:

- Discount rate adjustment technique, which is the traditional method where the denominator incorporates all risk elements related to the single cash flow being discounted.¹⁸
- Expected present value technique, which is a function of the probability weighted average of all possible cash flows discounted at a risk-free rate. There are two methods:
 1. Adjusting the expected cash flows for systematic (or market) risk.
 2. Not adjusting the expected cash flows for systematic risk, but instead including the risk adjustment in the discount rate.¹⁹

The *market approach* uses prices of market transactions involving identical or similar assets or liabilities. Remember here the fair value hierarchy: Level 1 is identical assets or liabilities and Level 2 is similar assets or liabilities. Therefore, the market approach may be either a Level 1 or Level 2 determination. Further, matrix pricing is considered consistent with the market approach. This applies to debt securities that do not rely exclusively on quoted prices for the specific securities, but rather rely on the securities' relationship to other benchmark quoted securities. Because people often confuse the term "market approach" with "market value," the forthcoming exposure draft of the revised IVS uses the term "Direct Market Comparison Approach" rather than "Market Approach."

Inputs: Observable and Unobservable

Inputs refer broadly to the assumptions that market participants would use in pricing the asset or liability and can be of two types:

1. *Observable inputs* are based on assumptions that market participants would use and be independent of the reporting entity.
2. *Unobservable inputs* are based on the entity's own assumptions about the assumptions market participants would use based on the best available information.²⁰

Fair value measurements require maximizing observable inputs and minimizing unobservable inputs.

Active Market

The FASB has provided the following, rather vague, definition of active market:

*An active market for an 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.*²¹

As stated previously, Level 1 inputs are observable market inputs that reflect quoted prices for identical assets or liabilities in active markets. In explaining its reasoning for referencing quoted market prices, the FASB cited paragraph 57 of SFAS No. 107:

*The Board concluded that quoted market prices provide the most reliable measure of fair value. Quoted market prices are easy to obtain and are reliable and verifiable. They are used and relied upon regularly and are well understood by investors, creditors, and other users of financial information. In recent years, new markets have developed and some existing markets have evolved from thin to active markets, thereby increasing the ready availability of reliable fair value information. (emphasis added)*²²

Further, the FASB affirmed:

*that its intent was not to preclude adjustments to a quoted price if that price is not readily available or representative of fair value, noting that in those situations, the market for the particular asset or liability might not be active. To convey its intent more clearly, the Board clarified that in those situations, the fair value of the asset or liability should be measured using the quoted price, as adjusted, but within a lower level of the fair value hierarchy. (emphasis added)*²³

The FASB recognizes the distinction between a thin and an active market. The ASC essentially calls for a process to determine whether a market may not be active and a transaction is not distressed.²⁴ First, a preparer of a company's financial statements should analyze factors that indicate a market is not active, including:

- Few recent transactions (based on volume and level of activity in the market). Thus, there is not sufficient frequency and volume to provide pricing information on an ongoing basis.
- Price quotations are not based on current information.
- Price quotations vary substantially either over time or among market makers (for example, some brokered markets).

- Indexes that previously were highly correlated with the fair values of the asset are demonstrably uncorrelated with recent indications of fair value for that asset or liability.
- Abnormal (or significant increases in) liquidity risk premiums or implied yields for quoted prices when compared with reasonable estimates (using realistic assumptions) of credit and other nonperformance risk for the asset class.
- Abnormally wide bid-ask spread or significant increases in the bid-ask spread.
- A significant decline or absence of a market for new issuances (i.e., a primary market).
- Little information is released publicly (for example, a principal-to-principal market).

After evaluating all factors and considering the significance and relevance of each factor, the reporting entity shall use its judgment in determining whether the market is active. If the reporting entity concludes that the market for the asset is not active, then the transactions or quoted prices available may be distorted and not indicative of fair value. In such a case, the reporting entity must develop further analysis and may determine that a significant adjustment is necessary to the transaction or quoted price. Such analysis may include whether there was sufficient time before the measurement date to allow for usual and customary marketing activities for the asset and/or whether there were multiple bidders for the asset.

Efficient Market

The idea behind fair value measurements is transparency; the goal is to provide the user with current market information that will enable that user to make an informed decision. This approach assumes the market is stable and reasonable in order to allow the most efficient allocation (investing) of capital. But what if the market information is biased?

The theory that markets are in some degree efficient has been around since the 1960s. Eugene Fama did original work in the area and observed:

*Market efficiency requires that in setting the prices of securities at any time $t - 1$, the market correctly uses all available information.*²⁵

Michael Jensen offered this definition:

*A market is efficient with respect to a given information set if it is impossible to make profits by trading on the basis of that information set. By economic profits is meant the risk-adjusted returns net of all costs.*²⁶

Some know this efficient market theory as the “random walk theory.” In *The Stock Market: Theories and Evidence*, James H. Lorie, Peter Dodd, and Mary Hamilton Kimpton said:

Three forms of the efficient market hypothesis have been distinguished: (1) the weak form, (2) the semistrong form, and (3) the strong form. The weak form asserts that current prices fully reflect the information implied by the historical sequence of prices. . . . The semistrong form asserts that current prices fully reflect public knowledge about the underlying companies and that efforts to acquire and analyze this knowledge cannot be expected to produce superior investment results. . . . The strong form asserts that not even those with privileged information can make use of it to secure superior investment results.²⁷

An efficient market means that the market pricing is not biased; it is reflecting all information rationally such that excess profits (or losses) cannot be made. Such a market is said to be efficient or balanced.

But what if the market is not efficient, not balanced? What if the market is inactive or hyperactive? Inactive or hyperactive markets are merely subsets of inefficient markets. The 2008 to 2009 recession, which featured sellers outnumbering buyers, resulted in few transactions, and at depressed prices. Conceptually, this is the flip side of 1999 (and subsequent), when buyers outnumbered sellers, and prices reached unreasonably high levels.

Accordingly, the first step in valuing an asset that is publicly traded, or in valuing an asset based on market inputs, would be to ascertain whether the market is balanced (buyers and sellers in equal numbers). Only in those cases could market data be used without adjustments. In cases of imbalance, the preparer must adjust the data, or move to an alternative method of valuation, such as a discounted cash flow (DCF) model.

If a fair value measurement is biased by using market data without regard to the degree of market efficiency, then the measurement will reflect whatever inefficiency is embodied in that market at that time. We believe, based on many years of working with the FASB, that the Board intended fair value measurement to reflect management’s use of the investor’s assets in an unbiased market. In many ways, using management inputs assuming a market participant or reasonable investor (Level 3) may be more reflective of an efficient market than using only observable data (Level 1) in an inactive market.

There is a presumption in the accounting and audit communities that observable inputs should always trump unobservable inputs. However, a Level 1 market price of an asset in an orderly and efficient market is no more than the equilibrium price at a point in time. That is, the number of buyers who think the asset is worth more equals the number of sellers who

think the asset is worth less. If the buyers are flush with cash and optimism, the price can be above fair value. And if the sellers are under pressure to raise cash or redeem investors, the price will be below fair value.

One solution may be to perform fundamental analyses, such as an income or DCF Model, in all valuations. If these could be coupled with an analysis of market volume, either extraordinarily high, or very low, a persuasive argument could be made for the market prices, or against the market prices, as the best indicator of fair value.

The goal of fair value measurement is to allow the user of financial statements to judge management's utilization of the assets. This requires that such measurement and judgment be made in an unbiased environment. Fair value measurement must assume an efficient market. Unbiased capital allocation by the user and investor requires it.

Orderly Transaction

In order to determine if a transaction is orderly, a reporting entity shall consider:

- If the weight of the evidence indicates the transaction is not orderly, a reporting entity shall place little, if any, weight (compared with other indications of fair value) on that transaction price when estimating fair value or market risk premiums.²⁸
- If the weight of the evidence indicates the transaction is orderly, a reporting entity shall consider that transaction price when estimating fair value or market risk premiums. The amount of weight placed on that transaction price when compared with other indications of fair value will depend on the facts and circumstances such as the volume of the transaction, the comparability of the transaction to the asset or liability being measured at fair value, and the proximity of the transaction to the measurement date.²⁹
- If a reporting entity does not have sufficient information to conclude that the transaction is orderly or that the transaction is not orderly, it shall consider that transaction price when estimating fair value or market risk premiums. However, that transaction price may not be determinative of fair value (that is, that transaction price may not be the sole or primary basis for estimating fair value or market risk premiums). A reporting entity shall place less weight on transactions on which a reporting entity does not have sufficient information to conclude whether the transaction is orderly when compared with other transactions that are known to be orderly.³⁰

In its determinations, a reporting entity need not undertake all possible efforts, but shall not ignore information that is available without undue cost and effort. A reporting entity would be expected to have sufficient information to conclude whether a transaction is orderly when it is party to the transaction.³¹ Importantly, a reporting entity's intention to hold the asset or liability is not relevant in estimating fair value. Fair value is a market-based measurement, not an entity-specific measurement.³² Further, a fair value measurement should include a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) in the cash flows.³³ Risk premiums should be reflective of an orderly transaction (that is, not a forced or distressed sale) between market participants at the measurement date under current market conditions.³⁴

Subsequent Events

In an effort to obtain the most relevant price available, even if it is after the measurement date, the FASB is allowing subsequent events to determine such price.³⁵ As the Board observes, in some cases significant events might occur after the close of a market but before the measurement date, which will defeat the previously determined quoted price such that it might not be representative of fair value at the measurement date. Examples given include principal-to-principal transactions, brokered trades, or announcements. As a result, the FASB stated:

*The reporting entity should not ignore information that is available at the reporting date (for example, a large change in the price in another market after the close of the principal market in which the asset or liability trades). The Board agreed that entities should establish and consistently apply a policy for identifying those events that might affect fair value measurements. However, if a quoted price is adjusted for new information, the fair value measurement is a lower level measurement.*³⁶

Securities Owned as an Asset and Blockage Discounts

The FASB focused on securities owned as an asset and the unit of account. It considered whether the unit of account for a block position that trades in an active market is an individual unit or a block. The fair value measurement price consequently would be a function of the price either reflecting or not reflecting the blockage factor (generally, a depression of value resulting from the size of the position traded). After considering its own previous pronouncements on this issue and many comments from users and providers, the FASB decided to not allow blockage adjustments.

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 and 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.³⁷

Therefore the ASC precludes the use of blockage discounts in fair value measurements and eliminates the exceptions of using blockage as provided in previous pronouncements (i.e., SFAS Nos. 107, 115, 124, 133, and 140). The unit of account for an instrument that trades in an active market is the individual trading unit.

As of this writing, the FASB is very near adopting an Accounting Standards Update (ASU) that would reaffirm the prohibition against blockage factors. Further, the ASU would specifically extend this prohibition to valuation techniques other than quoted prices (i.e., Level 2 and 3 categories). Discounts or premiums other than blockage, however, are allowed when market participants would consider them. The authors believe this ASU will be adopted.

Restricted Stock

The fair value of restricted stock must be determined based on whether market participants would consider the effect of the restriction. For example, a publicly traded stock restricted under Rule 144 or similar rules of the SEC would be adjusted to reflect such restrictions if the restriction is an attribute of the security and would transfer to market participants.³⁸

Mark-to-Market Accounting

On March 12, 2009, FASB Chairman Robert Herz testified about mark-to-market accounting before the U.S. House of Representatives Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises. Herz appeared at a hearing convened by Congressman and Committee Chairman Paul E. Kanjorski (D-PA) on "Mark-to-Market Accounting: Practices and Implications."

Many investors have made it clear that, in their view, fair value accounting allows companies to report amounts that are more relevant, timely,

and comparable than amounts that would be reported under alternative accounting approaches, even during extreme market conditions.

The fact that fair value measures have been difficult to determine for some illiquid instruments is not a cause of current problems but rather a symptom of the many problems that have contributed to the global crisis—including lax and fraudulent lending, excess leverage, the creation of complex and risky investments through securitization and derivatives, the global distribution of such investments across rapidly growing unregulated and opaque markets lacking a proper infrastructure for clearing mechanisms and price discovery, faulty ratings, and the absence of appropriate risk management and valuation processes at many financial institutions.

Statement 157 is a principles-based standard that requires the application of sound judgment in determining fair value estimates. Judgment is not new in accounting; however, the increased attention on fair value estimates and principles-based standards has increased focus on the use of judgment. In its final report to the SEC, CIFIIR recommended that the SEC issue a statement of policy articulating how it evaluates the reasonableness of accounting judgments, including the factors that it considers when making this evaluation. That recommendation also included a suggestion that the PCAOB should adopt a similar approach with respect to auditing judgments.³⁹

The reality is that the standard setters, like FASB, are quite limited outside that role. Others, principally the SEC, must enforce them. The newly appointed Chairman of the SEC, Mary Schapiro, recently announced additional funding to bolster the enforcement division of the SEC. It's all a simple formula, really. The FASB establishes the standards, the preparers (companies) implement them in their financial statements, and the SEC and others are the cops to make sure that the laws are followed. Chairman Herz was more elegant when he stated:

The primary roles of accounting standard setters and prudential regulators are fundamentally different. Accounting standard setters focus on developing accounting standards that help provide transparency in general-purpose financial statements of reporting enterprises that are used by investors and others to make capital resource allocation decisions. The information needs of those parties often differ from that of regulators, who are largely concerned with safety and soundness and financial stability. Accounting standard setters stress the importance of having the information in general purpose financial statements be neutral, that is, free from bias. The goal is to provide information useful to

users of financial statements in their decision making. Such users include present and potential investors, lenders, suppliers, and other trade creditors, customers, employees, governments and their agencies, and the public. Primacy is given to the informational needs of investors (both equity and debt security holders).

The focus of financial reports is on the communication of information to investors and the capital markets to facilitate informed investment decisions, without which markets do not function well. This focus informs the structure and purpose of the financial accounting and standard-setting process and the resultant standards.

A paramount goal of the federal government has been to ensure the stability of the financial system. A principal policy tool used to achieve this goal has been the prudential regulation and supervision of financial institutions, which is designed to remove or lessen the threat of systemic instability, as well as, in the case of commercial banks and other deposit-taking institutions, to protect customer deposits.⁴⁰ (footnotes omitted)

Fair value including mark to market requires orderly transactions. When a market is judged to not be orderly, preparers, auditors, valuers, regulators, and users of financial statements all have a responsibility to use judgment . . . the judgment to present reasonable estimates based on an efficient, balanced, and stable market. To do otherwise creates a bias that harms everyone.

Notes

1. Reprinted from Rebecca Toppe Shortridge and Pamela A. Smith, "Understanding the Changes in Accounting Thought," *Research in Accounting Regulation*, 21, 11–18 (2009), with permission from Elsevier.
2. Ibid.
3. Ibid.
4. Christian Laux and Christian Leuz, "The Crisis of Fair-Value Accounting: Making Sense of the Recent Debate," *Accounting, Organizations and Society* (2009), doi:10.1016/j.aos.2009.04.003.
5. Financial Accounting Standards Board, Accounting Standards Codification (2009), Section 820-10-20.
6. Ibid., at 820-10-35-40, 820-10-35-47 to 820-10-35-48.
7. The IVSB is currently working on an exposure draft of the revised International Valuation Standards.
8. Financial Accounting Standards Board, Accounting Standards Codification (2009), at 820-10-35-5.
9. Ibid., at 820-10-35-7.

10. Ibid., Glossary.
11. Ibid., at 820-10-35-10 to 820-10-35-13.
12. Ibid., at 820-10-35-16.
13. Ibid., 820-10-35-3.
14. Ibid., at 820-10-35-28 to 820-10-35-35.
15. Ibid., at 820-10-35-36.
16. Ibid., at 820-10-35-33.
17. Accounting standard setters have classified accounting pronouncements and other publications into a hierarchy (or levels).
18. Financial Accounting Standards Board, Accounting Standards Codification (2009), at 820-10-55-4.
19. Ibid., at 820-10-55-15 to 820-10-55-16.
20. Ibid., at 820-10-35-36.
21. Ibid., Section 820-10-20.
22. Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, (2006), at C66.
23. Ibid., at C68.
24. Financial Accounting Standards Board, Accounting Standards Codification (2009), at 820-10-35-51a.
25. Eugene F. Fama, "Efficient Capital Markets: Reply." *The Journal of Finance*, vol. 31, no. 1 (1976, March), p. 143.
26. Michael C. Jensen, "Some Anomalous Evidence Regarding Market Efficiency." *Journal of Financial Economics*, vol. 6, nos. 2/3 (1978) 95–101, p. 3.
27. James H. Lorie, Peter Dodd, and Mary Hamilton Kimpton, *The Stock Market: Theories and Evidence*. (Homewood, IL: Richard D. Irwin, 1984), p. 56.
28. Financial Accounting Standards Board, Accounting Standards Codification (2009), at 820-10-35-51f.
29. Ibid.
30. Ibid.
31. Ibid.
32. Ibid., at 820-10-35-51d.
33. Ibid., at 820-10-35-51g.
34. Ibid.
35. Ibid., at 820-10-35-43.
36. Ibid.
37. Ibid., at 820-10-35-44.
38. Ibid., at 820-10-55-52.
39. Testimony of Robert H. Herz, Chairman, Financial Accounting Standards Board, before the U.S. House of Representatives Financial Services Subcommittee On Capital Markets, Insurance, and Government Sponsored Entities, March 12, 2009, p. 8.
40. Ibid., p. 4.
41. For more information on this flowchart, see *Business Combinations with SFAS 141R, 157, and 160: A Guide to Financial Reporting*, by Michael J. Mard, Steven D. Hyden, and Edward W. Trott, available at John Wiley & Sons.

APPENDIX 1.1

Fair Value Flowchart

To facilitate compliance with fair value measurement, we have developed the flowcharts shown in Exhibits 1.3 to 1.8.⁴¹

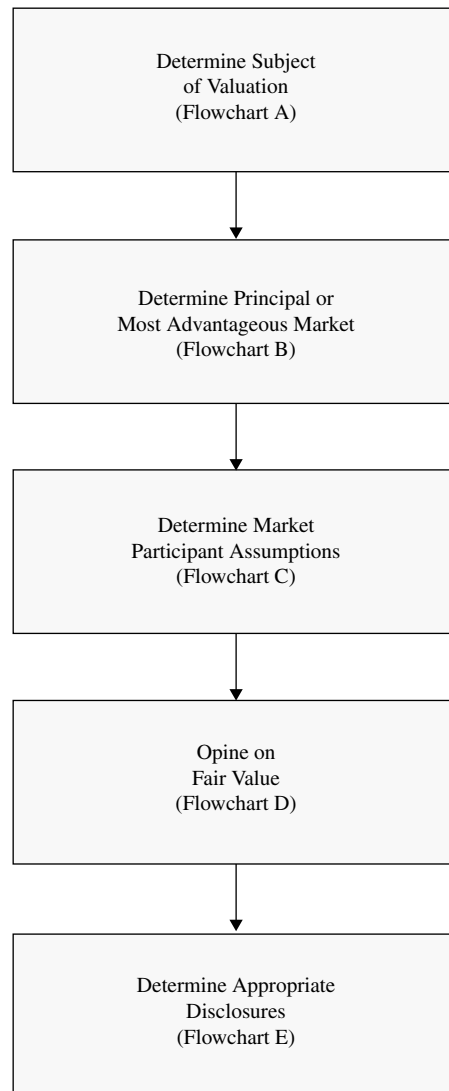
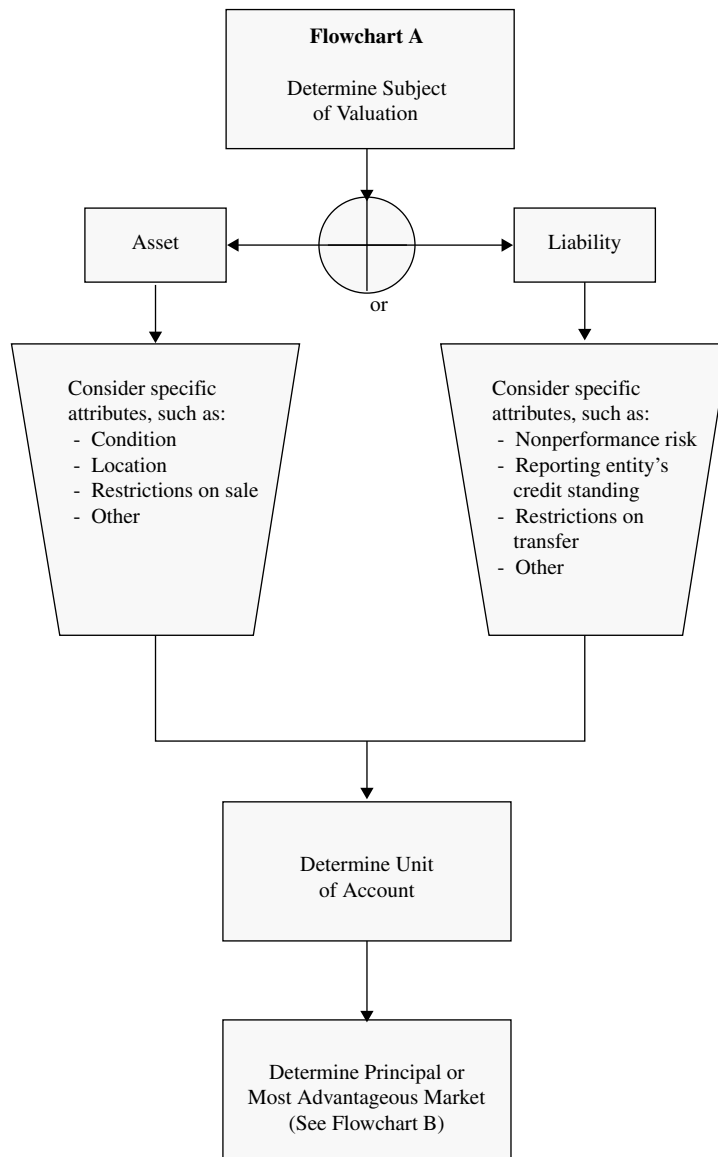
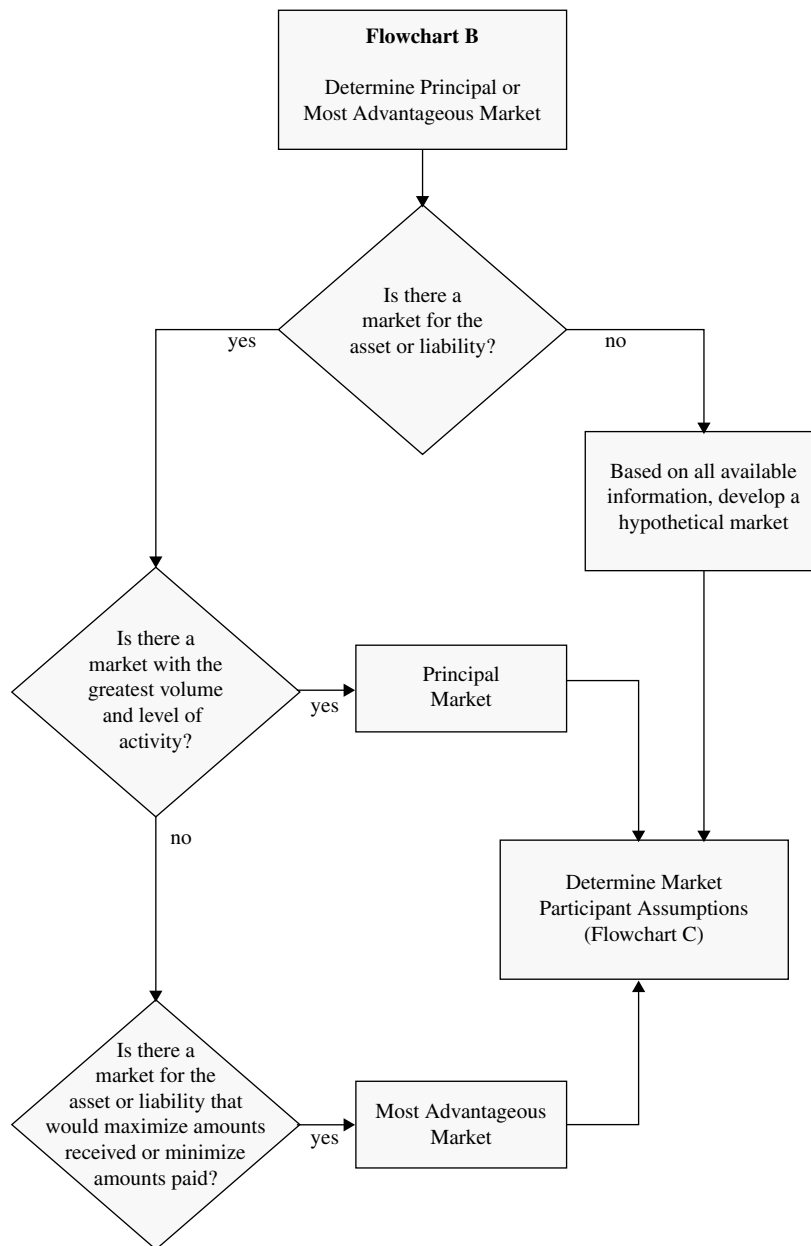


EXHIBIT 1.3 Fair Value Flowchart Overview

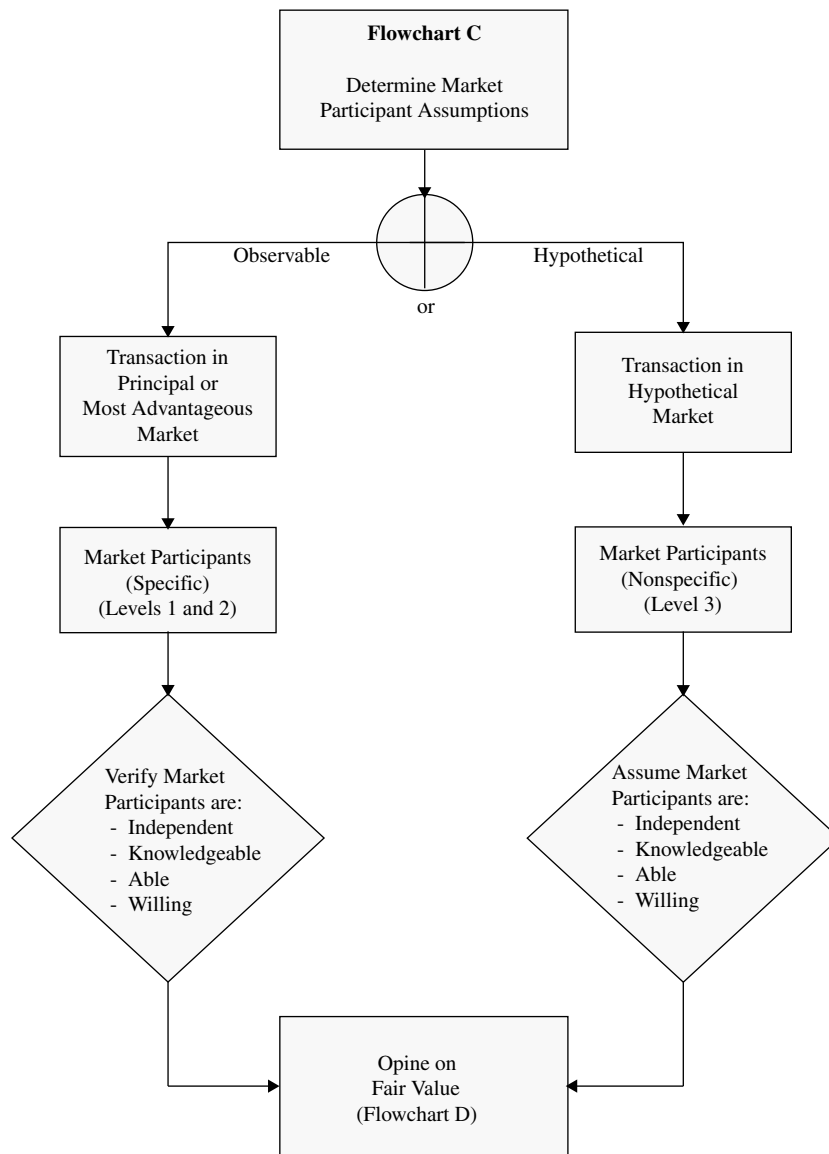
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**EXHIBIT 1.4 Fair Value Flowchart A**

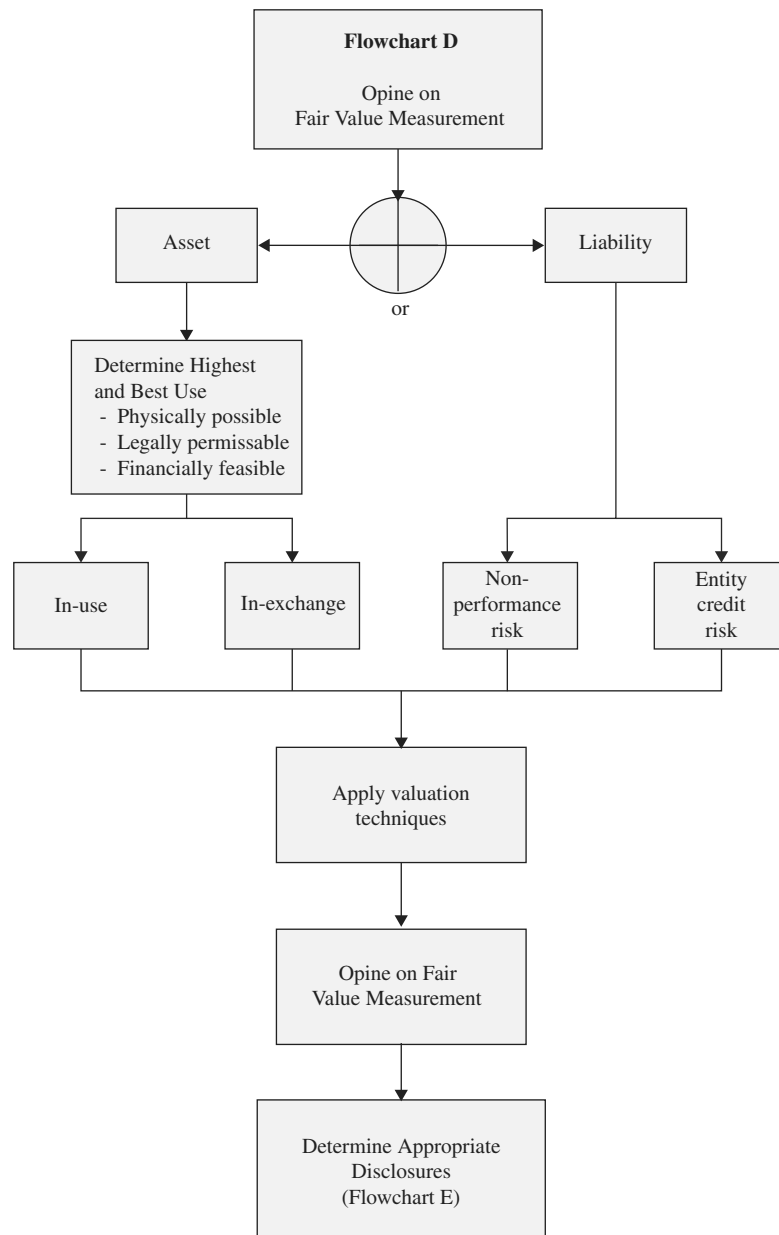
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**EXHIBIT 1.5 Fair Value Flowchart B**

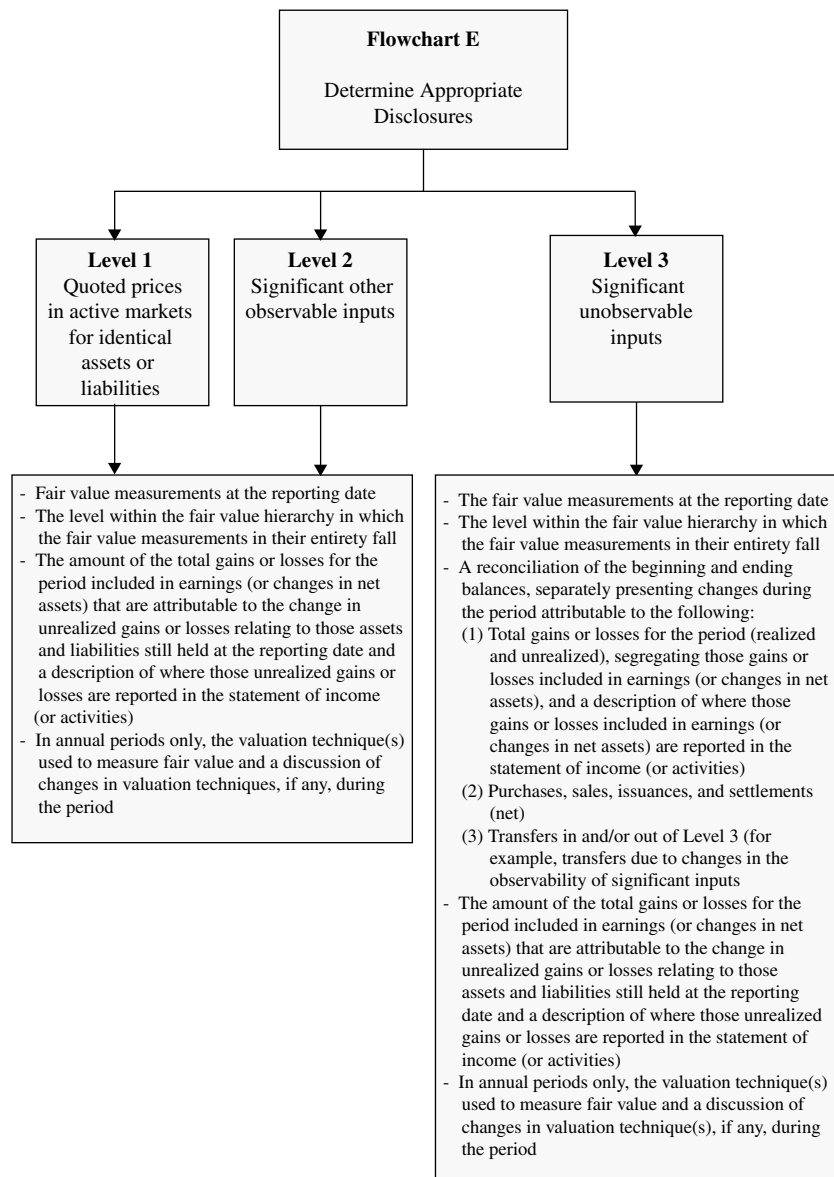
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**EXHIBIT 1.6 Fair Value Flowchart C**

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**EXHIBIT 1.7 Fair Value Flowchart D**

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**EXHIBIT 1.8 Fair Value Flowchart E**

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