FASB Issues Guidance for Measuring Fair Value for US Issuers – No Credit Implications Anticipated; Disclosures Helpful

Key Take-Aways

- SFAS 157 defines and establishes a framework for measuring fair value if required by other accounting pronouncements, it does not require any new fair value measurements.
- Any company that uses fair value would need to implement the standard, however we believe US securities firms, with their increasingly complex trading books, will be most impacted.
- That being said, it appears the standard is not a major change from current valuation practices and we do not expect the consolidated impact to be notable either from an absolute value or earnings volatility perspective.
- The standard could have a broad impact on purchase accounting by forcing companies to assign value to non-financial assets they plan to retire. When and how these values would be subsequently written-off is unclear. Moody’s could potentially make analytical adjustments to financial statements for these items if we believe the valuation required by the standard is not reflective of the actual value the company will derive from the asset.
- The standard requires disclosures which relate to the extent to which fair value is used, where an entity’s valuation technique falls within a hierarchy and, for assets and liabilities remeasured at fair value on a recurring basis using unobservable inputs, the related income statement impact. The disclosures which we consider to be most helpful are; 1) a uniform presentation of the amount of assets and liabilities valued using “unobservable” inputs and 2) for assets and liabilities remeasured at fair value on a recurring basis, the quantification of the income statement impact of assets and liabilities valued using unobservable inputs (with further identification of the amount of this impact related to unrealized gains and losses). These disclosures will improve financial statement users’ understanding of the impact on a company’s results of transactions which lack price transparency. However, they do not provide a comprehensive understanding of the true reliability or the sensitivity of valuations.
The New Standard

The Financial Accounting Standards Board (FASB) recently issued Statement of Financial Accounting Standards No. 157 – Fair Value Measurements (SFAS 157), which defines and establishes a framework for measuring fair value. The statement does not require any new fair value measurements, but provides guidance on how to apply fair value if required under other accounting pronouncements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 (early adoption is permitted).

Not Much Earnings Impact Expected

Although any US company that uses fair value would need to implement the standard, we believe the securities firms, with their increasingly complex trading books, will be most impacted. That being said, it appears the standard does not represent a major change from current valuation practices. Therefore, we do not expect the consolidated earnings impact to be notable either from an absolute value or volatility perspective. (Although the standard could materially change the valuation of certain individual financial instruments from time to time).

However, three nuances of the standard are worth mentioning due to their shift from current practice:

- **Elimination of “blockage” factors** – Current practice is to apply a discount to the market price when valuing large blocks of financial instruments as it is believed the “block” cannot be sold at the current market price – the sale would move the market. However, the standard does not permit the use of a discount and requires large blocks to be valued at price times quantity.

- **Nullification of the “minimum reliability threshold” guidance of EITF 02-3** – Under EITF 02-3, recognition of derivative trading profit at inception (“day one”) is prohibited unless fair value is observable (i.e. - based on market data obtained from sources independent of the reporting entity). However, the EITF did not provide guidance in regards to subsequent profit recognition, resulting in diversity in both the method and timing of income recognition. The new standard eliminates this “threshold” as the FASB decided it was no longer necessary with the enhanced disclosures included in SFAS 157 (as discussed below).

- **Consideration of a company’s own credit standing** – The standard requires consideration of a company’s own credit standing when calculating the fair value of liabilities. This will create some counterintuitive results, for example income statement gains when the fair value of liabilities decline due to a deterioration in credit quality. However we do not expect the overall impact to be significant as most long term liabilities are not currently fair valued. This will be a much larger concern if companies are permitted to fair value their long term debt in the future under the FASB’s proposed Fair Value Option Standard.

A Larger Impact In Purchase Accounting?

The new standard could have a significant impact on the purchase accounting valuation of non-financial assets acquiring companies (both financial and non-financial) plan to retire. The framework requires that asset fair value measurement “assumes the highest and best use of the asset by market participants.” Market participants are independent (i.e. not related parties) entities that are knowledgeable about the related asset and are able and willing to transact for the asset. Highest and best use is the use that maximizes the fair value of the asset or the group of assets within which the assets would be used. The impact this framework could have on purchase accounting is best illustrated through the following example:

Assume there are four cola companies. Companies A, B and C each have 30% market share and company D has 10%. Company A acquires company D and plans to retire its brand as it is clearly inferior to company A’s. Under previous application of purchase accounting, no value would be assigned to company D’s brand as, post transaction, the brand is not anticipated to produce any cashflows. However, under the new standard, the value that Company A must assign to company D’s brand in its purchase accounting is the value that Company B and C would theoretically assign to company’s D brand, if they were to purchase and keep the brand in use (its “highest and best use”). The value assigned to company D’s brand under the new accounting would have most likely increased goodwill under the old accounting.

---

1. This statement does not apply under accounting pronouncements that address share-based payment transactions, FASB statement No. 123, etc.
2. See Moody’s special comment: FASB Proposes to Allow Companies to Elect Fair Value Accounting – A Step in the Right Direction or a Stumble into Non-comparability?, February 2006
Unfortunately the FASB has not provided guidance on “Day 2” accounting. That is, how is this item to be treated after purchase accounting? Should the market participant and highest and best use approach continue to be applied? Should the asset be written off immediately as it clearly will not produce future cash flow? Should it be written off only when actually retired? Moody’s could potentially make analytical adjustments to financial statements for these items if we believe the valuation required by the standard is not reflective of the actual value the company will derive from the asset.

The Fair Value Hierarchy And Disclosures: Incremental Insight Into Large Securities Firm Activities

The standard also provides a fair value “hierarchy” and required disclosures. The hierarchy prioritizes the inputs used in valuation into three categories and requires valuation techniques to maximize Level 1 and 2 inputs and minimize Level 3 inputs. Where within the fair value hierarchy an instrument falls is determined based on the lowest level (i.e. - 1, 2 or 3) input that is significant to fair value:

- **Level 1** – Observable (i.e. - based on market data obtained from sources independent of the reporting entity) inputs that reflect “quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.”
- **Level 2** – Observable prices for similar instruments in active markets, identical or similar instruments in inactive markets, and inputs other than quoted prices (interest rates, volatilities, etc.); and inputs that are corroborated from observable market data (for example through extrapolation or interpolation).
- **Level 3** – Unobservable inputs.

The required disclosures (listed below) primarily relate to the extent to which fair value is used, where an entity’s valuation technique falls within the hierarchy and, for assets and liabilities remeasured at fair value on a recurring basis using unobservable inputs, the related income statement impact. The disclosures which we consider to be most helpful are the following:

- A uniform presentation of the amount of assets and liabilities valued using unobservable inputs. This will improve financial statement users’ understanding of the impact on a company’s balance sheet of transactions which lack price transparency. In regards to securities firms, the general magnitude of their activities involving transactions which lack price transparency is generally already known. Additionally, most securities firms currently provide quantification, in some form, of their assets and liabilities measured at fair value using unobservable inputs. However, the new disclosures will provide more precision and eliminate the comparability difficulties of the current disclosures.
- The quantification of the income statement impact of assets and liabilities remeasured on a recurring basis using unobservable inputs. Additionally, the amount of this impact attributable to unrealized gains and losses will also be disclosed. This will improve financial statement users’ understanding of the impact on a company’s income statement of transactions which lack price transparency, and the amount of that impact which is unrealized. In regards to securities firms, most analysts use the current balance sheet disclosures mentioned above, and other company data, to estimate the income statement impact of these transactions. These disclosures will obviously be significantly more precise than the current estimates.

For each major category of assets and liabilities entities will be required to disclose the following:

- For assets and liabilities that are remeasured at fair value on a recurring basis:
  - The fair value measurements at the reporting date.
  - Where within the fair value hierarchy the fair value measurements fall.
  - For Level 3 fair value measurements a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to the following:
    - 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 statement of income (or activities)
    - Purchases, sales, issuances, and settlements (net)
- Transfers in and/or out of Level 3 (for example, transfers due to changes in the observability of significant inputs)

- The amount of Level 3 gains and losses for the period included in earnings that are attributable to the change in unrealized gains or losses relating to those assets and liabilities still held at the reporting date and a description of where those unrealized gains or losses are reported in the statement of income.

- In annual periods only, the valuation technique(s) used to measure fair value and a discussion of changes in valuation techniques, if any, during the period.

For assets and liabilities that are remeasured at fair value on a nonrecurring basis:

- The fair value measurements recorded during the period and the reason(s) for the measurements.
- Where within the fair value hierarchy the fair value measurements fall.
- For Level 3 fair value measurements, a description of the inputs and the information used to develop the inputs.
- In annual periods only, the valuation technique(s) used to measure fair value and a discussion of changes, if any, in the valuation technique(s) used to measure similar assets and/or liabilities in prior periods.

To order reprints of this report (100 copies minimum), please call 1.212.553.1658.

Report Number: 99829

Craig Emrick  
Tara Cheparev

© Copyright 2006, Moody's Investors Service, Inc. and/or its licensors and affiliates including Moody's Assurance Company, Inc. (together, “MOODY'S”). All rights reserved. ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY COPYRIGHT LAW AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSPONDERED, DISSEMINATED, DISTRIBUTED, REDISTRIBUTED OR SOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT. All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, such information is provided “as is” without warranty of any kind and MOODY'S, in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such information. Under no circumstances shall MOODY'S have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of MOODY'S or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if MOODY'S is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The credit ratings and financial reporting analysis observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities.

MOODY'S hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock, for any particular purpose of any such information. Under no circumstances shall MOODY'S have, prior to assignment of any rating, agreed to pay to MOODY'S for appraisal and rating services rendered by it fees ranging from $1,500 to $2,400,000. Moody's Corporation (MCO) and its wholly-owned credit rating agency subsidiary, Moody's Investors Service (MIS), also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually on Moody's website at www.moodys.com under the heading "Shareholder Relations — Corporate Governance — Director and Shareholder Affiliation Policy." This credit rating opinion has been prepared without taking into account any of your objectives, financial situation or needs. You should, before acting on the opinion, consider the appropriateness of the opinion having regard to your own objectives, financial situation and needs.