

# New Accounting Rules for Valuing and Reporting Investments in Plan Financial Statements

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Employee Benefit Plan  
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## A Summary of the Reporting and Disclosure Requirements of FASB Statement No. 157, *Fair Value Measurements*

### Introduction

Employee benefit plans will need to apply new accounting rules for valuing and reporting the fair value of their investments in the plan's financial statements. The EBPAQC has prepared this summary of the accounting requirements of Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (FAS 157) to provide a general understanding of the new requirements. While plan management may outsource the mechanics of the plan investment valuation process, they will need to retain responsibility for the oversight of the final valuations reported in the plan's financial statements, including determining the adequacy of the related note disclosures. As such, it is important to read and understand FAS 157 in its entirety. The full text of FAS 157 is available at the Financial Accounting Standards Board website at <http://www.fasb.org/pdf/fas157.pdf>.

FAS 157 establishes a framework for measuring fair value under generally accepted accounting principles (GAAP), clarifies the definition of fair value within that framework, and expands financial statement disclosures about the use of fair value measurements. While employee benefit plans have always been required to report plan investments at fair value in their financial statements, the FAS 157 framework for measuring fair value may change current valuation practices for certain investments and require additional disclosures. This document summarizes the key provisions of FAS 157 and recently issued clarifying guidance, which include:

- a new and uniform definition of "fair value,"
- acceptable valuation techniques,
- a hierarchy framework for measuring fair value
- additional disclosure requirements about fair value measurements in the notes to the financial statement
- application of FAS 157 in uncertain markets

### New Definition of "Fair Value"

The FAS 157 definition of fair value changes the perspective from which the asset is valued. FAS 157 defines fair value as the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. This new definition focuses on the price that would be received to sell the asset—an exit price—not the price that would be paid to acquire the asset (an entry price). It is a market-based measurement rather than an entity-specific measurement. The transaction to sell the

asset is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset.

The FAS 157 definition of fair value retains the exchange price notion in earlier definitions of fair value however, it clarifies that the exchange price is the price in an orderly transaction between market participants to sell the asset in the market in which the reporting entity would transact for the asset, which would be the principal or most advantageous market for the asset.

## Fair Value Valuation Techniques

FAS 157 discusses acceptable valuation techniques, which include a market approach, income approach and cost approach. The selection of a valuation technique or a combination of valuation techniques for each asset will depend on the particular circumstances.

- a. **Market approach.** The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might lie in ranges with a different multiple for each comparable. The selection of where within the range the appropriate multiple falls requires judgment, considering factors specific to the measurement (qualitative and quantitative). Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities.
- b. **Income approach.** The income approach uses valuation techniques to convert future amounts

(e.g., cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Those valuation techniques include present value techniques; option-pricing models, such as the Black-Scholes-Merton formula (a closed-form model) and a binomial model (a lattice model), which incorporate present value techniques; and the multiperiod excess earnings method, which is used to measure the fair value of certain intangible assets.

- c. **Cost approach.** The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). From the perspective of a market participant (seller), the price that would be received for the asset is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. Obsolescence encompasses physical deterioration; functional (technological) obsolescence; and economic (external) obsolescence and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (based on specified service lives).

## Framework for Measuring Fair Value

### Fair Value Hierarchy

FAS 157 requires fair value measurement to be determined based on the assumptions that market participants would use in pricing the asset. As such, FAS 157 establishes a fair value hierarchy that distinguishes between (1) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (2) the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs) as a basis for considering market participant assumptions in fair value measurements. The fair value hierarchy established by FAS 157 prioritizes the inputs discussed above as follows:

**Level 1 Inputs (Quoted Prices)**—are quoted prices in active markets for identical assets that the plan has the ability to access at the measurement date (for example, prices derived from NYSE, NASDAQ and the Chicago Board of Trade). If a level 1 input is available for a particular investment, it must be used to value that investment.

**Level 2 Inputs (Observable Inputs)**—are inputs (other than quoted prices included within level 1) that are observable for the asset, either directly or indirectly. Observable inputs are those that reflect the assumptions market participants would use in pricing the asset developed on market data obtained from sources independent of the plan (e.g., matrix pricing, yield curves and indices).

**Level 3 Inputs (Unobservable Inputs)**—are unobservable inputs for the asset. Unobservable inputs are those that reflect the plan’s own assumptions about the assumptions that market participants would use in pricing the asset developed, based on the best information available in the circumstances (e.g., investment manager pricing for private placements, private equities and hedge funds).

For situations in which there is little, if any, market activity for the asset at the measurement date, the plan is not required to undertake all possible efforts to obtain information about market participant assumptions but can instead use unobservable inputs, as long as it does not ignore information about market participant assumptions that is reasonably available without undue cost and effort.

### **Assumptions About Risk and Restrictions**

Market participant assumptions include assumptions about risk (e.g., 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. Market participant assumptions also include assumptions about the effect of a restriction on the sale or use of an asset. FAS 157 states that a fair value measurement should (1) include an adjustment for risk if market participants would

include one in pricing the related asset, even if the adjustment is difficult to determine, and (2) consider the effect of the restriction if market participants would consider the effect of the restriction in pricing the asset. FAS 157 specifies that the guidance applies for stock with restrictions on sale that terminate within one year that is measured at fair value under FASB Statements No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

### **Application of FAS 157 in Uncertain Markets**

On Sept. 30, 2008, the SEC Office of the Chief Accountant and the FASB Staff issued a joint press release to provide clarification regarding questions surrounding the determination of fair value resulting from the current market environment. The press release, which can be found at <http://www.fasb.org/news/2008-FairValue.pdf>, addresses the following questions:

- Can management’s internal assumptions (e.g., expected cash flows) be used to measure fair value when relevant market evidence does not exist?
- 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?
- Are transactions that are determined to be disorderly representative of fair value? When is a distressed (disorderly) sale indicative of fair value?

- Can transactions in an inactive market affect fair value measurements?
- What factors should be considered in determining whether an investment is other-than-temporarily impaired?

In October 2008, the FASB Staff issued FASB Staff Position (FSP) No. FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*, which 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. FSP 157-3 can be found at [http://www.fasb.org/pdf/fsp\\_fas157-3.pdf](http://www.fasb.org/pdf/fsp_fas157-3.pdf).

## Financial Statement Disclosures

FAS 157 requires new financial statement disclosures about the use of fair value to measure assets subsequent to initial recognition. These disclosures include information that enables readers of the financial statements to assess the inputs used to measure fair value by identifying the level within the fair value hierarchy into which each investment falls and, for recurring fair value measurements using significant unobservable inputs (level 3), the effect of the measurements on changes in net assets for the period.

Also, for recurring fair value measurements using significant unobservable inputs (level 3), a reconciliation of the beginning and ending balances, separately presenting changes during the period, must be disclosed. The new standard encourages entities to combine the fair value information disclosed under FAS 157 with the fair value information disclosed under other accounting pronouncements, including FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, where practicable.

## Effective Date

FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The provisions of FAS 157 should be applied prospectively as of the beginning of the fiscal year in which the Statement is initially applied, except as follows. The provisions should be applied retrospectively to the following financial instruments as of the beginning of the fiscal year in which FAS 157 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 FAS 157

- b. A financial instrument that was measured at fair value at initial recognition under FAS 133 using the transaction price in accordance with the guidance in footnote 3 of Issue 02-3 prior to initial application of FAS 157
- c. A hybrid financial instrument that was measured at fair value at initial recognition under FAS 133 using the transaction price in accordance with the guidance in FAS 133 (added by FAS 155) prior to initial application of FAS 157

The transition adjustment, measured as the difference between the carrying amounts and the fair values of those financial instruments at the date FAS 157 is initially applied, should 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 the fiscal year in which the Statement is initially applied.