



BDO Seidman, LLP
Accountants and Consultants



Fair Value Measurements, Statement 157 Questions and Answers

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Introduction

Statement 157, *Fair Value Measurements*, defines fair value. There are more than forty accounting standards that permit or require fair value measurement, but prior to Statement 157 there were several similar, but not identical, definitions of fair value. The Standard establishes a framework for measuring fair value and expands disclosures about fair value measurements. Statement 157 applies under other accounting pronouncements that require or permit fair value measurements but does not require any new fair value measurements. The Statement is effective for fiscal years beginning after November 15, 2007.

This FAQ document invites you to a Statement 157 Gala to Measure Fair Value:

- Given by:** The reporting company
- Event:** Gala to hypothetically sell the asset or transfer the liability
- Who's invited:** Market participants that are buyers and sellers in the principal market for the asset or liability that are independent of the reporting company, knowledgeable about the asset or liability, and willing and able to purchase the asset or assume the liability.
- Where:** Principal market for the reporting company. That is the market with the greatest volume and level of activity where the company would sell the asset or transfer the liability.
- Gala Games:** Measure fair value based on market participant assumptions. The games are assumed to be orderly.
- When:** At the measurement date.
- Bottom Line:** The reporting company will leave the gala with a fair value.

This FAQ document begins with a five page summary of Statement 157. The summary is followed by a frequently asked question section, organized according to BDO's Matrix of Steps in Performing a Fair Value Measurement under Statement 157. The six steps are provided as a header to the six sections of frequently asked questions. The complete Matrix is included as Appendix I to the document.

Summary of Statement 157

Definition of Fair Value under Statement 157

Fair value in Statement 157 continues to be based on an exchange price notion. However, the Statement 157 definition no longer presumes that the initial transaction price or entry price or purchase price represents fair value. Fair value is defined in the Statement as an exit price or sales price. The Statement 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. Entry and exit prices often are different. Companies do not necessarily sell or otherwise dispose of assets at the prices paid to acquire them. Similarly, companies do not necessarily transfer liabilities at the prices paid to assume them. 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, but not all the time.

For example, Winter Glow buys and sells vacation time share intervals in Aspen, Colorado. On August 25, 2007, Winter Glow buys a time share interval for \$10,000. Under the former definition of fair value this would represent the initial transaction price and fair value on the closing date. Under Statement 157, Winter Glow estimates fair value based on the proceeds it could receive if it sold the interval. If Winter Glow could sell the interval for \$9,400, this would represent the exit price and fair value.

The measurement should consider attributes specific to the asset or liability. For the Aspen time share these would include:

- The condition – pristine condition as it is in a brand new vacation condominium building
- Location – in beautiful Aspen, walking distance to lift
- Size – two bedrooms
- Restrictions – no children allowed, available only the first week in November

All these attributes must be considered in the measurement of fair value. (Note that here, and throughout the FAQs, we sometimes use examples of assets or liabilities that typically are not measured at fair value under GAAP to illustrate key aspects of Statement 157.)

The asset or liability being measured could be standalone or a group of assets and/or liabilities. For our time share example, it is a standalone asset. In other cases, it might be a group of assets, such as a group of assets in a production line. Whether the asset or liability is standalone or a group depends on the unit of account. The unit of account determines what is being measured by referring to the level at which the asset or liability is grouped for purposes of applying other accounting pronouncements.

A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction. This assumes that the sale is not forced, that is, not a fire sale, and that there is adequate time for appropriate marketing activities before the transaction. The measurement also assumes that the transaction occurs between market participants in the principal market. Fair value is a market-based assumption, not an entity specific measurement, and is based on the assumptions market participants would use to price the asset or liability. The transaction to transfer the liability or sell the asset is a hypothetical transaction (just as our Statement 157 gala is a hypothetical gala) as of the measurement date.

Principal Market

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. This is the market in which the reporting company would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability. The principal market is identified from the perspective of the reporting company. If there is no principal market, then the reporting company would assume the transaction occurs in the most advantageous market. This is the market in which the reporting company would sell the asset or transfer the liability with the price that maximizes the price received for the asset or minimizes the amount paid to transfer the liability.

For example, a Chicago-based reporting company, Wagons for Rent, owns a fleet of used Volvo 850 station wagons. To fair value the fleet for purposes of impairment testing, the company performs research and identifies a large used car company creating a

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wholesale market in Volvos in Indiana (a market the company can access). Based on the research, this is the market with the greatest volume and level of activity for station wagons. If the Chicago-based company had been unable to identify a principal market, it would have worked to identify, through the general business and marketing knowledge of management, the market in which it could receive the maximum price.

If there is a principal market for the asset or liability, the fair value measurement represents the price in that market. This is true even if the price in a different market could be more advantageous at the measurement date. The Standard establishes the principal market, if it exists, over the most advantageous market in measuring fair value, to limit the effort that would be required to locate the most advantageous market. If the Chicago-based company had spent further time and effort, it could have located the most advantageous market for used Volvo station wagons in Iowa. However, the Standard supports a practical approach that allows the company to use the price in its principal market in Indiana.

The price in the principal market used to measure fair value does not include transaction costs. The Standard notes that transaction costs are not a characteristic of the asset or liability that has value, and consequently they are not included. If a reporting company is measuring a fair value for one of its business lines, transaction costs might include legal, accounting, and investment banking fees. These fees do not add value to the business line, and would be ignored in estimating fair value. While transaction costs are not included in fair value, transportation costs can be included if they are a characteristic of an asset, such as for a commodity.

Market Participants

Market participants are the buyers and sellers in the principal (or most advantageous) market that are:

- Independent of the reporting company. They are not related parties under Statement 57;
- Knowledgeable about the asset or liability and the transaction; and
- Willing and able to purchase the asset or assume the liability. This means the market participant is in a financial, operating, and legal position to purchase the asset or assume the liability. It also means that the participant is motivated but not forced into the transaction.

The reporting company determines the principal or most advantageous market from its perspective. Sometimes, companies in the reporting company's industry are the identified market participants, and sometimes, the market participants are outside of the reporting company's industry. For example, No Horizons, a cable company, houses its operations in a plant it owns in Rochelle, Illinois. No Horizons also owns 50 acres of land surrounding the plant. The company is estimating the fair value of the land as part of a decision to sell the land, and decides that the participants in the market for buying the land include the local corn agribusinesses, a group interested in building an ethanol plant, and a golf course development company. On the basis of these market participants and their assumptions for pricing the land, No Horizons estimates a fair value for its land.

The Statement notes that the reporting company is not required to identify specific market participants and their assumptions when it is developing fair value for an identified asset or liability. The reporting company is only required to identify characteristics that distinguish market participants generally, and to consider specific factors for:

- The asset or liability
- The principal or most advantageous market for the asset or liability, and
- Market participants with whom the reporting company would transact in the market.

This means that the reporting company does not measure fair value on the basis of the value of, in our example, land to one market participant. Nor does the reporting company measure fair value on the basis of the value of land for its own use. Rather, fair value is measured on the basis of the assumptions that market participants in general would make for valuing the land. This means that No Horizons would not fair value the land on the basis of the local corn agribusinesses and synergies these businesses would have by adding local acres to their preexisting base. Nor would it value the land on the basis of the value to the prospective ethanol plant and the value the land would have given its prime railroad location and access to the local corn agribusinesses. Rather, No Horizons would consider all the market participant assumptions, based on information obtained through the knowledge of management and outside valuation experts, including those of the golf course developer, in fair valuing its 50

acres. No Horizons was able to identify actual market participants, but it was only required to identify characteristics and assumptions for general (hypothetical like our gala participants) market participants.

Highest and Best Use (Assets) and Nonperformance Risk (Liabilities)

A fair value measurement assumes the highest and best use of the asset by market participants. Highest and best use refers to the use of an asset by market participants that would maximize the value of the asset. Highest and best use is determined based on the use of the assets by market participants, even if the intended use by the reporting company is different. For example, rather than selling the land, No Horizons may leave its 50 acres undeveloped to build a bigger plant and headquarters on the site as the company grows. However, the highest and best use of the land may be to sell it for one of a number of uses (e.g., agribusiness, ethanol plant, golf course development). Consequently, No Horizons would measure the fair value of the land on the basis of its fair value as sold (in-exchange), not as used by the company (in-use). The highest and best use of the asset establishes the valuation premise used to measure the fair value of the asset, specifically in-use or in-exchange.

For liabilities, a fair value measurement assumes that the liability:

- Is transferred to a market participant at the measurement date;
- To the counterparty continues, that it is not settled; and
- Related nonperformance risk is the same before and after its transfer.

Nonperformance risk relates to the risk that the obligation will not be fulfilled. This risk affects the value at which the liability is transferred.

Valuation Premise

In use – The highest and best use of an 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. This might be the case for certain nonfinancial assets that are installed or otherwise configured for use. For example, Illinois Transformer Hardware makes transformer boxes for lighting equipment, and is in the process of measuring the fair value of its dies for an impairment test. The company determines that the highest and best use of its dies would be in use in combination with its punch presses. 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. This means that Illinois Transformer Hardware should measure both the fair value of the dies and the punch presses on the basis of an in-use valuation premise.

In exchange – The highest and best use of an asset is in-exchange if the asset would provide maximum value to market participants principally on a standalone basis. This might be the case for a financial asset such as a marketable equity security. Further, this is the case for No Horizons land – its highest and best use is on a standalone basis. When using an in-exchange valuation premise, the fair value of the asset is measured based on the price that would be received in a current transaction to sell the asset on a standalone basis.

Fair Value at Initial Recognition

As noted above, exit and entry prices may be different, that is, companies do not necessarily sell assets at the prices paid to acquire them. 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. Sometimes, however, this may not be the case. The reporting company should consider the following questions to determine if the transaction price might not represent fair value (a yes answer indicates the need to perform further work to measure fair value):

- Is the transaction between related parties?
- Did the transaction occur under duress? For example, was the reporting company in a liquidity crisis and forced to enter into the transaction without the proper marketing exposure for the asset?

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- Was the unit of account represented by the transaction different from the unit of account measured at fair value? This might be the case if the transaction includes unstated rights and privileges that should be separately measured, or if the transaction includes transaction costs. For example, the seller of a machine grants an interest free loan to the purchaser. That is, the transaction includes unspecified rights and privileges.
- Did the transaction occur outside of the reporting company's principal or most advantageous market?

Prior to Statement 157, footnote 3 of EITF Issue 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities" prohibited inception gains for certain derivatives in the absence of:

- Quoted market prices in an active market;
- Observable prices of other current transactions; or
- Other observable data supporting the valuation technique

Statement 157 nullifies this footnote, and fair value at initial recognition is no longer limited to transaction price.

At the December 2006 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff cautioned that there continues to be "many instances in which day one gains are not appropriate. Statement No. 157 does not allow the practice of carrying the transaction at the fair value based on a price generated by a model (also known as 'marking to model') if the transaction occurs in the entity's principal market." The staff comments indicate that if all of the four questions in the first paragraph above are answered "no," the transaction price and the fair value are very likely the same on day 1.

Valuation Techniques, Inputs, and the Fair Value Hierarchy

Statement 157 requires valuation techniques consistent with the market, income, and/or cost approaches. Inputs to valuation techniques are assumptions that market participants would use in pricing the asset or liability, such as assumptions about risk. The Statement divides inputs into two groups:

- Observable inputs that reflect the assumptions that market participants would use in pricing the asset or liability based on market data; and
- Unobservable inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability based on the best information available in the circumstances.

The Statement recommends that valuation techniques used to measure fair value should maximize the use of observable inputs and minimize the use of unobservable inputs.

The Standard outlines a hierarchy that prioritizes the inputs to valuation techniques in order to help users assess the reliability of fair value measurements. There are three levels in the fair value hierarchy. The highest level, Level 1, is for quoted prices in active markets for identical assets or liabilities. The lowest level, Level 3, is for unobservable inputs. The higher the level, the more reliable the inputs. The levels are also used to classify the fair value measurements themselves, and the level of a fair value measurement is that of the lowest level input that is significant to the fair value measurement in its entirety.

Disclosures are required that enable users to assess the inputs used to develop the measurements for both recurring (e.g., trading securities) and nonrecurring (e.g., asset impairments) fair value measurements. The lowest level, Level 3, requires the greatest amount of disclosures.

The follow section responds to frequently asked questions on Statement 157. The questions are organized by the six steps in BDO's Statement 157 Summary Matrix of Basic Steps (see Appendix I). It should be noted a robust valuation under Statement 157 may be an iterative process. While BDO's Matrix is presented in a natural sequence, considerations in a latter step may cause determinations in former steps to be revisited.

Readers should also be aware that responses to certain of the frequently asked questions reflect BDO's interpretive view as of the date of publication. These are subject to change if and when additional authoritative guidance is issued.

Step 1: Statement 157 Summary Matrix of Basic Steps – Identify Asset or Liability Being Measured – Unit of Account

Determine the unit of account for the asset or liability being valued. Companies need to consider what they are valuing and how it is grouped for accounting purposes under GAAP. The account being valued might be an asset, liability, group of assets and/or liabilities. For example, it could be an asset group, a reporting unit, a business, or an instrument measured at fair value that is classified in stockholders' equity.

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Concept Definitions

Unit of account – Determines the asset or liability that is being measured at fair value for financial reporting purposes. It clarifies whether the asset or liability should be measured alone or in a larger group. It should be determined in accordance with the provisions of other accounting pronouncements. For example, the asset or liability may be standalone (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).

Unit of valuation – The asset, liability, or group of assets and/or liabilities to which valuation techniques (valuation approaches and methods) are applied to measure fair value. Often the unit of valuation is identical to the unit of account. If not (for example, if the unit of account is an individual asset but the unit of valuation is a group of assets), then after the valuation techniques are applied to the unit of valuation to measure its fair value, that fair value is then imputed to the unit of account by some reasonable method of allocation.

Frequently Asked Questions – Step 1

Unit of Account

1. What is the difference between a unit of account and a unit of valuation?

The unit of account is the asset or liability that is being measured at fair value. Before applying Statement 157, the asset or liability being measured must be identified, and the appropriate GAAP for recognition, presentation and disclosure determined.

The unit of valuation is the asset, liability, or group of assets and/or liabilities to which valuation techniques are applied to measure fair value. If the asset is a financial asset such as a marketable equity security, the unit of account and unit of valuation will probably be the same. For Illinois Transformer Hardware example discussed above, the company reports its dies separately from its punch presses for financial reporting purposes. Its unit of account is dies. However, the company values its dies and punch presses together, and then allocates the value. Its unit of valuation is punch presses and dies. That is, Illinois Transformer Hardware defines the unit of account and unit of valuation for its dies in a different manner.

Step 2: Statement 157 Summary Matrix of Basic Steps – Determine the Exit Market

Determine the exit market (that is, the principal market or, if none exists, the most advantageous market) for the asset or liability being valued. In this step, the reporting company determines the potential exit markets it would use to dispose of the asset or transfer the liability being valued. If the reporting company does not have any actual exit transactions in any markets, the company should consider hypothetical exit transactions.

Statement 157

Concept Definitions

Principal market – The market where the reporting company would sell the asset or transfer the liability with the greatest volume and level of activity. There may not always be a principal market for the asset or liability from the reporting company's perspective. If there is a principal market for the asset or liability, the fair value measurement should represent the price in that market, even if the price in a different market is potentially more advantageous at the measurement date. Different subsidiaries or operating units of a reporting company may have different principal markets because they may have different activities and transact in different markets.

Most advantageous market – The market where the reporting company would receive the highest amount to sell the asset or pay the lowest amount to transfer the liability, after considering transaction costs. Different subsidiaries or operating units of a reporting company may have different most advantageous markets because they may have different activities and transact in different markets. A company need only determine the most advantageous market if there is no principal market for the asset or liability. Sometimes the principal and most advantageous markets are the same.

Frequently Asked Questions – Step 2

Exit Market

The exit market is the market in which the reporting company would sell the asset or transfer the liability being valued. This market is the principal market or, if none exists, the most advantageous market. Different companies with different activities may have different exit markets. Examples of exit markets include retail and wholesale markets. Some companies may not have an exit market for a particular asset or liability (for example an asset retirement obligation), in which case a hypothetical market must be used.

2. How can a company identify its principal or most advantageous market?

A company should consider the market in which it has historically purchased or transferred the asset or liability in question. Frequently, this will be the principal market because there are no other markets with a greater volume or level of activity. However, if (and only if) a principal market doesn't exist, companies should identify the market in which they could transact to maximize the price received for an asset or minimize the price paid to transfer a liability, considering the effects of transaction costs.

This determination is made from the perspective of the reporting company. Consequently, although deep markets may exist with favorable pricing, companies can only designate them as the principal or most advantageous market if they have access to the market.

For example, Illinois Transformer Hardware entered into an interest rate swap to hedge its variable rate debt. Its counterparty is a large financial institution. The company reports the fair value of the swap based on an exit price in its principal market, the retail market. If the reporting company had been a large financial institution that had access to the interdealer market, (the institution's principal market) the fair value of the swap would have been the exit price in the interdealer market. The fair value of the swap for Illinois Transformer Hardware would be different from the fair value of the swap for the large financial institution.

3. Can different divisions or subsidiaries within a consolidated company arrive at different fair value measurements for the same asset or liability?

Yes. The FASB recognized that because different companies (and operating units within those companies) with different activities transact in different markets, the principal or most advantageous market for the same asset or liability might differ among companies.

For example, Umbrella Financial Services Company, has a broker-dealer division and an insurance division. Its broker-dealer division has access to the wholesale and retail markets for various derivatives. On the other hand, the insurance division is only able to access the retail market. In this scenario, these two divisions could value an identical derivative at different prices if the broker-dealer identified the wholesale market as its principal market.

Step 3: Statement 157 Summary Matrix of Basic Steps – Identify the market participants in the exit market identified in Step 2.

In this step, the reporting company identifies the market participants in the exit market. That is, it identifies the buyers and sellers in its exit market.

Statement 157

Concept Definitions

Market participants – In any given market, there may be multiple types of market participants. Market participants include, for example, strategic buyers and financial buyers. A strategic buyer generally has operations in the industry or a related or similar industry. A strategic buyer may assess a potential acquisition based on the projected cash flows of the target on a standalone basis, plus the value of synergies from combining the target businesses with those of the strategic buyer. A financial buyer generally has no operations of its own in the industry. A venture capitalist is often a financial buyer.

The fair value of an asset or liability is based on the assumptions that market participants would use in pricing the asset or liability. In developing these assumptions, the reporting company need not identify specific market participants. Rather the reporting company should identify characteristics that distinguish market participants with which the reporting company would transact.

Frequently Asked Questions – Step 3 Market Participants

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

- Independent of the reporting company (i.e., not related parties under Statement 57);
- Knowledgeable about the asset or liability and the transaction; and
- Willing and able to purchase the asset or assume the liability (“able” means having the legal ability and operating/financial capacity; “willing” means motivated but not forced or otherwise compelled).

4. Can a company consider its own intentions when measuring an asset or liability at fair value?

The definition of fair value is market-based, not company-specific. This definition assumes that the exchange is an orderly transaction (i.e., not a fire sale) in the reporting company’s principal or most advantageous market. 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. The definition focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price).

A fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. For example, Macy’s purchased Marshall Field’s, a retailer with a substantial presence in the Midwest. Macy’s initiated a branding campaign for all its retail divisions and renamed all its stores with the flagship store name. Consequently, Macy’s retired the Marshall Field’s brand name. Under Statement 157, Macy’s could not consider its intention to retire the brand name (thereby valuing it at zero),

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and would be required to use market-based assumptions to value the Marshall Field's brand name (considering the value placed on the brand by other active Midwestern retailers).

5. When a company considers market participant assumptions regarding an asset, can it consider the restrictions on the trading of marketable equity securities?

Yes. The scope of Statement 115 includes equity securities that are restricted from sale for less than one year (securities

restricted in excess of one year are excluded from the scope of Statement 115). Historically, Statement 115 precluded adjustments to the value of a restricted security in its scope to reflect a discount from the market price of an identical, unrestricted security. Statement 157 amends Statement 115 to require an adjustment to the value of a restricted security.

Further, any restriction placed on a security—regardless of duration—would be considered in its fair value measurement under Statement 157.

Step 4a: Statement 157 Summary Matrix of Basic Steps – Determine the highest and best use for an asset being valued or nonperformance risk for a liability being valued.

Based on market participant assumptions, the reporting company determines the highest and best use for the asset, group of assets, the reporting unit, or business, or the nonperformance risk for the liability being valued. The reporting company makes this determination based on market participant assumptions (for the market participants identified in Step 3).

Statement 157 Concept Definitions

In-use valuation premise – Highest and best use is in-use if the asset would provide maximum value to market participants principally through its use with other assets as a group (as installed or otherwise configured for use).

In-exchange valuation premise – Highest and best use is in-exchange if the asset would provide maximum value to market participants principally on a standalone basis.

Frequently Asked Questions – Step 4a Highest and Best Use

Market participant assumptions may differ from the reporting company's assumptions about an asset or liability. Market participant assumptions are used to determine the highest and best use for an asset, which may differ from the company's current or intended use for the asset.

The highest and best use by market participants is the one that maximizes the future cash inflows related to an asset or asset group. The highest and best use establishes the valuation premise—either in-use or in-exchange—used to measure the fair value of the asset.

6. What is highest and best use of an asset?

Fair value measurements assume the highest and best use of assets by market participants. This means the use of the asset by market participants that maximizes the value of the assets or the group of assets in which the asset being valued would be used. The highest and best use is based on the use by market participants, even if the reporting company's current or intended use is different. The highest and best use is determined based on what is physically possible, legally permissible, and financially feasible.

Step 4b: Statement 157 Summary Matrix of Basic Steps – Determine the valuation premise (in-use vs. in-exchange) based on highest and best use for an asset, group of assets, reporting unit, or business being valued.

The reporting company determines the highest and best use for the asset being valued is in-use (through use in combination with other assets as a group) or in-exchange (principally on a standalone basis).

Frequently Asked Questions – Step 4b

In-Use and In-Exchange

7. How does a company determine the highest and best use of an asset ?

The fair value of the asset in-use is compared to the fair value of the asset in-exchange. For example, Rosie Drugs acquires a drug patent in a business combination. The company does not intend to produce drugs based on the patent as they would compete with its own drugs. Instead, Rosie Drugs intends to hold the patent for defensive value, to prevent its competitors from obtaining access to the patent. For purposes of measuring the fair value of the patent at initial recognition, the highest and best use of the patent would be determined based on its use by market participants. For example:

- The highest and best use of the patent would be in-use if market participants would produce the drug based on the patent and that use would maximize the value of the business line in which the patent would be used. The fair value of the patent would be determined based on the price that would be received in a current transaction to sell the patent, assuming that the patent would be used with a business line and that those complementary business-line assets would be available to market participants;
- The highest and best use of the patent also would be in-use if, for competitive reasons, market participants would lock up the patent and that use would maximize the value of the group of assets in which the patent would be used (as a locked-up project). That might be the case if market participants have patents in a more advanced stage of drug development that would compete with Rosie Drugs' newly acquired patent, and that the patent would be expected to provide defensive value if locked-up. The fair value of the patent, measured using an in-use valuation premise, would be determined based on the price that would be received in a current transaction to sell the patent, assuming that the patent would be locked up with its complementary assets as a group and that those complementary assets would be available to market participants;
- The highest and best use of the patent would be in-exchange if market participants would discontinue the development of the drug. That might be the case if the patent, if used to produce a drug, is not expected to provide a market rate of return and would not otherwise provide defensive value if locked up. The fair value of the patent, measured using an in-exchange valuation premise, would be determined based on the price that would be received in a current transaction to sell the patent standalone.

Rosie Drugs compares the fair value in-use to the fair value in-exchange, and determines that the highest and best use of the patent is in-use to produce the drug as this maximizes the cash flow to the company.

Step 4c: Statement 157 Summary Matrix of Basic Steps – Determine the unit of valuation based on the highest and best use and the valuation premise.

The reporting company is measuring the fair value of an individual asset. The company determines whether the unit of valuation is an individual asset or a group of assets. If the latter, the company then must impute value down to the individual asset based on the group fair value.

Frequently Asked Questions – Step 4c

Unit of Valuation

8. How does a company determine the unit of valuation?

The company determines the unit of valuation based on the highest and best use of the asset and the valuation premise. For example, Illinois Transformer Hardware is measuring the fair value of its punch presses (because, for example, they are being assessed for impairment under Statement 144). The company has already determined that the use that maximizes cash flows to the company is to use the presses to manufacture transformer boxes. Illinois Transformer Hardware's valuation premise is in-use. Based on these determinations, the company considers the unit of valuation, and decides that the unit is the die and the punch press. However, as noted earlier, for financial reporting purposes the dies and presses represent separate units of account. The company values the dies and punch presses together and then allocates the value.

Step 5: Statement 157 Summary Matrix of Basic Steps – Determine a value for the unit of valuation based on market participant assumptions and other market-based inputs, and apply one or more appropriate valuation techniques.

Now that the reporting company has determined the unit of valuation (i.e., the item to which the various valuation approaches and methods are applied), the company measures the fair value of the asset or liability.

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Concept Definitions

Valuation techniques – Methods used to measure fair value under the three approaches to valuation: the market, income, and cost approaches.

Valuation techniques used to measure fair value should be consistently applied. However, a change in a valuation technique 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. A change in valuation technique is accounted for as a change in accounting estimate.

Nonperformance risk – For a liability, the risk that the obligation will not be fulfilled. Nonperformance risk includes but may not be limited to the reporting company's own credit risk. The valuation of liabilities is not based on a settlement concept; rather, it is assumed that the liability is transferred and that nonperformance risk is the same before and after the transfer.

Frequently Asked Questions – Step 5

Valuation

9. What valuation techniques should be used to measure fair value?

The reporting company must use techniques consistent with the market, income, and/or cost approaches to valuation:

- Market approach – Uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). The market approach is commonly used for marketable securities.
- Income approach – Uses valuation techniques such as present value techniques and option pricing models (Black-Scholes-Merton formula and binomial models) to convert future amounts such as cash flows or earnings to a single discounted present amount.
- Cost approach – Based on the amount that currently would be required to replace the service capacity of an asset, often referred to as current replacement cost.

Companies should use valuation techniques that are appropriate and for which sufficient data are available to measure fair value. In some cases, for example, valuing an asset using

quoted prices in an active market for identical assets, a single valuation technique is not only appropriate, it is required.

In other cases, such as valuing a customized machine, multiple valuation techniques will be appropriate. For example, a company, Souvenir Molder, is evaluating the fair value for one of its customized plastic Lincoln head machines. Souvenir Molder values the machine under both a market and a cost approach. The company determines that the fair value indicated by one approach, the market approach, is more representative of fair value, and consequently gives this fair value more weight. Souvenir Molder reached this decision on the basis of the relative reliability of the inputs, and notes that the inputs in the market approach require fewer and less subjective adjustments. In reaching its decision, the company also observed that the market approach range is narrower than the cost approach range.

Statement 157 states that fair value is “the point within the range that is most representative of fair value in the circumstances.”

10. If a company measures its own debt at fair value, is it proper to record decreases in earnings to reflect increases in fair value resulting from decreases in the company's own credit risk?

Yes. The fair value of debt reflects nonperformance risk, and this risk includes the company's own credit risk. In all reporting periods in which debt is measured at fair value (for example, because a company has elected fair value measurement under Statement 159), the company should consider the effect of its credit risk or credit standing on the fair value of its debt. Although it is counterintuitive, this means that if a company's credit standing improves, the fair value of the company's debt liability would increase, and the change in fair value would

result in an expense charged to the current statement of operations. Conversely, if a company's credit standing declines, the company's liability would decrease, and the change in fair value would result in income credited to the current statement of operations.

For example, No Horizons records its debt at fair value of \$1,000 upon issuance at January 1, 2007 and elects to carry the debt at fair value under Statement 159. At March 31, 2007, credit spread for corporate bonds and the credit worthiness of the company are unchanged and the fair value of the debt remains at \$1,000. At June 30, 2007, the company's credit worthiness weakens, and as a result the fair value of the company's debt decreases to \$950. This quarter, the company records a \$50 credit to income for the decrease in the value of the debt. See also, Example 10 in Statement 157, paragraph A32.

11. If a company measures its accounts receivable at fair value, is it proper to record increases to earnings as a result of decreases in the debtor's credit risk?

Yes. The fair value of an asset should consider the effect of the debtor's credit risk in determining the carrying value of the asset. This situation is a mirror image of the situation in Q10. The reporting company should consider the effect of the debtor's credit risk or credit standing on the fair value of its receivables in all periods in which they are measured at fair value. This means that if a debtor's credit standing improves, the fair value of the company's receivable would increase, and the change in fair value would result in income credited to the current statement of operations. If a debtor's credit standing declines, the fair value of the company's receivable would decrease, and the change in fair value would result in an expense charged to the current statement of operations.

Step 6: Statement 157 Summary Matrix of Basic Steps – Classify inputs used in Step 5 as Level 1, 2, or 3, then accordingly classify the fair value measurement in its entirety, and prepare Statement 157 disclosures.

The reporting company answers the question whether the inputs used to measure the asset or liability were based on observable or unobservable data. The company determines whether the inputs fall into Level 1, 2, or 3, and considers how significant each input is in arriving at the fair value. Further, the company decides where the overall fair value measurement falls in the fair value hierarchy. The overall fair value measurement is classified into the lowest level input that is significant to the fair value measurement in its entirety.

Statement 157

Concept Definitions

Level 1, 2, or 3 inputs – Three broad categories of inputs used to measure fair value, classified as to reliability:

Level 1 (most reliable) – Unadjusted quoted prices for identical assets or liabilities in active markets that the reporting company has the ability to access at the measurement date; these inputs should be used whenever available.

Level 2 – Observable inputs other than Level 1 quoted prices, such as quoted prices for *similar* assets or liabilities in active markets, quoted prices for identical assets in markets that are *not active*, inputs other than quoted prices that are observable for the asset or liability (e.g., interest rates), or inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3 (least reliable) – Unobservable inputs for the asset or liability not corroborated by observable market data:

- Should be used to the extent that observable inputs are not available
- Should reflect the reporting company's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk)
- Based on best information available, which might include reporting company's own data
- Reporting company need not undertake all possible efforts to obtain information about market participant assumptions, but should not ignore information about market assumptions that is reasonably available without undue cost or effort

Level 1, 2, or 3 fair value measurements – A fair value measurement is classified as Level 1, 2, or 3 in the fair value hierarchy based on the lowest level input (Level 1 being the highest and Level 3 being the lowest) that is significant to the fair value measurement.

Frequently Asked Questions – Step 6 Disclosure

12. What is the fair value hierarchy?

The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). (See the definition of the Levels on the left-hand side of this page.)

In certain situations, the inputs used to measure fair value fall into different levels of the fair value hierarchy. The fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques themselves.

13. What constitutes an “active” market?

Statement 157 defines an active market as “a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis.” However, the phrase “sufficient frequency and volume” is not clearly defined, leaving room for judgment. To assist preparers, auditors and users of financial statements in making that assessment, the standard provides certain characteristics of what an active market is *not*:

- There are few transactions for the asset or liability,
- The prices are not current,
- Price quotations vary substantially over time or among market makers, or
- Little information is released publicly.

An example of an inactive market might be the market for a security on an exchange in a developing country where there is limited trading. As a result, pricing information is not available on an ongoing basis.

In contrast, a nationally-recognized exchange in a developed country is presumptively an active market (e.g., the New York Stock Exchange). While the definition of an active market focuses on the trading frequency of the particular asset or lia-

bility in question (not on the market itself), most national exchanges in developed countries employ minimum trading volume requirements as a condition of continued listing.

It's also worth noting 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 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. In those cases, the quoted price should be adjusted, resulting in a final measurement below Level 1 of the fair value hierarchy.

14. How does a company determine where in the fair value hierarchy a fair value is properly positioned?

The level used to classify a fair value measurement in its entirety is based on the lowest level input significant to that fair value measurement. The hierarchy prioritizes inputs to valuations techniques, not the techniques themselves. For example, a fair value measurement using discounted cash flows might fall within Level 2 or 3 depending on the inputs that are significant to the measurement in its entirety, and the levels within which those inputs fall.

Statement 157 does not define significance either qualitatively or quantitatively. The Statement states that the determination of significance requires, "judgment, considering factors specific to the asset or liability." Best practices may call for companies to establish a policy that defines when an input is significant in terms of a percentage of the overall measurement amount, or other relevant metrics.

15. What should a company do if market-based information isn't available?

If market-based information isn't available, a fair value measurement requires management to develop its own assumptions about the assumptions that market participants would use in pricing the asset or liability. Even though management may be limited in this regard, the objective of fair value measurement remains unchanged. That is, management should use the best information available in the circumstance to develop a hypothetical exit price from the perspective of a market participant.

In developing unobservable inputs, a company isn't obligated to undertake all possible efforts to obtain information about market participant assumptions. However, the company also can't ignore information about market participant assump-

tions that is reasonably available without undue cost and effort.

16. May block discounts still be used in fair value measurement?

It depends. Block discounts cannot be used in Level 1 measurements 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.

However, for measurements beneath Level 1 of the fair value hierarchy, the use of block discounts may be *required* if trading volume is relevant to the valuation. Level 2 and 3 measurements are based on inputs into a valuation technique (model), as opposed to quoted prices for identical instruments in an active market. In particular, Level 2 inputs should reflect *the volume and level of activity* in the markets within which the inputs are observed. Since Level 3 inputs rely on unobservable inputs, there may be little to no market-based data to adjust. But in all cases, the objective of fair value is to incorporate market participants' assumptions about the exit price received to sell an asset or paid to transfer a liability. Therefore, if a market participant would apply a "haircut" or otherwise adjust a valuation to reflect an assessment of the instrument's illiquidity, then the reporting company must take this into account for all Level 2 and 3 measurements.

17. What if only bid and ask are quoted?

In some situations, inputs might be determined based on bid and ask prices, for example, in a dealer market where the bid price represents the price the dealer is willing to pay and the ask price represents the price at which the dealer is willing to sell.

The price within the bid-ask spread that is most representative of fair value in the circumstances should be used to measure the fair value of the related asset or liability within all levels of the fair value hierarchy, provided that the price is consistently determined. Bid and ask prices establish the boundaries within which market participants would negotiate the price in the exchange for the related asset or liability. Companies should use judgment, and the use of bid prices for long positions (assets) and ask prices for short positions (liabilities) is permitted but not required.

Statement 157 does not preclude the use of mid-market pricing or other pricing conventions as a practical approach for determining a price within the bid-ask spread.

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18. Do Level 3 disclosures distinguish between realized and unrealized gains and losses for assets and liabilities measured at fair value on a recurring basis (for example, trading securities)?

Yes. For fair value measurements for such assets and liabilities using Level 3 (significant unobservable) inputs, companies must present 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 statement of income (or activities)
2. Purchases, sales, issuances, and settlements (net)
3. Transfers in and/or out of Level 3 (for example, transfers due to changes in the observability of significant inputs)
4. The amount of the total gains or losses for the period in (1) above included in earnings (or changes in net assets) 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 (or activities)

Statement 157 includes an example of such a reconciliation:

(\$ in 000s)	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)		
	Derivatives	Venture Capital Investments	Total
Beginning balance	\$14	\$11	\$25
Total gains or losses (realized/unrealized)			
Included in earnings (or changes in net assets)	11	(3)	8
Included in other comprehensive income	4		4
Purchases, issuances, and settlements	(7)	2	(5)
Transfers in and/or out of Level 3	<u>(2)</u>	<u>0</u>	<u>(2)</u>
Ending balance	<u>\$20</u>	<u>\$10</u>	<u>\$30</u>
The amount of total gains or losses for the period included in earnings (or changes in net assets) attributable to the change in unrealized gains or losses relating to assets still held at the reporting date	<u>\$7</u>	<u>\$2</u>	<u>\$9</u>

Gains and losses (realized and unrealized) included in earnings (or changes in net assets) for the period (above) are reported in trading revenues and in other revenues as follows:

	Trading Revenues	Other Revenues
Total gains or losses included in earnings (or changes in net assets) for the period (above)	<u>\$11</u>	<u>\$(3)</u>
Change in unrealized gains or losses relating to assets still held at reporting date	<u>\$7</u>	<u>\$2</u>

19. What other disclosures are required by Statement 157?

A reporting company is required to disclose information for assets and liabilities that are measured at fair value on a recurring basis (for example, trading securities) and on a nonrecurring basis (for example, impaired assets) in periods subsequent to initial recognition. This information should be enough for users to assess the inputs used to develop measurements. The information should be disclosed for each interim and annual period separately for each major category of assets and liabilities and includes:

For assets and liabilities that are measured at fair value on a recurring basis:

- a. The fair value measurement 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 Level 1, 2, and 3 inputs, respectively;
- c. The information required for Level 3 inputs above; and
- d. In annual periods only, the valuation techniques used to measure fair value and a discussion of changes in valuation techniques, if any.

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

- a. The fair value measurement recorded during the period and the reason for the measurements;
- b. The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using Level 1, 2, and 3 inputs, respectively;
- c. For fair value measurements using significant Level 3 inputs, a description of the inputs and the information used to develop the inputs; and
- d. In annual periods only, the valuation techniques used to measure fair value and a discussion of changes in valuation techniques used to measure similar assets and/or liabilities in prior periods.

Transition**20. Should Statement 157 be adopted purely on a prospective basis?**

No. Statement 157 should be applied prospectively as of the beginning of the fiscal year in which the Statement is initially applied, except for the following financial instruments. These instruments should be retrospectively restated as of the beginning of the fiscal year in which the Statement is initially applied:

- a. A position in a financial instrument that trades in an active market held by a broker-dealer or investment company 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 footnote 3 of EITF 02-3 prior to initial application of this Statement. This footnote did not allow for day 1 gain recognition, and under this guidance day 1 gain was deferred; and
- c. A hybrid financial instrument that was measured at fair value at initial recognition under Statement 133 using the transaction price in accordance with the guidance in Statement 133 (added by Statement 155) prior to initial application of this Statement.

The transition adjustment should be measured as the difference between the carrying amounts and the fair values of those financial instruments at the date Statement 157 is initially applied. It should be recognized as a cumulative-effect adjustment to the opening balance of retained earnings for the fiscal year in which the Statement is initially adopted.

21. Should the adoption of Statement 157 be considered a triggering event for an impairment analysis, for example under Statement 142?

No. The summary of Statement 157 explains it was issued to define fair value, establish a framework for measuring fair value in GAAP, and expand disclosures about fair value measurements. It applies under other accounting pronouncements that require or permit fair value measurements, but does not, on its own, require any new fair value measurements. However, for some companies, the application of this Statement will change current practice when implemented.

For example, companies are required to test goodwill for impairment at least annually, using the two-step approach specified in Statement 142. Prior to Statement 157, practice was mixed regarding whether a purchase price allocation that recorded separately-identifiable intangible assets had to measure such intangibles from the perspective of a market participant or based on the company's own intentions. Assume a company purchased a business with the intent to abandon an acquired trademark for

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which it had no use. The company may have considered its intent to abandon the trademark when estimating its fair value, resulting in a valuation lower than the amount that a market participant would have been willing to pay. If the company is required to perform Step 2 of the goodwill impairment test after adopting Statement 157, the trademark in question would be measured based on market participant assumptions,¹ thereby increasing the fair value of the trademark, reducing the implied fair value of goodwill, and increasing the likelihood of an impairment charge.

While similar situations may occur when companies assess goodwill for impairment after the initial adoption of Statement 157, we do not believe that initial adoption itself should be considered a potential impairment trigger.

22. Should capital vs. operating lease analyses be revisited when Statement 157 is adopted?

No. Statement 157 does not require or permit retrospective application for lease accounting under Statement 13. In late September 2007, the FASB decided to move in the direction of amending Statement 157 to exclude leases from its scope. Other than in limited cases noted in Q2 above, Statement 157 may only be adopted on a prospective basis.

23. How should pension disclosures change as a result of Statement 157?

Statement 157 conforms the definition of fair value for employers with funded pension and other postemployment benefit plans to its definition of fair value. This affects employer's accounting and disclosure under FASB Statement 87, Employers' Accounting for Pensions, and FASB Statement 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, and FASB Statement 35, Accounting and Reporting by Defined Benefit Pension Plans, for plan financial statements. This change in definition affects plan assets but it does not affect the measurement of pension and other postemployment liabilities. Statements 87 and 106 define the measurement of those liabilities.

While Statement 157 states that transaction costs should not be included in the fair value of an asset, it also specifies that transactions should be accounted for in accordance with other relevant GAAP. Statements 35, 87, and 106 require that plan asset fair value be reduced by brokerage commissions and other sales costs if those costs are significant. Consequently, the plan assets should be accounted for net of those costs.

Plan financial statements that are prepared in accordance with Statement 35 should conform to the disclosure requirements summarized in Qs18 and 19, including the information required for Level 3 inputs.

Plan assets are measured at fair value on a recurring basis. If a company delays plan asset gains and losses as allowed by Statement 87 and 106, the Statement 157 required disclosures on Level 3 gains and losses included in earnings may not be appropriate. If the plan gains and losses are the result of the amortization of gains or losses that have developed over time, then the Level 3 disclosures are not relevant as these changes are not the result of current year changes in plan assets. However, all other Statement 157 disclosures would be required.

24. Will the fair value of a "plain-vanilla" interest rate swap on variable rate debt be affected by Statement 157?

Yes. In the past, many companies have valued interest rate swaps based on quotes from the counterparty, which were frequently large, reputable financial institutions. However, the price paid to transfer or received to sell an interest-rate swap should be based on the reporting company's principal or most advantageous market. Because the reporting company may be limited to the retail market for interest rate swaps, the quoted price from a large bank that transacts in the wholesale market would not be appropriate for purposes of the reporting company's valuation under Statement 157. Rather, the reporting company would have to consider what price would be paid or received to transact in the retail market with a counterparty that may not be a bank. Companies requesting quotations from counterparties should be specific about which market the counterparty should consider. Some interest rate swaps may need to be measured using a valuation technique instead of relying on a current counterparty quotation.

For example, Illinois Transformer Hardware enters into an interest rate swap in a retail market with Biggo Financial (a securities dealer) in which the transaction price is zero. Illinois Transformer Hardware buys and sells only in the retail market. Biggo

¹ As a reminder, the use of market participant assumptions is not limited to accounting for business combinations or goodwill. Impairment analyses under Statement 144, lease classifications (operating vs. capital) under Statement 13, and any other standard in US GAAP that requires or permits fair value measurement must incorporate market participant assumptions after Statement 157 is adopted.

Financial both buys and sells into the retail market (with retail counterparties) and buys and sells in the inter-dealer market (with securities dealer counterparties).

For Illinois Transformer Hardware, the retail market in which it bought the swap is its principal market for the swap. If Illinois Transformer Hardware were to transfer its rights and obligations under the swap, it would do so with a securities dealer counterparty in that market. For Biggo Financial, the inter-dealer market is the principal market for the swap. If Biggo Financial were to transfer its rights and obligations under the swap, it would do so with a securities dealer in that market. Because the retail market in which Biggo Financial initially entered the swap is different from its principal market for the swap, the transaction price (zero) would not necessarily represent the fair value of the swap to Biggo Financial at initial recognition.

Matrix of Steps in Performing a Fair Value Measurement under Statement 157

The summary and full matrix below facilitate performing fair value measurements under Statement 157. Although the steps are in many cases interrelated, the matrix has been structured in a linear fashion in order to present the steps in the general order in which they should be performed. A determination or decision in one step could affect a determination or decision in another step. For example, the determination of the highest and best use might result in a reconsideration of the identity of market participants. Neither the summary nor the full matrix is intended to be a substitute for reading and understanding the Statement 157 guidance in its entirety.

Fair Value Measurement under Statement 157 – Summary of Basic Steps

The following summary outlines the basic steps for performing a fair value measurement under Statement 157. (**Bolded** terms are defined in the Q&A.)

1. Determine **unit of account**
2. Determine **exit market** (= **principal market** or, if none exists, **most advantageous market**)
3. Identify **market participants** in the exit market
- 4a. Determine **highest and best use** for asset (or **nonperformance risk** for liability)
- 4b. Based on highest and best use, determine **valuation premise** (in-use vs. **in-exchange**)
- 4c. Based on highest and best use and valuation premise, determine **unit of valuation**
5. Based on unit of valuation, perform valuation, using **market participant assumptions** and other market-based inputs, and apply one or more appropriate **valuation techniques**
- 5a. If applicable, impute value determined in step 5 to unit of account
6. Classify valuation inputs as **Level 1, 2, or 3**, classify the fair value measurement in its entirety, and prepare Statement 157 disclosures

Fair Value Measurement under Statement 157 – Full Matrix of Steps, Including Example

The full matrix of Statement 157 steps represents a tool that can be used to facilitate performing and documenting fair value measurements. The matrix, which is available as a practice aid on the BDO Seidman Infonet includes the following columns (**bolded** terms are defined in the Q&A):

First column – Brief description of each step in fair value measurement under Statement 157

Second column – Explanation of the step described in the first column

Third column – A blank column, to be completed in the performance of fair value measurement

The following filled-in matrix illustrates how a reporting entity might complete the third column of the matrix for Step 1 of its goodwill impairment testing for a reporting unit that creates and sells software. The reporting entity is a calendar year entity that performs its required annual goodwill impairment testing every October 1. If Step 1 indicates a potential impairment (i.e., carrying value of reporting unit exceeds fair value), the reporting entity would then need to complete Step 2 to compare the carrying amount of the reporting unit's goodwill with its implied fair value. To do this, the reporting entity would need to perform the same basic steps of the matrix to measure fair value for each of the identified assets and liabilities of the reporting unit.

Reporting Entity Perspective		
Step in fair value measurement	Explanation	Response: To be completed by reporting entity for each fair value measurement based on facts and circumstances
1. Determine unit of account for the asset or liability being valued	Answer the question: What is the reporting entity valuing; consider how it is grouped for accounting purposes under applicable GAAP. Is it an asset, liability, group of assets and/or liabilities (e.g., asset group, reporting unit, business), or instrument measured at fair value that is classified in stockholders' equity?	<i>Reporting unit that creates and sells software</i>
2. Determine exit market (principal market or, if none exists, most advantageous market) for the asset or liability being valued	Answer the questions: What are the potential exit markets? From the reporting entity's perspective, what is the exit market it would use to dispose of the asset or transfer the liability being valued? If there are no actual exit transactions by the reporting entity in any markets, consider hypothetical exit transactions.	<i>The entity determines that it has a principal market for the software business, which is the private market for buying and selling software businesses, and which is the same market in which it acquired the reporting unit.</i>

Reporting Entity Perspective

Step in fair value measurement	Explanation	Response: To be completed by reporting entity for each fair value measurement based on facts and circumstances
3. Identify the market participants in the exit market identified in Step 2	Answer the question: Who are the buyers and sellers in the exit market?	<i>The entity determines that market participants with which it would transact have the characteristics of both financial (in-exchange) buyers and strategic (in-use) buyers and include those buyers that originally bid for the reporting unit.</i>
4a. Determine highest and best use for an asset being valued or nonperformance risk for a liability being valued	Answer the question: From the perspective of the market participants identified in Step 3, what is the highest and best use for the asset, group of assets, reporting unit, or business, or what is the nonperformance risk for the liability?	<i>The entity determines that the reporting unit would provide maximum value to market participants if it was operated in its current capacity (versus, e.g., discontinuing its operations so it does not compete with a buyer's existing, similar software)</i>
4b. If valuing an asset, group of assets, reporting unit, or business, determine the valuation premise (in-use vs. in-exchange) based on the highest and best use	Answer the question: Is the highest and best use (to market participants) based on the value of the asset in-use or in-exchange?	<i>The valuation premise is in-use because the highest and best use (to market participants) is continuing to operate the reporting unit in its current capacity.</i>
4c. Based on the highest and best use and the valuation premise, determine the unit of valuation (not a Statement 157 concept but widely accepted)	Answer the question: Assuming the unit of account is an individual asset, is the reporting entity measuring fair value for an individual asset, or is the reporting entity measuring the fair value of a group of assets and then imputing value down to the individual asset based on the group fair value?	<i>The unit of valuation is the reporting unit. Therefore the reporting entity values the reporting unit on a standalone basis (versus, for example, valuing the individual assets and liabilities and either adding their values or imputing some summary value to the reporting unit)</i>
5. Determine a value for the unit of valuation, based on market participant assumptions and other market-based inputs, and apply one or more appropriate valuation techniques	Answer the question: Now that the reporting entity has determined the unit of valuation (i.e., the item to which the various valuation approaches and methods are applied), what is the fair value?	<i>The reporting entity determines it is appropriate to apply multiple valuation techniques under the market and income approaches. The resulting indications of fair value are evaluated and weighted to determine a reasonable range of values. The reporting entity determines that \$10 million is the point within the range that is most representative of the fair value of the reporting unit in the circumstances.</i>

Reporting Entity Perspective		
Step in fair value measurement	Explanation	Response: To be completed by reporting entity for each fair value measurement based on facts and circumstances
5a. If applicable, impute the value determined in step 5 to the unit of account.	If the unit of valuation was other than the individual asset—for example, if the unit of valuation was a group of assets to which the asset that is the unit of account belonged —impute or allocate value to the individual asset.	<i>Not applicable because the unit of valuation—the reporting unit—is also the unit of account.</i>
6. Classify inputs used in step 5 as Level 1, 2, or 3 , then accordingly classify the fair value measurement in its entirety, and prepare Statement 157 disclosures.	Answer the question: Were the inputs used to measure the asset or liability based on observable or unobservable data? Do the inputs fall into Level 1, 2, or 3? How significant is each input in arriving at the fair value? Where does the overall fair value measurement fall in the fair value hierarchy? Note: The overall fair value measurement is classified based on the lowest level input (1 being the highest and 3 the lowest) that is significant to the fair value measurement in its entirety.	<i>Level 3 measurement. There are no observable market prices for this reporting unit or for similar software businesses. Note that if fair value exceeds carrying amount, the fair value measurement is not reflected in the financial statements and it becomes a moot point that it is a Level 3 measurement. If carrying amount exceeds fair value, and the company records an impairment of goodwill, the fair value measurement for the goodwill impairment would be a Level 3 measurement and the reporting entity would make the disclosures required under paragraph 33 of Statement 157 and paragraph 47 of Statement 142.</i>

Material discussed in this *Financial Reporting Letter* is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual circumstances.