Management Information Insights

What Financial Advisers Need to Know About SFAS No. 157 Fair Value Measurements

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ESOP financial advisers rely on employer corporation financial statements for stock valuation, feasibility analysis, fairness opinion, and other purposes. Therefore, ESOP financial advisers should be aware of the basis for the preparation of the sponsor company financial statements. The Financial Accounting Standards Board recently issued SFAS No. 157, Fair Value Measurements. *This FASB statement provides a new definition of fair value and significant valuation professional guidance with regard to the measurement of fair value. Financial advisers should be aware of how this Statement does (and does not) affect employer corporation financial statements. And, financial advisers (and other parties who rely on ESOP sponsor company financial statements) should know when fair value measurements should be (and should not be) used for ESOP stock valuation purposes.*

Introduction

Parties associated with an employee stock ownership plan (ESOP) frequently have to rely on employer corporation financial statements for numerous reasons. These parties may include ESOP independent financial advisers, employer stock valuation analysts, ESOP trustees, ESOP legal counsel, leveraged ESOP lending institutions, ESOP participants, government regulatory agencies (e.g., DOL), and government taxing authorities (e.g., IRS).

And, the various purposes for relying on employer corporation financial statements include sponsor company stock valuation, ESOP formation feasibility analysis, leveraged ESOP debt repayment and covenant analysis, trustee assessment of any potential sponsor company stock purchase or sale transactions, regulatory and taxation compliance, and others.

There should be special consideration given by each of the above parties (and for each of the above purposes) when the employer corporation financial statements are affected by fair value measurements and fair value disclosures. Normally, employer corporation financial statements are presented on a historical cost basis. However, under generally accepted accounting principles (GAAP), there are certain transactions that are reported on a fair value basis.

Parties who rely on employer corporation financial statements should understand the differences between these two different bases of financial statement presentation. In particular, parties who rely on employer corporation financial statements should understand (1) when and (2) how these financial statements present fair value (instead of historical cost) measurements.

This discussion will provide an introduction to and an overview of SFAS No. 157 from the perspective of the independent financial adviser performing an employer corporation stock valuation.

In particular, this discussion will:

1. consider those transactions and circumstances to which SFAS No. 157 applies (and does not apply),
2. review the key provisions of SFAS No. 157, particularly with respect to the fair value valuation approaches, methods, and procedures, and
3. consider the applications and the limitations of SFAS No. 157 fair value measurements for other purposes—such as for the employer corporation stock valuation.

SFAS No. 157

The Financial Accounting Standards Board ("FASB" or "the Board") issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements ("SFAS No. 157" or "the Statement"), in September 2006. The Statement is effective for financial statements (including employer corporation financial statements) issued for fiscal years beginning after November 15, 2007 (and for interim periods within that fiscal year).

For reporting entities that have not already issued financial statements for their current fiscal year, earlier application of the Statement is encouraged.

The objectives of the Statement are to:

1. provide a comprehensive definition of fair value for purposes of U.S. generally accepted accounting principles (GAAP),
2. develop a procedural framework for measuring fair value for GAAP purposes, and
3. expand the required financial statement disclosures regarding fair value measurements.

It is particularly noteworthy that SFAS No. 157 does not expand the types of transactions or circumstances for which fair value accounting is required. In other words, the Statement does not require any new fair value measurements in instances where such measurements are not already required. That is, all employer corporation financial statements will not be issued on a fair value basis from now on.

However, first, the Statement does provide a new (and different) definition of fair value. Second, the Statement does require a new (and more rigorous) valuation framework for estimating fair value. And, third, the Statement does require new (and more comprehensive) disclosures regarding those fair value estimates.

For financial advisers who perform ESOP financial advisory services or employer stock valuations (and for trustees and others who rely on the employer stock valuations), SFAS No. 157 is perhaps the most significant Statement ever issued by the Board. This is because the SFAS No. 157 fair value definitions, procedures, and disclosures now apply to all prior Statements that require fair value measurements.

In other words, this Statement effectively amends all prior Statements and all prior Accounting Principles Board (APB) pronouncements that related to fair value. Accordingly, ESOP financial advisers who provide employer corporation stock valuations should be familiar with both the content and the intent of SFAS No. 157.

"For financial advisers who perform ESOP financial advisory services or employer stock valuations . . . SFAS No. 157 is perhaps the most significant Statement ever issued by the Board."

Application of SFAS No. 157

SFAS No. 157 updates the definition and measurement of fair value related to any FASB or APB pronouncements that refer to fair value. For example, SFAS No. 157 updates the fair value provisions of these Statements:

1. Statement No. 141 – Business Combinations
2. Statement No. 142 – Goodwill and Other Intangible Assets
3. Statement No. 143 – Accounting for Asset Retirement Obligations
4. Statement No. 144 – Accounting for the Impairment or Disposal of Long-Lived Assets
5. Statement No. 146 – Accounting for Costs Associated with Exit or Disposal Activities
6. various other Statements that require fair value measurements

The Statement appendix D provides a complete listing of both the FASB and the APB pronouncements that are amended by the Statement.

Although numerous GAAP pronouncements require or permit fair value measurements, these pronouncements provided differing definitions of fair value. In addition, these GAAP pronouncements provided a valuation analyst with very little implementation guidance with regard to fair value measurements. Also, whatever fair value implementation guidance did exist was dispersed among numerous GAAP pronouncements.

Accordingly, the Board promulgated the Statement in order to increase the consistency and comparability of fair value measurements among reporting entities.

In the Statement, the Board also revised and expanded the GAAP definition of fair value. The Statement emphasizes that fair value is a market-based measurement—and not an entity-specific measurement (as it was previously interpreted to be). This revised definition should also increase the consistency and comparability of reporting entity fair value measurements.

The Fair Value Standard of Value

The Statement requires the standard of value of fair value—and not fair market value. In particular, Statement paragraph C50 indicates:

> However, the Board observed that the definition of fair market value relates principally to assets (property). Further, the definition has a significant body of interpretive case law, developed in the context of tax regulation. Because such interpretive case law, in the context of financial reporting, may not be relevant, the Board chose not to adopt the definition of fair market value, and its interpretive case law, for financial reporting purposes.

In addition, at various points, the Statement refers to fair market value as an "other" definition of value. For example, Statement paragraph C25 indicates:

> To convey the notion more clearly, the Board revised the definition of fair value in this Statement to refer to an orderly transaction, as do other definitions used in valuations for purposes other than financial reporting that are similar to fair value (for example, fair market value).

The current GAAP definition of fair value is presented in Statement paragraph 5:

> Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

This Statement definition of fair value retains the exchange price notion in earlier FASB fair value definitions. However, the Statement clarifies that the fair value exchange price is the price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would normally transact for that asset or liability.

That is, the Statement introduces the concept of the "principal" or "most advantageous" market for the subject asset or liability. In addition, the Statement's contemplated transaction to sell the asset or transfer the liability is a hypothetical transaction at the fair value measurement date.

This hypothetical sale transaction is considered from the perspective of a market participant that already holds the asset or owes the liability. Accordingly, the new GAAP fair value definition focuses on the price that would be received to sell the subject asset or paid to transfer the subject liability (i.e., an exit price).

In other words, the Statement's definition of fair value is not the price that would be paid to acquire the subject asset or received to assume the subject liability (i.e., an entry price).

According to the Statement, the market participants are buyers and sellers in the principal (or most advantageous) market for the subject asset or liability. These market participants are:

1. independent of the subject reporting entity; that is, they are not related parties;
2. knowledgeable and have a reasonable understanding about the subject asset or liability and the subject transaction based on all available information, including all information that may be obtained through usual and customary due diligence efforts;
3. able to transact for the subject asset or liability; and
4. willing to transact for the subject asset or liability; that is, they are motivated but not forced or otherwise compelled to transact.

The Statement explains that the fair value of the asset or liability should be determined by the valuation analyst based on the assumptions that market participants would use to price the subject asset or liability. In developing those assumptions, the valuation analyst need not identify any specific market participants.

Rather, the valuation analyst should identify characteristics that distinguish market participants generally, considering those factors specific to: (1) the subject asset or liability, (2) the principal (or most advantageous) market for the subject asset or liability, and (3) the market participants that the reporting entity would transact with in that market.

The Statement affirms that the hypothetical transaction assumes an exposure to the market for a period prior to the measurement date. This assumed pre-transaction exposure to the market will allow for both information dissemination and marketing related to the subject asset or liability. Therefore, the exchange participants are able to transact at the most advantageous price for the subject asset or liability at the measurement date.

The Fair Value Measurement

The Statement cautions that the fair value measurement is for a particular asset or liability. That is, the fair value measurement should consider attributes specific to the subject asset or liability.

For example, the valuation analyst should consider:

1. the condition and/or location of the subject asset or liability and
2. any restrictions on the sale or use of the subject asset at the measurement date.

The subject asset or liability may be a stand-alone asset or liability, or it may be a group of assets and/or liabilities. Whether the subject asset or liability is a stand-alone asset or liability or a group of assets and/or liabilities depends on its "unit of account." The Statement explains that this unit of account determines what is being measured by reference to the level at which the asset or liability is aggregated, for purposes of applying other GAAP pronouncements.

The Statement's fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date. The Statement indicates that an orderly transaction is a transaction that assumes

exposure to the market for a period prior to the measurement date.

This exposure to the market allows for marketing activities that are usual and customary for transactions involving such assets or liabilities. The Statement emphasizes that the fair value transaction is not a forced transaction (for example, a forced liquidation or a distress sale).

The Statement contemplates that the transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date. This hypothetical transaction is considered from the perspective of a market participant that already holds the asset or that already owes the liability. Therefore, the objective of a fair value measurement is to determine the price that would be received to sell the asset or the price that would be paid to transfer the liability at the measurement date (i.e., an exit price).

The Fair Value Is an Exit Price

The Statement repeatedly mentions that the transaction to sell the subject asset or transfer the subject liability is a hypothetical transaction at the measurement date. The fair value transaction is considered from the perspective of a market participant that holds the asset or owes the liability.

Therefore, the Statement explains that "the objective of a fair value measurement is to determine the price that would be received for the asset or paid to transfer the liability at the measurement date, that is, an exit price."

The Board concluded that this exit price objective is appropriate. This is because the exit price objective embodies current expectations about (1) the future inflows associated with the subject asset and (2) the future outflows associated with the subject liability from the perspective of market participants.

The Concept of the Principal Market

The Statement's fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the subject asset or liability. In the absence of a principal market, the Statement assumes that the fair value transaction takes place in the most advantageous market for the subject asset or liability.

The Statement defines the principal market as the market in which the reporting entity would sell the asset or transfer the liability with (1) the greatest volume and (2) the greatest level of activity. The Statement defines the most advantageous market as the market in which the reporting entity would sell the asset or transfer the liability at the price that:

1. maximizes the amount that would be received for the asset or
2. minimizes the amount that would be paid to transfer the liability.

The Statement indicates that the most advantageous market considers transaction costs in the respective market(s).

In either case, the principal (or the most advantageous) market (and, therefore, the market participants) should be considered from the perspective of the reporting entity. This perspective allows for differences in concluded asset or liability values between and among reporting entities that have different activities.

The SFAS No. 157 Definition of Market Participants

"The Statement emphasizes that a fair value measurement is a market-based measurement, and not an entity-specific measurement."

The Statement emphasizes that a fair value measurement is a market-based measurement, and not an entity-specific measurement. Therefore, the fair value measurement should be estimated by the valuation analyst based on the assumptions that market participants—that is, buyers and sellers in the principal (or most advantageous) market for the asset or liability—would use in pricing the subject asset or subject liability.

To more clearly convey the idea of a fair value measurement that is made from the perspective of market participants, the Statement clarifies the "willing parties" referred to in earlier FASB definitions of fair value in the context of market participants. The Statement refers to buyers and sellers in the principal (or most advantageous) market for the subject asset or liability.

According to the Statement, the buyers and sellers should be:

1. independent of the reporting entity (unrelated),
2. knowledgeable, and
3. both able and willing to transact.

The Price Paid Typically (But Does Not Always) Equals Fair Value

The Statement clarifies that, in many cases, the transaction price, that is, the price paid (received) for a particular asset (liability) will represent the fair value of that asset (liability) at initial recognition. However, the Statement indicates that the valuation analyst should not automatically make this assumption.

Statement paragraph 16 indicates:

> When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price represents the price paid to acquire the asset or received to assume the liability (an entry price). In contrast, the fair value of the asset or liability represents the price that would be received to sell the asset or paid to transfer the liability (an exit price). Conceptually, entry prices and exit prices are different.

The Statement recognizes that a reporting entity would not necessarily sell its assets at the price it paid to acquire the assets. Similarly, a reporting entity would not necessarily transfer its liabilities at the price it received to assume the liabilities. Statement paragraph 17 recognizes that:

> 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.

However, the Statement cautions that to determine whether a transaction price represents the fair value of the asset or liability at its initial recognition, the valuation analyst should consider factors specific to:

1. the subject transaction and
2. the subject asset or liability.

The Statement cautions that a transaction price may not represent the fair value of the subject asset or liability at its initial recognition if the following conditions are present:

1. The transaction is between related parties.
2. The transaction occurs under duress or the seller is forced to accept the price in the transaction. For example, that situation may be the case if the seller is experiencing financial difficulty.
3. The unit of account represented by the transaction price is different from the unit of account for the subject asset or liability measured at fair value. For example, this situation may be the case if (a) the subject asset or liability is only one component of a complex transaction, (b) the transaction includes unstated rights and privileges that should be separately measured, or (c) the transaction price includes transaction costs.
4. The market in which the actual transaction occurred is different from the market in which the reporting entity would normally sell the subject asset or transfer the liability (i.e., the principal or most advantageous market).

"The Statement recognizes that a reporting entity would not necessarily sell its assets at the price it paid to acquire the assets."

The Statement indicates that, because the exit price valuation objective applies for all assets and liabilities measured at fair value, any fair value measurement requires that the reporting entity—and the valuation analyst—determine the following:

1. the particular asset or liability that is the subject of the measurement (consistent with its unit of account)
2. for an asset, the appropriate premise of value for the measurement (consistent with the subject asset's highest and best use)
3. the principal (or most advantageous) market for the asset or liability (for an asset, consistent with its highest and best use)
4. the appropriate valuation approaches and methods for the fair value measurement; the selection of the appropriate valuation approaches and methods should consider (a) the availability of the data needed to develop the valuation inputs that represent the assumptions that market participants would use in pricing the subject asset or liability and (b) the level in the fair value hierarchy within which the valuation inputs fall

Highest and Best Use

According to the Statement, highest and best use is a valuation concept that refers broadly to the use of an asset. The highest and best use would maximize the value of the asset or the group of assets in which the asset would be used by market participants. The Statement recognizes that, for some assets (in particular, nonfinancial assets), the application of the highest and best use concept could have a significant effect on the fair value measurement.

A fair value measurement assumes the highest and best use of the subject asset by market participants. According to the Statement, the analysis of highest and best use considers the use of the asset that is (1) physically possible, (2) legally permissible, and (3) financially feasible as of the measurement date.

According to the Statement, the highest and best use is determined based on the use of the subject asset by market participants, even if the intended use of the subject asset by the reporting entity is different.

The highest and best use of the asset establishes the premise of value that the valuation analyst should use to measure the fair value of the assets.

The Statement describes the following two premises of value:

1. Value in use. The highest and best use of the asset is in-use if the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (as installed or otherwise configured for use).
2. Value in exchange. The highest and best use of the asset is in-exchange if the asset would provide maximum value to market participants principally on a stand-alone basis.

Statement paragraph A4 emphasizes that the highest and best use analysis should be based on the actions of market participants:

The valuation premise used to measure the fair value of an asset depends on the highest and best use of the asset by market participants.

If the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (highest and best use is "in-use"), the asset would be measured using an in-use valuation premise. If the asset would provide maximum value to market participants principally on a stand-alone basis (highest and best use is "in-exchange"), the asset would be measured using an in-exchange valuation premise.

The Premise of Value

The premise of value that the valuation analyst uses to measure the fair value of an asset depends on the highest and best use of the asset by market participants (and not by the subject reporting entity). When the valuation analyst measures the fair value of an asset based on a value in use premise, the value in use valuation premise can be incorporated in the subject valuation in different ways.

The way in which the valuation analyst selects to incorporate the value in use premise will depend on the individual circumstances of the subject asset. For example:

1. The fair value of the subject asset may be the same whether the valuation analyst uses a value in use premise or a value in exchange premise.
2. The value in use premise may be incorporated in the fair value of the subject asset through adjustments the analyst makes to the value of the asset based on an in exchange premise.
3. The value in use premise may be incorporated in the fair value of the subject asset through the market participant assumptions that the analyst uses to measure the fair value of the subject asset.
4. The value in use premise may be incorporated in the fair value of the subject asset through the valuation approaches and methods that the analyst uses to measure the fair value of the subject asset.
5. In limited situations, the subject asset may be measured at an amount that approximates its fair value in use when the valuation analyst allocates the total fair value of an asset group to the individual assets of that group.

The SFAS No. 157 Valuation Approaches

The Statement recognizes the three generally accepted approaches to asset (and liability) valuation: the market approach, the income approach, and the cost approach. The Statement uses the term "valuation techniques" to describe what most experienced valuation analysts would call (1) valuation methods (within each of the three approaches) and/or (2) valuation procedures (within each individual valuation method).

According to the Statement, the valuation analyst should only use valuation techniques that are consistent with the market approach, income approach, and cost approach to measure fair value.

According to the Statement, the market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business enterprise).

According to the Statement, the income approach uses valuation techniques to convert future income amounts (for example, cash flow or earnings) to a single present amount (i.e., a discounted amount). The Statement specifically recognizes the following income approach "valuation techniques":

1. present value techniques
2. option-pricing models, such as the Black-Scholes-Merton formula (a closed-form model) and the binomial model (a lattice model), which incorporate present value techniques
3. the multiperiod excess earnings method, which may be used to measure the fair value of certain intangible assets

According to the Statement, the cost approach is based on the amount that currently would be required to replace the service capacity of the subject asset (often referred to as the replacement cost). In addition, the Statement recognizes that the measurement of obsolescence is broader than accounting depreciation measured for financial reporting purposes (i.e., an allocation of historical cost) or for income tax reporting purposes (i.e., based on specified service lives).

The Use of Multiple Value Indications

The Statement recognizes that, in some cases, the valuation analyst will use a single valuation technique to estimate fair value. In other cases, the valuation analyst will use multiple valuation techniques to estimate fair value. When the analyst uses multiple valuation techniques, then the conclusion of those techniques will be evaluated and weighted by the valuation analyst in order to conclude the final fair value estimate.

The Statement acknowledges that the valuation techniques used by the analyst will differ, depending on (1) the subject asset or liability and (2) the availability of data. However, in all cases, the Statement cautions that the valuation analyst should use the valuation technique (or the combination of valuation techniques):

1. that is appropriate in the circumstances and
2. for which there are sufficient data.

The Statement hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives (1) the highest level of priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (i.e., Level 1) and (2) the lowest level of priority to unobservable inputs (i.e., Level 3).

In some cases, the inputs that valuation analysts use to measure fair value may fall into different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety.

Assessing the significance of a particular input to the fair value measurement in its entirety requires the valuation analyst's judgment and a consideration of the factors specific to the subject asset or liability.

The Hierarchy of Valuation Inputs

In the Statement, the term "valuation inputs" refers broadly to the assumptions that market participants would use to price the subject asset or the liability, including any assumptions about investment risk. According to the Statement, valuation inputs may be either:

1. observable or
2. unobservable.

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

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

The Statement advises that the valuation techniques the analyst uses to measure fair value should

1. maximize the use of observable inputs and
2. minimize the use of unobservable inputs.

In order to increase consistency and comparability in fair value measurements and related disclosures, the Statement establishes a fair value "hierarchy" of valuation inputs. That hierarchy of valuation inputs prioritizes the inputs to the valuation techniques that analysts use to measure fair value into three broad levels.

The level in the fair value hierarchy into which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to that measurement in its entirety.

Level 1 valuation inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. In order for the analyst to rely on quoted price data, the reporting entity must have the ability to access those quoted prices at the measurement date. The Statement explains that a Level 1 input will be available for many financial assets and liabilities, some of which may be exchanged in several active markets (for example, on different stock exchanges).

In some situations, a quoted price in an active market may not represent fair value at the measurement date. That may be the case, for example, if a significant event (e.g., a principal-to-principal transaction, a brokered trade, or an announcements) occurred after the close of a market but before the measurement date.

The valuation analyst should identify those events that may affect fair value measurements. However, if the quoted price is adjusted for new information, then the price adjustment changes the fair value measurement to a lower level measurement.

Level 2 inputs are inputs other than quoted prices included in Level 1 that are observable for the subject asset or liability. The Level 2 inputs must be observable either directly or indirectly through corroboration with observable market data (i.e., market-corroborated inputs).

An adjustment to a Level 2 input that is significant to the fair value measurement in its entirety may lower that measurement to a Level 3 measurement.

According to the Statement, Level 2 inputs include the following:

1. quoted prices for similar assets or liabilities in active markets
2. quoted prices for identical or similar assets or liabilities in markets that are not active; examples of such markets include markets where (a) there are few transactions for the asset or liability, (b) the prices are not current, (c) price quotations vary substantially, either over time or among market makers or (d) little information is released publicly
3. valuation inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at intervals, volatilities, prepayment penalties, loss severities, credit risks, and default rates)
4. valuation inputs that are derived principally from, or corroborated by, observable market data by correlation or by other means

Level 3 inputs are unobservable inputs for the subject asset or liability. That is, Level 3 inputs reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the subject asset or liability (including assumptions about investment risk).

Level 3 inputs are developed by the valuation analyst based on the best information available in the circumstances. Level 3 inputs include:

1. assumptions about the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and/or
2. the risk inherent in the inputs to that valuation technique.

If a valuation input used to measure fair value is based on bid and ask prices (e.g., in a dealer market), then the price within the bid-ask spread that is most representative of fair value in the circumstances should be used to measure fair value. This is true regardless of where in the Statement fair value hierarchy that valuation input falls (i.e., Level 1, 2, or 3).

The Statement does not preclude the use of mid-market pricing or other pricing conventions as a practical expedient for fair value measurements within a bid-ask spread.

The Statement explains that, in situations in which the reporting entity acquires an asset or assumes a liability in an exchange transaction, the transaction price represents the price paid to acquire the asset or received to assume the liability (i.e., an entry price). The fair value of that asset or liability represents the price that would be received to sell the asset or paid to transfer the liability (i.e., an exit price).

The Statement indicates that entry and exit prices are conceptually different. Reporting entities do not necessarily sell or otherwise dispose of assets at the price they paid to acquire them. Similarly, reporting entities do not necessarily transfer liabilities at the price they paid to assume them.

Fair Value Measurements for Purposes Other than Financial Accounting

The fair value measurements determined under the provisions of the Statement may not be applicable for valuations performed for purposes other than financial accounting. For example, fair value measurements would not be applicable for purposes related to ESOP employer stock valuations, federal income taxation, federal gift and estate taxation, ad valorem property taxation, financing collateral values, certain bankruptcy-related determinations, family law, and any other instance where a fair market value (or a market value) measurement is appropriate.

In addition, the Statement definition of fair value is fundamentally different from the standard of fair value that is used in (1) state statutory dissenting shareholder appraisal rights cases and (2) shareholder oppression litigation cases.

Accordingly, it is important for financial advisers to be aware of the following:

1. Fair value is not the same standard of value as fair market value.
2. Other valuation purposes (e.g., ESOP-related employer stock valuations) may require a premise of value that is different than the appropriate SFAS No. 157 premise of value.
3. The GAAP reporting entity may be at a different organizational level (e.g., parent corporation) than the subject entity that is the subject of the other valuation purpose.
4. Fair value measurements at a parent corporation level may not trickle down to the entity that is the valuation subject for another valuation purpose.
5. Only transactions that involve a specific FASB Statement's fair value measurements are recorded at fair value on the reporting entity's financial statements.
6. The Statement emphasis on a hierarchy of observable valuation inputs may be inconsistent with the valuation procedures that are appropriate for other purposes.
7. Prior GAAP definitions of fair value are subtly (but significantly) different from the new SFAS No. 157 definition of fair value.

8. The Statement focuses on an exit price as a measure of fair value. The fair market value standard of value focuses on an entry price as an indication of value.
9. Most reporting entities will report financial statements that reflect a combination of fair value accounting measurements (for certain transactions) and historical cost-based measurements (for most accounts).
10. Even reporting entities that present fair value–based accounts will report a combination of pre-SFAS No. 157 and post-SFAS No. 157 fair value measurements.

Therefore, financial advisers (and those parties who rely on employer corporation stock valuation reports) should be extremely careful when attempting to use SFAS No. 157 fair value measurements for any purpose other than for financial accounting disclosures.

Summary and Conclusion

The Statement provides the current GAAP guidance related to fair value measurements. The Statement amends all prior FASB and APB pronouncements that require fair value disclosures for GAAP compliance purposes.

The Statement fair value measurement guidance provides for a consistency of accounting practice among reporting entities. This does not necessarily imply that the Statement's fair value measurement procedures represent best practices for valuations performed for any other (e.g., employer stock valuation) purposes.

The Statement emphasizes that valuation techniques consistent with the market approach, income approach, and/or cost approach should be used by the valuation analyst to measure fair value. In some cases, a single valuation technique will be appropriate. In other cases, multiple valuation techniques will be appropriate.

If multiple valuation techniques are used by the valuation analyst, then the analyst should evaluate the value indications considering the reasonableness of the range of values indicated by those indications.

The Statement explains that the fair value measurement is the point within that range of value indication that is most representative of fair value in the circumstances. The Statement provides for a single definition of fair value and a comprehensive framework for measuring fair value. Therefore, the Statement is expected to result in increased consistency and comparability in reporting entity fair value measurements.

The Statement provides expanded disclosures about the use of fair value to measure assets and liabilities. These expanded disclosures should provide financial statement users with better information about:

1. the extent to which fair value is used to measure recognized assets and liabilities,
2. the valuation inputs used to develop the fair value measurements, and
3. the effect of fair value measurements on earnings (or changes in net assets) for the period.

The Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 (and for interim periods within those fiscal years). Earlier application is encouraged (provided that the reporting entity has not yet issued financial statements for that fiscal year).

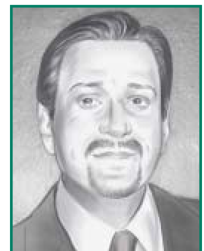
This discussion was presented from the perspective of the ESOP financial adviser. Therefore, this discussion did not focus on the Statement's financial statement disclosure requirements. In any event, these disclosure requirements would be drafted by the ESOP's financial accountant and not by the ESOP financial adviser.

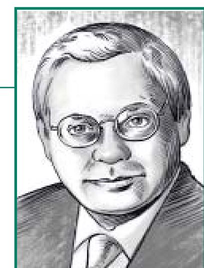
Likewise, this discussion did not focus on the description of the generally accepted valuation techniques (e.g., present value techniques) included in the Statement appendices. The experienced financial adviser will already be familiar with the fundamentals of these basic valuation procedures.

This discussion did focus on the valuation content and intent of the Statement. Financial advisers who perform employer corporation stock valuation engagements should be familiar with the provisions of the Statement.

These financial advisers should be aware of when (and how) these new fair value measurements affect the employer corporation financial statements. And, these financial advisers should consider when these fair value measurements affect (and when they do not affect) the employer corporation stock valuation.

Lastly, parties who rely on employer corporation stock valuations (or who rely directly on employer corporation financial statements) should be generally familiar with the Statement's fair value measurement provisions. These parties may include ESOP trustees, ESOP legal counsel, lending institution officers, ESOP participants, regulatory and taxation authorities, and others.





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