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Fair Value Hierarchy

Are you challenged by SFAS 157?

There is difficulty in measuring fair value of illiquid assets even in the best of economic times. Add declining markets to the mix and you have a prescription for a challenging endeavor, at best. The following article emphasizes the use of market inputs in valuing an asset or liability under Statement 157.

FASB Statement No. 157, Fair Value Measurements

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Introduction

To "increase consistency and comparability in fair value measurements and related disclosures," Statement 157 establishes a three-tier "fair value hierarchy" that prioritizes the inputs that are based on market data and assumptions (observable inputs) over those that represent an entity's own assumptions (unobservable inputs). Statement 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Accordingly, an entity is required to maximize the use of observable inputs measuring fair value. The fair value hierarchy is established to provide guidance to entities in determining the most reliable inputs to be used when applying valuation techniques to the measurement of an asset or liability. It is important to emphasize that it is the inputs into the valuation techniques, rather than the valuation techniques themselves, that are the focus of the three-tier hierarchy.

In addition to prioritizing the inputs used in the valuation techniques, the fair value hierarchy is also used to identify the overall reliability of the fair value measurement for a particular asset or liability. The concluded measurement of fair value of a particular asset or liability is assigned an overall level within the hierarchy based on the inputs significant to the measurement in its entirety and the level in the hierarchy where those inputs fall. For example, if there are five "material" inputs into a valuation model and four are Level 1 inputs and one is a Level 3 input, the asset or liability would be deemed to be a "Level 3" measurement.

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The three broad levels are discussed in the following sections.

Level 1 Inputs

Level 1 inputs are "quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access as of the measurement date." For many financial assets and liabilities (such as actively traded equities and bonds) there may be more than one "active" market. In such cases, Level 1 inputs are defined by:

- the principal market for the asset or liability or, if there is no principal market, the market that is most advantageous to the reporting entity; and
- whether the reporting entity has the ability to access such a market.

Even though Statement 157 requires that the asset or liability be valued at its pretransaction-cost price, the most advantageous market is one that results in the reporting entity receiving the highest posttransaction-cost proceeds.

Level 2 Inputs

Level 2 inputs are "inputs other than quoted prices included within Level 1 that are observable for the asset or liability either directly or indirectly through corroboration with observable market data."

While a Level 1 input requires an observable market quote for an identical asset in an active market, a Level 2 input is characterized as an observable market quote 1) for a "comparable (similar)" asset or liability in an active market, or 2) for an identical or similar asset or liability in a market that is not active. The words "comparable" and "similar" relate to both this type of asset or liability and the stated or contractual term of the asset or liability.

If the "observable market data" is materially adjusted, the measurement would be a Level 3 measurement rather than a Level 2 measurement. The decision as to whether an input is a Level 2 or Level 3 input is nuanced in that an input interpolated from "market-corroborated" inputs (such as interest rates and yield curves) may still be considered a Level 2 input. The application of an observed Price/Earnings multiple derived from one publicly traded equity instrument to value a different, nontraded equity instrument, on the other hand, requires considerable judgment and would represent a Level 3 measurement. The distinction lies in factors such as the level of judgment required to arrive at the measurement of fair value.

Level 3 Inputs

A Level 3 input is one that is "unobservable" in the market, that is, one that reflects the entities' own assumptions about what the "market participants" would assume in pricing the asset or liability. These Level 3 inputs should be developed based on "the best information available" and should include assumptions regarding the risk inherent in the valuation technique used, as well as the risk inherent in the inputs into the valuation technique.

In performing fair value measurements, it is important to be cognizant of, and properly apply, the Fair Value Hierarchy prescribed by Statement 157. It is also important to recognize that a Level 3 input is not necessarily less appropriate than a Level 2 input. For many assets and liabilities, Level 3 inputs may be the most appropriate inputs. •

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