

# Valuation Clarification

## New FASB Rule on Fair Value Adds Consistency, Comparability and Transparency

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**I**T IS NO SURPRISE THAT valuation of assets is the most challenging operational issue concerning hedge fund investors. The primary purpose of each net asset value (NAV) calculation is to establish a price at which investors subscribe and redeem. The largest component of the NAV is made up of the fund's investments, which include realized and unrealized gains or losses in value since the prior NAV calculation. Investors need to understand the fund's valuation process and how they arrive at 'fair value,' which is an accounting term defined as the most relevant measure for a financial instrument.

### THE GOALS OF FASB RULE 157

Financial Accounting Standards Board (FASB) Rule 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP) and expands disclosures about fair value measurements. The intentions of this regulatory change are to provide transparency, comparability and consistency to investors and the industry. The rule is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years.

### DEFINITION OF FAIR VALUE

FASB Rule 157 introduces a revised definition of fair value that replaces all existing definitions in GAAP: "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." While the definition in the rule maintains the exchange price notion that existed in previous definitions of fair value in accounting literature,



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this revised definition focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price).

**Applying FASB Rule 157 will provide ongoing benefits, including greater clarity regarding the inputs used in arriving at fair value measurements.**

### FRAMEWORK FOR MEASURING FAIR VALUE

There are three key valuation techniques employed to measure fair value: market approach (transactions involving identical or comparable assets or liabilities), income approach (converts future amounts to a single discounted present value) and cost approach (current replacement cost adjusted for obsolescence). While one or more of these valuation techniques may be used, the fair value hierarchy focuses on market inputs, not valuation techniques.

FASB Rule 157 has created a fair value hierarchy that prioritizes the inputs (observable versus unobservable) into three broad levels. Market inputs can be

observable (market data obtained from independent sources) or unobservable (based on the reporting entity's assumptions of market inputs).

In the fair value hierarchy:

- **Level 1**, 'mark-to-market,' uses observable inputs that reflect quoted prices for identical assets or liabilities in active markets.
- **Level 2**, 'mark-to-model,' uses observable inputs, other than quoted prices included in Level 1, for the asset or liability, including market-corroborated inputs. The price is an estimate based on observable inputs, such as quoted prices for similar assets in active markets or quoted prices for identical or similar assets in markets that are not active.
- **Level 3** is the lowest level of significant inputs, consisting of unobservable inputs. Unobservable inputs are those that reflect the reporting entity's own assumptions about what market participants would use to price the asset or liability (considering inherent risks), developed using the best information available without undue cost and effort. There is no verification requirement if the assumptions are in line with those of market participants.

## EXPANDED DISCLOSURES ABOUT THE USE OF FAIR VALUE

The expanded disclosures about the use of fair value to measure assets and liabilities should provide users of financial statements with better information about the extent to which fair value is used to measure recognized assets and liabilities, the inputs used to develop the measurements and the effect of certain of the measurements on earnings (or changes in net assets) for the period.

FASB Rule 157 requires reporting entities to disclose the level within the fair value hierarchy in which a fair value measurement falls, presented by major category of asset or liability (see example below).

FASB Rule 157 also requires a reconciliation of the beginning and ending balances for any fair value measurements that utilize significant unobservable inputs (Level 3 inputs). Therefore, any asset or liability that was determined to be a Level 3 measurement at either the beginning or the end of a reporting period would need to be considered in the reconciliation. To enhance the information provided in the reconciliation with respect to total gains and losses recognized in earnings, the rule requires the reporting entity to also disclose the change in unrealized gains and losses recognized in earnings (for the period) for assets and liabilities measured in Level 3 that are still held at the reporting date. Effectively, this will require an entity to distinguish its unrealized gains and losses from its realized gains and losses for Level 3 measurements.

## GOING BEYOND THE REGULATION

This regulation provides guidance; however, investment managers and their administrators need to use judgment when working through the practical realities of compliance. FASB Rule 157 will have a direct result on pricing policies, systems (to track, monitor and report types of inputs and transfers in and out of hierarchy levels) and financial statement preparation and presentation.

Indirect consequences will result as well. Valuation techniques for esoteric and illiquid instruments also will need to be examined for consistent application. In certain cases, it may be appropriate to change a valuation technique or its application if the change results in a measurement that is equally or more representative of fair value. Revisions resulting from a change in valuation technique or its application will be accounted for as a change in accounting estimate in the financial statement footnote disclosures.

Applying FASB Rule 157 will provide ongoing benefits, including greater clarity regarding the inputs used in arriving at fair value measurements. Regular testing of pricing models for accuracy against market prices and a collaborative approach between managers, administrators and accountants on level assignment for certain instruments can

be counted as positive consequences as well.

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(\$ in 000's)

### Summary of Fair Value Measurements by Level Category at Report Date

Security Description	Total Owned at 12/31/XX			
	Level 1	Level 2	Level 3	
Equities owned	\$ 235	\$ 205	\$ 30	\$ -
Fixed income securities owned	160	88	72	-
Unrealized gain on derivatives	45	20	5	20
Private equity securities owned	60	-	-	60
Other fund investments	105	-	85	20
<b>Total</b>	<b>\$ 605</b>	<b>\$ 313</b>	<b>\$ 192</b>	<b>\$ 100</b>

Level 1 - Quoted prices in active markets for identical assets

Level 2 - Significant other observable inputs

Level 3 - Significant unobservable inputs

(Note: A similar table disclosure will need to be presented for liabilities)