Fair Value Considerations in Illiquid Markets

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In September 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 157 - Fair Value Measurements. This Statement, which is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years, was issued to provide increased consistency and comparability in fair value measurements and to expand disclosures about fair values.

In October 2007, the Center for Audit Quality of the American Institute of Certified Public Accounts (the Center) issued a white paper, *Measurements of Fair Value in Illiquid (or Less Liquid) Markets*. The objective of the white paper was to discuss issues associated with the measurements of fair value under existing generally accepted accounting principles (GAAP) in the context of illiquid (or less liquid) market conditions that currently exist in certain markets with the intention of helping preparers of financial statements and auditors understand the application of existing GAAP in the context of illiquid market conditions.

In particular, during the summer of 2007, a liquidity crisis arose in the credit markets, as evidenced by a sharp rise in the rate of delinquency and default by subprime mortgage loan borrowers. Most subprime loans were financed by investors who purchased securities backed by the underlying subprime mortgage loans. As a result of the uncertainty in the marketplace, demand for investments in assets backed by subprime mortgage loans declined, creating a so called "liquidity crisis." This crisis in the subprime mortgage market also spread to collateralized bond obligations, high-yield bond, and other credit instruments. This liquidity crisis resulted in a variety of assets experiencing severe price volatility as a result of the increased credit risk and the reduced liquidity in the marketplace. That volatility, in turn, gave rise to questions about how to measure fair value of subprime mortgage-related assets, as well as other assets, affected by the illiquidity of a market.

Statement No. 157 clarified the definition of fair value but it maintained the previous concept found in the prior accounting literature that fair value remains an "exchange price notion" with a focus on the assumptions marketplace participants would use in pricing the asset or liability. Although the guidance in Statement No. 157 will change measurement practices for these assets (*e.g.*, application of the guidance on "principal markets" and "most advantageous market"), it is expected that differences arising solely from whether or not an entity has adopted Statement No. 157 will be limited. Statement No. 157 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." Statement No. 157 goes on to state, "An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale)."

The question raised in the Center's white paper is whether, in light of the liquidity crisis, current market prices are consistent with the definition of fair value in Statement No. 157, or whether current market prices are more indicative of distressed sales. In addressing this question, the Center differentiated between an imbalance in supply and demand (*e.g.*, fewer buyers than sellers, thereby forcing prices down) and a "forced" or "distressed" transaction referred to in Statement No. 157. The Center noted that the U.S. Securities and Exchange Commission addressed illiquid market conditions in a 2004 Accounting and Auditing Enforcement Release. In particular, the Commission concluded that a registrant should have considered current market conditions, such as imbalances in supply and demand, when determining the then-current market value. The Commission objected to the practice of ignoring prices quoted by external pricing sources and taking a "longer view" of the market (*i.e.*, a view that assumed equilibrium would occur and facilitate transacting at a more "rational" price).

Statement No. 157 states that if orderly transactions are occurring between market participants in a manner

continued on page 12

that is usual and customary for transactions involving such assets, than those transactions are not "forced" sales. Persuasive evidence is required to establish that an observable transaction is a forced or distressed transaction. The fact that transaction volume in a market is significantly lower than in previous periods does not necessarily mean that these are forced or distressed sales or that the market has become inactive. The determination of fair value requires consideration of current market conditions, including the relative liquidity of the market. Even if the volume of observable transactions is not sufficient to conclude that a market is "active", those observable transactions would still constitute level 2 inputs that must be considered in the measurement of fair value.

Statement No. 157 defines an active market as one that has a sufficient transaction volume such that quoted market prices are the most reliable measure of fair value. Markets with reduced transaction volume under current conditions are still considered active markets if transactions are occurring frequently enough on an ongoing basis to obtain reliable pricing information. Statement No. 157 generally requires that quoted prices from active markets (level 1 inputs) be used to measure fair value whenever they are available. If a market is not considered active due to transaction volume that is insufficient to produce reliable pricing information, then observable transactions in that market still are considered level 2 inputs which cannot be ignored in measuring fair value.

With respect to many mortgage-backed securities backed by subprime mortgage loans, it is possible that current market conditions might continue for some time given the uncertainties surrounding default rates and real estate prices. Even with these current market conditions, it is likely that quoted prices and observable transactions for identical assets still exist even with trading levels being far less than in the past. Statement No. 157 states that quoted prices (level I inputs) provide the most reliable evidence of fair value and should be used to measure fair value whenever available. The use of level 2 or level 3 inputs is generally not permitted when level 1 inputs are available.

If quoted market prices are not available for identical assets, then reporting entities should determine whether level 2 inputs are available, including quoted market prices for similar assets in active markets, or for identical assets or similar assets in markets that are not active markets (*i.e.*, markets in which there are few transactions for the asset, the prices are not current, price quotations vary substantially, or in which little information is released publicly). Level 2 inputs also include inputs that are derived principally from or corroborated by observable market data by correlation or other means. Adjustments to level 2 inputs will vary depending on factors specific to the asset. An adjustment that is significant to the fair value measurement in its entirety might render the measurement a level 3 measurement.

Level 3 inputs are unobservable inputs for an asset. Such level 3 inputs should only be used to measure fair value to the extent that observable inputs are not available. As such, level 3 inputs should be used to measure fair value in the absence of other observable inputs. Even with a level 3 input, the objective of the fair value measurement remains the same. The objective is to derive an exit price in the principal market from the perspective of a market participant that holds the asset.

When quoted market prices in an active market do not exist, entities may utilize valuation techniques, such as a discounted cash flow model that utilizes level 2 and level 3 inputs. Statement No. 157 states that the use of an entity's own assumptions about future cash flows is compatible with an estimate of fair value, provided there is no contrary data indicating the marketplace participants would use different assumptions. If such data exists, the entity must adjust its assumptions to incorporate that market information. As discussed previously, the use of unobservable inputs is only appropriate to the extent that observable inputs are not available. Unobservable inputs must reflect the assumptions that market participants would use in pricing the asset in a current transaction. As such, valuation models must reflect current market conditions within their assumptions. To test whether a model reflects current market conditions, the model can be applied to similar securities for which price information is available. If the model appropriately reflects current market conditions, it should produce approximately the same market price. Valuation models that utilize historical default data or an entity's own default assumptions,

continued on page 15

PRESS CHECK continued from page 14

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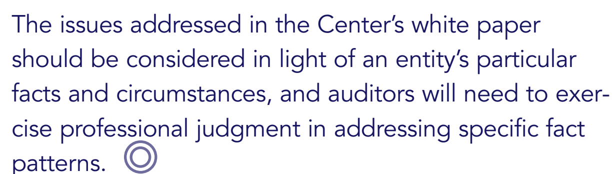
MFA ON ACCOUNTING continued from page 12

rather than assumptions that marketplace participants would use, are not appropriately utilizing market participant assumptions.

The use of valuation models is generally only acceptable when quoted prices in active markets are not available. If a valuation model is used, the objective of the measurement is to obtain the exit price at the current measurement date from the prospective of the seller. If market data exists about the assumptions that marketplace participants would use in pricing the asset, including observable market prices for similar assets, as well as other level 2 inputs, that information must be incorporated into the entity's assumptions. Finally, any significant unobservable assumptions, including significant adjustments to level 2 inputs, likely renders the entire measurement a level 3 measurement.



The issues addressed in the Center's white paper should be considered in light of an entity's particular facts and circumstances, and auditors will need to exercise professional judgment in addressing specific fact patterns.

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