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Fair Value Accounting Requires Judgment

When SFAS Statement 157, *Fair Value Measurements* was issued in September 2006, the Statement's underlying concepts of fair value (an exit price) and the fair value hierarchy (more emphasis is to be placed on market transactions when determining a security's fair value) seemed reasonable. It was understood at the time that a level 3 price, which is a fair value calculated based on unobservable market inputs, would carry less weight by market analysts. However, in that benign market environment it was not a challenging task to obtain reasonable and observable market data to support fair value measurements. Today, with liquidity and trading volumes near all time lows, it can be difficult to obtain observable market data to support a fair value. Further, even when there is observable market data, it can be challenging to ascertain if the market data is related to orderly transactions between two willing parties, which should only be used to support a true exit price, or if the transactions are a result of distressed sales or forced liquidations.

This past September the FASB and the SEC released a document that answered questions surrounding fair value accounting. Below are several excerpts from the memo:

- “The determination of fair value often requires significant judgment”
- “Determining whether a particular transaction is forced or disorderly requires judgment”
- “The determination of whether a market is active or not requires judgment”
- “Determining whether impairment is other-than-temporary is a matter that often requires the exercise of reasonable judgment based upon the specific facts and circumstances of each investment”

The individuals who are deeply involved with establishing the fair values of investments or making impairment decisions should completely agree with the bullet points above. There are several characteristics that are indicative of an impaired security (length of time and severity of unrealized loss position) or transactions resulting from an inactive market (significant spread between bid and ask prices). However, making these ultimate decisions requires the input and judgment of those most familiar with the underlying facts and circumstances of the particular situation. Therefore, I would first like to encourage insurance companies to review their internal policies surrounding the determination of impaired securities and consider using the wording “reasonable judgment” as a component of your impairment policy. Secondly, I encourage these insurance companies to schedule some time with their asset manager to discuss the specific details surrounding any securities that, on the surface, appear to be other-than-temporarily impaired.

We recently met with a well respected Chicago based accounting firm to discuss FASB 157 and OTTI related issues. The members of this firm were impressed to see the level of security-specific information available to AAM's clients and believed that their firm's audit procedures could be completed much more efficiently if this information was available to them. It is apparent that auditors will be requiring more investment related information in discussions regarding impairments. AAM acknowledges this, believes the audit community should agree with this concept of reasonable judgment and is prepared to provide you with the necessary information to be prepared for your upcoming audit.

Joseph A. Borgmann, CPA
Vice President
Investment Accounting

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