



# **FAIR VALUE ACCOUNTING**

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# HISTORICAL COST TO FAIR VALUE

- Historical cost presents transactions at the price paid or received at the time of the transaction.
  - Balance Sheet values are often decreased to comply with the Matching Principle through the recognition of depreciation & amortization
  - Balance Sheet values are also decreased from time to time to reflect current market values when the lower of cost or market concept is followed



## HISTORICAL COST TO FAIR VALUE...CONT'D

- Although it has long been agreed that historical cost does not accurately reflect the true current market value of an entity, it does have several inherent positive aspects:
  - With few exceptions, values represent real values acquired/surrendered
  - Ambiguities such as estimates/assumptions are not prevalent
  - A basic stability is afforded to the financial markets
  - Accuracy can be assessed by examining source documents
  - Future operational costs can reasonably be derived from past data

Although we often think about historical cost as “cost”, another way to view it is that it is actually Market Value at the time of the transaction



## HISTORICAL COST TO FAIR VALUE...CONT'D

- Even with its numerous benefits, historical cost has some critical shortcomings:
  - It ignores the time value of money (inflation)
  - Entities acquire and dispose of assets and liabilities at different times and the changing value of money at these various times causes differences that may not truly be reflective of the worth of the entity
- The shifting value of currencies are always present, and these shifts can often occur frequently and be significant causing true distortion in real value



## HISTORICAL COST TO FAIR VALUE...CONT'D

- We tend to think of Fair Value accounting as a current activity, but it actually has its roots from the S & L crisis that occurred in the 1980's with the regulated thrift industry attempting to compete with the increasingly unregulated financial services industry
- The FASB first began to address fair value with the issuance of SFAS 107 in December, 1991
- Since that time, the FASB has issued 12 SFAS that refer to Fair Value
- This presentation will focus on ASC 820 (FASB 157) "Fair Value Measurements and Disclosures"



# MEASUREMENT

- ASC 820 definition of fair value:
  - “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”
  
  - Although this definition retains the exchange price concept that existed in previous definitions, it clarifies several points:
    - Since it is the price to sell an asset, or transfer a liability, it is the exit price and not the entry value
    - The price is the price in the principal market that the reporting entity would transact in, or the most advantageous market if a principal market does not exist
    - The exit price is not adjusted for transaction costs
    - Although the exit and entry price may be the same in many instances, the transaction price is no longer presumed to represent fair value on the initial recognition
    - Fair value is market, not entity based. Therefore, it is determined based on the assumptions that those market participants would use to price the asset or liability
    - Fair value assumes a sale or transfer, not a transaction to offset risk
    - Exit price is used even if the reporting entity has no intent or ability to sell the asset or transfer the liability
    - The transaction of a sale or transfer is hypothetical and assumes an appropriate period of market exposure for an orderly transaction



# FRAMEWORK

- The Principal or Most Advantageous Market:
  - The principal market (if one exists) would be the market where the entity would sell the asset or transfer the liability where there is the greatest level of activity or volume for the asset or liability
  - The most advantageous market would be the one where the entity would sell the asset to maximize the price or transfer the liability for the minimum price paid, considering transaction costs in that market
    - The most advantageous market can only be considered when there is no principal market
    - Although transaction costs are given consideration when determining the most advantageous market, the fair value of the asset or liability is not adjusted for these costs
    - Transaction costs do not include those incurred to transport the asset or liability unless location is an attribute of the asset or liability (commodity); in such cases, the transportation costs would adjust the fair value



## FRAMEWORK...CONT'D

### ○ Price:

- The measurement of fair value assumes the asset or liability is sold in an orderly transaction which necessitates sufficient market exposure prior to the measurement date to allow normal market activities to occur prior to that date (not a forced transaction)
- Because the fair value measurement is for a hypothetical transaction, the objective is to measure the fair value at the exit price
- Since the transaction is hypothetical, it gives no consideration to the actual intent or ability of the entity to actually sell the asset or transfer the liability at the measurement date
  - With this in mind, even as asset or liability that is restricted from sale or transfer at the measurement date does not preclude a hypothetical transaction to sell or transfer



## FRAMEWORK...CONT'D

### ○ Market Participants Must:

- Be independent of the reporting entity
- Able to conduct the transaction
- Knowledgeable by having a reasonable understanding of the asset or liability gained from all available information, including that which would/could be obtained through due ordinary due diligence
- Enter the transaction willingly (not forced)
  
- Obviously, determining the characteristics of market participants requires significant judgment. Additionally, fair value measurement is not entity specific. Therefore, if market participants would consider adjustments for the fair value assumptions or inherent risks in the asset or liability, then these adjustments would impact fair value



## FRAMEWORK...CONT'D

- Attributes of the Asset or Liability:
  - Since fair value is for a specific asset or liability, condition and or the location of the asset or liability enters into the determination of fair value(the miles flown by an aircraft are attributes that would be given weight)
  - For financial assets or liabilities, nonperformance is a significant attribute. Nonperformance risk for financial assets is generally referred to as “counterparty credit risk”. This risk represents the probability that the counterparty is unable to meet the terms of the agreement and or becomes insolvent
  - Counterparty credit risk is present in many financial assets with the exception of U S treasury securities
  - Nonperformance risk associated with financial liabilities is called the “entity’s own credit risk” (assumes the reporting entity becomes insolvent or cannot perform)



## FRAMEWORK: ATTRIBUTES...CONT'D

- Fair value of an entity's liability needs to be entity specific in that it would consider the reporting entity's actual credit risk (credit standing) in determining fair value
- For counterparty credit risk, the reporting entity would include such risk in measuring fair value if the market participants would use it in pricing the asset or liability



## FRAMEWORK...CONT'D

- Highest and Best Use:
  - Highest and best use generally only applies to assets, not liabilities
  - Highest and best use assumes how the asset would be utilized by the market participants, not how the asset is used by the reporting entity
  - Highest and best use terms determine whether the valuation is based on “in-use” or “in-exchange:
    - In-Exchange..if the asset would provide maximum value to the market participants on a stand –alone basis, then fair value is measured on an i-exchange basis (price in a current sale)
    - In-Use..if the asset would provide maximum value to market participants in combination with other assets as a group. An example would be land with an office building. If the land would offer maximum value with the building, then fair value would be measured in-use. However, if the maximum value would be without the building (some other use), then in-exchange basis would be used, net of demolition costs



## FRAMEWORK...CONT'D

- Unit of Account:
  - The unit of account defines what is being measured for fair value and it might be a stand alone asset or liability such as a financial instrument or a group of assets and or liabilities such as a division, subsidiary, etc.
  - Unit of account is inherently basic to the fair value determination of assets and or liabilities



## FRAMEWORK...CONT'D

- Fair Value at Initial recognition:
  - At acquisition, the transaction price represents the price paid to acquire the asset or assume the liability represents the entry price.
  - Although from a conceptual standpoint, entry and exit prices can be different because entities do not necessarily sell assets at the prices paid at acquisition, there are instances when the entry and exit prices would represent the same value'
  - For fair value measurement, the reporting entity needs to consider factors specific to the transaction:
    - Related party transaction
    - Transaction occurring under duress (seller with financial duress)
    - Acquisition unit of account is different from fair value unit (fair value is measured for only certain elements of the acquisition)
    - The market in which the transaction (acquisition) occurs is different from the market in which the asset or liability would be sold



# VALUATION METHODS

## ○ Market Approach:

- The market approach utilizes market prices and other relevant data that is generated by market transactions involving identical or very comparable assets and or liabilities.
  - These transactions could also involve a business.
  - This valuation technique often uses market based multiples that are derived from sets of comparable transactions
  - These multiples often lie within ranges with different multiples for each comparable transaction so that considerable judgment is often involved in considering which factors are specific to the fair value measurement



## VALUATION METHODS...CONT'D

### ○ Income Approach:

- The income approach generally converts future amounts (cash flows and or earnings) to a single present discounted value
- The discount is based on current market expectations about those future amounts
- The techniques used are various types of present value methods including option pricing models such as Black-Sholes and excess earnings (intangibles) models
- This use of the income approach and the degree of market uncertainty about the future cash flows from the collateral debt obligations (mortgage securities) was a large contributing factor in the 2007-2008 financial crisis that continues today



## VALUATION METHODS...CONT'D

### ○ Cost Approach:

- The cost approach is based on the amount that would currently be required to replace the service capacity of an asset...current replacement cost
- The fair value is the cost to a market participant (buyer) to acquire or construct a comparable asset
  - This cost is adjusted for obsolescence which encompasses physical deterioration, technological obsolescence and economic obsolescence
  - The degree of estimation in determining this cost can, in many instances, be very large and impact the fair value accordingly



## VALUATION METHODS...CONT'D

- ASC 820 does not prioritize the use of the methods since they will not all be appropriate to all assets and or liabilities.
- The reporting entity should use the method(s) that it deems most appropriate given the amount and accuracy of available data.
- Obviously, the determination of which method(s) should be used requires significant judgment as well as sufficient knowledge of the asset or liability coupled with a satisfactory level of expertise regarding the valuation methods



## VALUATION METHODS...CONT'D

- The use of only one method may be appropriate in measuring the fair value especially when there is an active open market with available quoted, unadjusted prices
- In many situations the use of multiple methods would be more appropriate and multiple methods should be utilized
- The FASB has emphasized that the application of valuation methods needs to be consistently applied among similar assets as well as across reporting periods
- If a change in valuation method(s) would result in a more representative fair value, then a change should be implemented



## VALUATION METHODS...CONT'D

- The circumstances that may cause a change in valuation method(s) could include changes in:
  - The exit market for the asset or liability
  - The available or observable market data
  - The highest and best use of the asset
  - The market participants for the asset or liability
- A change in valuation method(s) is accounted for as a change in estimate and applied prospectively
- In the case where there was an error in applying the method(s), the change would be accounted for as the correction of an error in accordance with ASC 250 (all periods shown should reflect the change)



## VALUATION INPUTS

- In the context used in ASC 820, inputs are broadly referred to as the assumptions that would be used by market participants to price an asset or liability including assumptions about risk
- These inputs may be either observable or unobservable:
  - Observable inputs are those assumptions that market participants would use to price the asset or liability and are based on actual market data from sources independent of the reporting entity
  - Unobservable inputs reflect the reporting entity's own assumptions about how market participants would price the asset or liability based on the best available information



## VALUATION INPUTS...CONT'D

- Per ASC 820, the valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs
- Although fair value may be determined by observable or unobservable inputs, they should always be an attempt to reflect the assumptions that market participants would use to price the asset or liability; as such, they are not meant to be entity specific assumptions
  - In the case of unobservable inputs, they may use the reporting entity's own data, but they need to reflect the reporting entity's interpretation of the assumptions that would be used by market participants
    - In valuing an intangible asset using unobservable inputs, the assumptions should reflect the intended use of the asset by market participants which could differ from the use by the reporting entity



# HIERARCHY

- In an attempt to bring consistency and comparability to fair value measurements, ASC 820 establishes a hierarchy for the valuation inputs to fair value:
  - Level 1 (highest) – Observable inputs from directly quoted prices for identical assets or liabilities in active markets. These inputs are unadjusted
  - Level 2 – Inputs other than quoted prices included in Level 1 that are observable either directly or indirectly
  - Level 3 (lowest) – Unobservable inputs which are usually the reporting entity's own data



## HIERARCHY...CONT'D

### ○ Level 1 inputs:

- These are quoted unadjusted prices for identical assets or liabilities in a active market. An example could be a quoted price for an equity security. These provide the most reliable input for fair value measurement and ASC 820 mandates their use to measure fair value, if available. Obvious examples would be: NYMEX futures contract prices; U. S. Treasury prices and New York Stock exchange prices for securities

### ○ Level 2 Inputs:

These are inputs which are observable either directly or indirectly, but do not qualify as Level 1. Per ASC 820, level 2 inputs would include:

- Quoted prices for similar assets or liabilities
- Quoted prices for identical or similar assets or liabilities in markets that are no longer active, such as markets with few transactions, non-current prices, or prices that vary substantially over time or among market makers (principal-to-principal market)



## HIERARCHY...CONT'D

### ○ Level 2 cont'd:

- Inputs which are not quoted prices for the asset or liability, but which are observable such as interest rates and yield curves observable at commonly quoted intervals
- Inputs that can be derived from or corroborated by observable market data through correlation or by other means (market corroborated inputs)

Level 2 input adjustments should include the condition and/or location of the asset or liability on measurement date as well as the volume and level of activity in the markets that the inputs are observed. An adjustment that is significant to fair value measurement may reduce the level to Level 3 in the hierarchy



## HIERARCHY...CONT'D

- Level 3 inputs:
  - ASC 820 defines Level 3 inputs as:
    - Unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity's own data. Level 3 inputs may include information derived through extrapolation or interpolation that cannot be corroborated by observable market data. In developing Level 3 inputs, a reporting entity need not undertake all possible efforts to obtain information about market participant assumptions: however, it should not ignore information that is reasonably available without undue cost and effort. Therefore, if a reporting entity uses its own data, that data should be adjusted if information is reasonably available that indicates market participants would use different assumptions.



## HIERARCHY...CONT'D

- Level 3 inputs cont'd:
  - Examples of Level 3 inputs may include models built using management assumptions that cannot be corroborated by observable market data; inputs obtained from broker quotes that are only indicative of value(s) (not being transacted upon) or not corroborated.
  - When Level 3 inputs are from broker quotes and/or pricing services, the degree of due diligence needed to be performed by the reporting entity to determine if the information obtained represents a Level 2 input would typically involve obtaining an understanding of how the price was developed. Such due diligence might include:
    - Comparisons with other external or internal valuation model outputs
    - Input from other brokers and/or pricing services in an attempt to corroborate the price(s)



## HIERARCHY...CONT'D

### ○ Level 3 inputs cont'd:

- The amount of due diligence required to be performed on Level 3 inputs will vary greatly depending on the facts and circumstances such as the type and complexity of the asset or liability being valued as well as observability and liquidity in the marketplace.
- Generally, the more unusual the asset or liability and the less liquid it is, the more due diligence would be required to raise the input from Level 3 to Level 2. However, a broker quote which the broker will not transact cannot be raised to Level 2 by support from an internal model populated with Level 3 information.
- It of paramount importance that the reporting entity document the due diligence performed to support raising the level of the input.



## HIERARCHY...CONT'D

- Inputs cont'd:
  - Another key source of inputs is often bid-ask prices. These prices may fall anywhere within the hierarchy (Level 1,2 or 3). If these inputs are used for fair value measurement, the price within the bid-ask spread that is most representative of fair value should be used. ASC 820 does not preclude the use of mid-market pricing or other pricing conventions as a practical approach to fair value measurement within a bid-ask spread.



## FAIR VALUE DISCLOSURES

- ASC 820 includes requirements for expanded disclosures about fair value measurements. These disclosures are primarily designed to provide the users of financial statements with additional information regarding:
  - The valuation techniques used
  - The impact of fair value measurements on earnings
  - The extent to which the reporting entity measures fair value
  - Tabular format is used for quantitative disclosures
  - Qualitative disclosures of techniques used are required for all annual periods

The disclosure requirements vary depending on whether the fair value is measured on a recurring or nonrecurring basis and the classification of the fair value measurement within the fair value hierarchy.



## DISCLOSURES...CONT'D

- Recurring fair value disclosures:
  - The following disclosures are intended to provide information for users to assess both the valuation techniques and inputs used as well as the impact on earnings or changes in net assets from the use of unobservable inputs. All of the following are required.
  - The fair value measurement at the reporting date
  - The level within the fair value hierarchy and the reasons for those
  - Significant transfers into each Level must be disclosed separately from transfers out
  - Level 3 (unobservable) measurements require a reconciliation of the beginning & ending balances with separate presentation for changes during the period attributable to any of the following:
    - Total gains & losses for the period (realized & unrealized), separately presenting gains & losses included in earnings (or changes in net assets) & gains & losses recognized in other comprehensive income and where they are reported in the statement of income or in other comprehensive income
    - Transfers in and/or out of Level 3 and the reason(s) for the transfers



## DISCLOSURES...CONT'D

- Recurring Level 3 disclosures cont'd:
  - Purchases, sales, insurances and settlements with each type disclosed separately
  - For both Level 3 & 2 (both with unobservable inputs), a description of the valuation technique(s) used; i.e. market, income or cost approach and the inputs used for in determining the values for each class valued
  - If there has been a change in the valuation technique (market to income), the change must be reported and the reason for the change



## DISCLOSURES...CONT'D

- The preceding disclosures are required for each class of asset and liability measured at fair value in the financial statements
- The fair value measurement disclosures for each class of assets and liabilities may require greater disaggregation than the reporting entity's line item classes in the Balance Sheet
- The nature and risks of the assets and liabilities coupled with their position in the fair value hierarchy (Levels 1,2 or3) is the determinate for the appropriate disclosure(s) and classification



## DISCLOSURES...CONT'D

- Non recurring fair value disclosures:
  - The disclosures need to be so that the users can properly assess the valuation techniques and inputs. To achieve those objectives, the following disclosures are required:
    - The fair value measurement and the reasons for the measurement
    - The level in the fair value hierarchy that the measurement falls i.e. quoted prices in active markets for identical assets and liabilities (Level 1); significant other observable inputs (Level 2) or significant unobservable inputs (Level 3)

For fair value measurements using significant other observable inputs (Level 2) and significant unobservable inputs (Level 3) a description of the valuation technique (or multiple) used, such as the market, income or cost approach as well as the inputs used in determining fair value for each class of assets or liabilities.

A reconciliation of beginning and ending balances is not required like is for recurring fair value measurements



# AUDITING

- SAS 101 established standards and guidance on auditing fair value measurements and disclosures in financial statements.
- In particular, it contains the following standards of fieldwork:
  - Management is responsible for establishing an accounting process for determining fair value measurements. The auditor needs to obtain an understanding of this process and the related disclosures as well as the controls sufficient to produce an effective audit approach. To obtain this understanding, the auditor should consider:
    - The expertise and experience of those determining fair value
    - Controls over the process used to determine fair value
    - The significant management assumptions used in determining fair value
    - The role that information technology has in the process
    - The extent to which the reporting entity relies on service organizations to provide fair value measurements or the data that develops the measurement
    - The types of accounts or transactions requiring fair value measurement or disclosures
    - The documentation supporting management's assumptions
    - The process used to monitor changes in assumptions
    - The extent to which specialists are relied upon
    - The process used to apply management's assumptions



## AUDITING...CONT'D

- The controls over the consistency, timeliness and reliability of the data used in valuation models
- The adequacy of security procedures for valuation model and systems, including the approval processes



## AUDITING...CONT'D

- Evaluating the conformity of fair value measurements and disclosures with GAAP:
  - It is management's responsibility to establish the accounting and financial reporting process for determining fair value measurements and disclosures and to ensure those measurements and disclosures are in conformity with GAAP
  - The auditor must obtain sufficient evidential matter to provide reasonable assurance that the measurements and disclosures are in conformity with GAAP
  - The evidence required, will, in part, depend upon the auditor's knowledge of the nature of the business as well as the reporting entity's internal control system
  - The auditor needs to evaluate both management's intent to carry out specific courses of action where intent is relevant to fair value measurements as well as their ability to execute those courses of action



## AUDITING...CONT'D

- Although the extent of evidence required to properly assess management's intent and ability is a matter of professional judgment, the auditor's procedures would ordinarily include inquiries of management with appropriate collaboration of responses, e.g.:
  - Reviewing written plans and other documentation, including applicable budgets, minutes, etc.
  - Considering management's past history of carrying out its stated intentions with respect to assets and liabilities
  - Considering management's stated reasons for choosing a particular course of action
  - Considering management's ability to carry out a particular course of action given the entity's economic circumstances, including any implications arising from contractual commitments



## AUDITING...CONT'D

- When there are no observable market prices and the entity estimates fair value using a valuation method, the auditor should evaluate the appropriateness of the entity's method(s) under the circumstances
  
- This evaluation involves judgment, but would require obtaining an understanding of management's rationale for selecting a particular method(s) by considering whether:
  - The valuation method(s) is/are appropriate given the nature of the item being valued
  - Management has sufficiently evaluated and correctly applied the criteria, if any, provided by GAAP to support the selected method
  - The valuation method is appropriate in relation to the business, industry and environment in which the entity operates



## AUDITING...CONT'D

- The auditor needs to evaluate whether the entity's method(s) for determining fair value is/are applied on a consistent basis and if such consistency is appropriate considering any changes in the environment or circumstances impacting the entity, or any changes in accounting principles
- If the entity has changed the method(s) for determining fair value, the auditor needs to consider whether management can adequately demonstrate that the new method(s) provides a more appropriate basis of measurement or whether the change is supported by a change in GAAP or circumstances



## AUDITING...CONT'D

- Testing the fair value measurements and disclosures:
  - Substantive tests of the fair value measurements may involve: testing management's significant assumptions; the valuation model, and the underlying data; developing independent fair value estimates for corroborative purposes; or reviewing subsequent events
  - The auditor uses both the understanding of management's process for determining fair value and his or her assessment of the risk of material misstatement to determine the nature, timing and extent of the audit procedures. Examples of considerations in developing the audit procedures are:
    - The fair value measurement may be made at a date that does not coincide with the date the entity is required to measure and report ( most likely to occur in a valuation by an independent appraiser). In such cases, the auditor needs to obtain evidence that management has taken into account the impact(s) of events, transactions and changes in circumstances between the dates



## AUDITING...CONT'D

- Collateral is often assigned for certain types of investments in debt instruments that are either required to be measured at fair value or are evaluated for possible impairment if the collateral is an important factor in measuring the fair value of the investment (Collateralized Debt Obligations). In such cases, the auditor needs to obtain sufficient evidential matter regarding the existence, value, rights, and access to or transferability of the collateral. This would include consideration of whether all appropriate liens have been filed and whether appropriate disclosures about the collateral have been made
- In some situations, additional procedures, such as the inspection of an asset by the auditor may be necessary to obtain sufficient audit evidence concerning the appropriateness of the fair value measurement. As an example, inspection of the asset may be necessary to obtain information about the physical condition of the asset relevant to its fair value, or an inspection of a security may reveal a restriction on its marketability which could impact its fair value.



## AUDITING...CONT'D

- Testing assumptions, valuation model and data:
  - When testing the entity's fair value measurements and disclosures, the auditor evaluates whether:
    - The fair value was determined using an appropriate model, if applicable
    - Management's assumptions are reasonable and reflect, or are not inconsistent with market data
    - Management uses relevant information that was reasonably available

Assumptions are integral components of more complex valuation methods, for example, valuation methods employ a combination of estimates of expected future cash flows together with estimates of the values of assets and liabilities in the future, discounted to present value.



## AUDITING...CONT'D

- Specific assumptions will vary with the characteristics of the item being valued and the valuation approach (cost, market or income). For example, where the discounted cash flows method (income) is used, there will be assumptions about the level of cash flows, the period of time used in the analysis, and the discount rate.
- Assumptions ordinarily are supported by differing types of evidence from internal and external sources that provide objective support for the assumptions used. The auditor evaluates the source of the evidence supporting management's assumptions for reliability and validity in light of historical market information.
- Audit procedures dealing with management's assumptions are performed in the context of the audit of the entity's financial statements.



## AUDITING...CONT'D

- The objective of the audit procedures is therefore not intended to obtain sufficient evidential matter to provide an opinion on the assumptions themselves. Rather, the auditor performs procedures to evaluate whether the assumptions provide a reasonable basis for measuring fair values in the context of an audit of the financial statements taken as a whole.
- The auditor will focus on significant assumptions that cover matters that materially impact fair value and may include those that are:
  - Sensitive to variation or uncertainty in amount or nature. e.g. assumptions about short term interest rates may be less susceptible to significant variation compared to long term rates
  - Susceptible to misapplication or bias



## AUDITING...CONT'D

- To be reasonable, the assumptions on which fair value is based individually and taken as a whole, need to be realistic and consistent with:
  - The general economic environment, the economic environment of the specific industry, and the entity's economic circumstances
  - Existing market information
  - The plans of the entity, including what management expects will be the outcome of specific objectives and strategies
  - Assumptions made in prior periods, if any
  - Past experience of, or previous conditions experienced by the entity to the extent currently applicable
  - The risk associated with cash flows, if applicable, including the potential variability in the amount and timing of the cash flows and the related impact on the discount rate



## AUDITING...CONT'D

- Where assumptions are reflective of management's intent and ability to carryout specific courses of action, the auditor considers whether they are consistent with the entity's plans and past experience
- If management relies on historical financial information in the development of assumptions, the auditor considers the extent to which such reliance is justified. However, historical information might not be representative of future conditions or events e.g. if management intends to engage in new activities or circumstances change
- For items valued using a model, the auditor is not expected to substitute his or her judgment for management's. Rather, the auditor would review the model and evaluates whether the assumptions used are reasonable and the model is appropriate considering the entity's circumstances



## AUDITING...CONT'D

- The auditor should test the data used and determine if the fair value was determined from the data coupled with management's assumptions. Specifically, the auditor evaluates whether the data on which the fair value is based, including the work of a specialist, is accurate, complete and relevant; also, whether the fair values have been properly determined using such data.
- The auditor should evaluate whether the disclosures about fair value made by the entity are in conformity with GAAP
- If an item contains a high degree of measurement uncertainty, the auditor assesses whether the disclosures are sufficient to inform users of the uncertainty
- If the entity has not appropriately disclosed fair value information required by GAAP, the auditor evaluates whether the financial statements are materially misstated



# FAIR VALUE OPTION

- Recent FASB pronouncements provide entities with an option to measure many financial instruments, selected hybrid financial instruments, and separately recognize servicing assets and liabilities at fair value. These fair value options (FVO) considerably expands the ability of a reporting entity to select the basis of measurement for certain assets and liabilities.
- The key implications of the FVO standards include the following:
  - ASC 860-50 *Servicing Assets and Liabilities* permits a reporting entity to choose between the amortization method and the fair value measurement method for each class of separately recognized servicing assets and liabilities
  - ASC 815-15-25 *Fair Value Election for Hybrid Financial Instruments* provides the FVO for certain hybrid financial instruments that contain an embedded derivative that would otherwise require separation under the requirements of ASC 815 (SFAS 133)
  - ASC 825-10 *Financial Instruments*: the FVO provides a measurement basis election for most financial instruments ( historical cost or fair value ), this allows reporting entities to avoid potential mismatches because certain financial assets are required to be measured at fair value but the related liabilities are required to be measured at amortized historical cost



## FVO...CONT'D

- In addition, ASC 815-15-25 allows entities to offset changes in the fair value of a derivative instrument and the related hedged item by selecting the FVO for the hedged item. This means entities can avoid application of the complex accounting provisions of ASC 815 *Derivatives & Hedging*.
- In accordance with the Standards discussed above, once the FVO election is made, it is **irrevocable**. Since FVO is optional, adoption of the option may result in reduced comparability of financial reporting between similar reporting entities and within a single entity because some assets and liabilities could be at historical cost and some at fair value. However, the disclosure requirements are intended to mitigate this issue by identifying the instruments for which the FVO is elected and extensive information about the effects on the financial statements.



## FVO...CONT'D

- Under ASC 825-10, reporting entities may elect the FVO for the following:
  - A recognized financial asset and liability, except those that are identified as excluded (defined later)
  - A firm commitment that would otherwise not be recognized at inception and that involves only financial instruments e.g. a forward purchase contract for a loan which is not readily convertible to cash. Such a commitment involves only financial instruments (loan & cash) and would not otherwise be recognized because it is not a derivative instrument
  - A written loan commitment
  - The rights and obligations under an insurance contract that is not a financial instrument (the insurer can provide goods or services rather than cash), but whose terms allow the insurer to settle by paying a third party to provide the goods or services
  - A host financial instrument resulting from the separation of an embedded non-financial derivative from a non-financial hybrid instrument ( a hybrid instrument where the value of the separated derivative is payable in cash, services or goods but the debt host is payable only in cash)



## FVO...CONT'D

- Under ASC 825-10 the following items are explicitly excluded from FVO:
  - An investment in a consolidated subsidiary
  - An interest in a variable interest entity requiring consolidation
  - Employers' and plans' obligations (or assets representing overfunded positions) for pension benefits, other post retirement benefits (including health and life insurance benefits), post employment benefits, employee stock options, stock purchase plans and other forms of deferred compensation
  - Financial assets and liabilities recognized as leases
  - Deposit liabilities, withdrawable on demand, of banks, savings and loan associations, credit unions and other similar depository institutions
  - ASC 470-20 *Debt with Conversion and Other Options* excludes financial instruments that are, in whole or in part, classified by the issuer as a component of equity (convertible bonds)



## ACCOUNTING ELECTION

- ASC 825-10 allows reporting entities to apply the FVO on an instrument by instrument basis. Accordingly, a reporting entity can elect the FVO for certain instruments, but not for others within a group of similar items. However, if the FVO is not elected for all eligible instruments, the entity is required to disclose the reasons for the partial election as well as the amounts to which it did not apply the FVO
- ASC 825-10 provides exceptions to the instrument by instrument election:
  - If multiple advances are made to one borrower pursuant to a single contract (line of credit, construction loan) the FVO is applied only to the larger loan balance and not the individual advances
  - If the FVO is applied to an investment that would otherwise be accounted for under the equity method of accounting, it shall be applied to all of the investor's financial interests in the same entity (equity & debt, including guarantees) that are eligible items



## ACCOUNTING ELECTION...CONT'D

- If the FVO is applied to an eligible insurance or reinsurance contract, it shall be applied to all claims and obligations under the contract
- If the FVO is elected for an insurance contract for which riders are issued either concurrently or subsequently, it must be applied to all the riders
- A financial instrument that represents a single contract may not be further separated into parts to elect FVO. However, a loan syndication arrangement may result in multiple loans issued to the same borrower. Under ASC 825-10, each of those loans is a separate instrument and the FVO may be elected for some but not all



## TIMING

- Subsequent to initial adoption, an entity can choose to apply the FVO on the date when any of the following occurs:
  - The entity first recognizes the eligible item
  - The entity enters into an eligible firm commitment
  - Financial assets that have been reported at fair value with unrealized gains and losses included in earnings because of specialized accounting principles cease to qualify for that specialized accounting
  - The accounting treatment for an investment in an entity changes
  - An event that requires an eligible item to be measured at fair value at the time of the event but does not require the fair value measurement in each subsequent reporting date, excluding impairment under lower-of-cost-or-market accounting business combinations, initial consolidation of a subsidiary)



## ACCOUNTING IMPACT

- ASC 825-10 requires immediate recognition of upfront costs and fees (not deferred) related to items for which the FVO is elected, but e.g. if the FVO is elected for an insurance contract, the entity should not recognize any deferred acquisition costs related to that contract. This can significantly alter the income or expense in the income statement:
  - For originated loans, not electing FVO, deferred fees and costs are capitalized and either amortized to interest income or recognized as part of the gain/loss on sale of the loan
  - For originated loans electing FVO, these costs and fees are recognized in current earnings



## INTEREST INCOME AND EXPENSE

- ASC 825-10 specifies that amortization of premiums and discounts does not apply to loans for which the FVO is elected.
- ASC 825-10 allows for significant policy discretion in how to report interest income and expense for items under the FVO. This may include the application of one (or some variation) of the following models for reporting interest income and expense:
  - Present the entire change in the FVO item, including the accrued interest in a single line item in the income statement
  - Separate the interest income or expense from the full change in the fair value of the FVO item and present that amount in interest income/expense with the remainder of the change in fair value presented in a separate line item in the income statement. The allocation to interest income/expense needs to be an acceptable method under GAAP



## OTHER INCOME STATEMENT IMPACT

- The SEC currently believes that changes in the fair value of an instrument recognized at fair value each reporting period should be presented on a single line on the income statement. The only exceptions to this single line item presentation are when other specific GAAP permits a separated presentation
- Exceptions to the single line presentation would include derivatives that are qualifying hedging relationships (put/call options on stock owned). The changes in fair value of these may be presented in other than a single line pursuant to GAAP



## FUTURE OF FAIR VALUE

- The SEC has said that in 2011 they will make their decision on the effective date for mandatory fair value reporting.
- In March, 2008, the IASB issued a discussion paper “Reducing Complexity In Reporting Financial Instruments”. This document, which was part of the *Memorandum of Understanding* between the IASB and FASB, sought to identify the main causes of complexity in reporting financial instruments. The discussion paper suggested intermediate and long term solutions to improve the reporting fro financial instruments. Included in the paper was the focus of using a single measurement attribute...fair value.
- The discussion paper issued by the IASB represents yet another significant move towards what many have long considered to be the future of financial reporting...all fair value, all the time!

