

39th Annual NABA National Conference

Fair value accounting and disclosures

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Agenda

- ▶ Fair value: The basics
- ▶ ASC 820, *Fair Value Measurements and Disclosures – Nonfinancial assets and liabilities*
- ▶ FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions that are Not Orderly* (codified in ASC 820)
- ▶ EITF Issue No. 08-5, *Issuer's Accounting for Liabilities Measured at Fair Value with a Third-Party Credit Enhancement* (codified in ASC 820-10)
- ▶ ASU 2009-05, *Fair Value Measurements and Disclosures (Topic 820) – Measuring Liabilities at Fair Value*
- ▶ ASU 2009-12, *Fair Value Measurements and Disclosures (Topic 820) – Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*
- ▶ ASU 2010-06, *Fair Value Measurements and Disclosures (Topic 820), Improving Disclosures about Fair Value Measurements*

Why focus on fair value?

- ▶ Increasing relevance to financial statements and financial statement users
- ▶ Increased complexity in financial instruments measured at fair value
 - ▶ Variety of fair value measurements and disclosures
 - ▶ Variety of prescribed methods for determining fair value
 - ▶ Different definitions of fair value or its determination in practice
- ▶ Heightened regulatory interest in fair value measurements in the financial statements
 - ▶ PCAOB
- ▶ Disruptions in credit markets

Primary accounting guidance

- ▶ FAS 157, Fair Value Measurements (issued 9/06)
 - ▶ Mandatory and affects HOW to measure fair value and adds disclosure requirements
- ▶ FAS 159, The Fair Value Option for Financial Assets and Liabilities (issued 2/07)
 - ▶ Elective and affects WHAT is fair valued and adds disclosure requirements
- ▶ FAS 107, Disclosures about Fair Value of Financial Instruments (12/91)
 - ▶ Requires all entities to disclose the fair value of financial instruments, both recognized and not recognized

FAS 157: Effective date

- ▶ Originally effective for fiscal years beginning after 11/15/2007 (i.e., 1/1/2008 for calendar year entities)
 - ▶ FSP 157-2 delayed the effective date for certain nonfinancial assets and nonfinancial liabilities
 - ▶ Effective date for these items was deferred to fiscal years beginning after 11/15/2008
- ▶ Examples of items eligible for deferral:
 - ▶ Reporting units measured at fair value in the first step of a goodwill impairment test under FAS 142
 - ▶ Asset retirement obligations initially measured at fair value under FAS 143
 - ▶ Nonfinancial long-lived assets (asset groups) measured at fair value for an impairment assessment under FAS 144

FAS 157: Fair value measurements

- ▶ What does FAS 157 do?
 - ▶ Establishes a singular definition of fair value
 - ▶ Provides a conceptual framework for measuring fair value
 - ▶ Expands disclosures about the use of fair value
- ▶ What does FAS 157 NOT do?
 - ▶ Require additional fair value measurements under US GAAP
 - ▶ Provide detailed “how to” guidance with respect to valuation
 - ▶ Address which items are to be measured at fair value or when this measurement should be used
 - ▶ Eliminate the practicability exceptions to fair value measurements that exist in other accounting pronouncements

FAS 157: Examples of items in versus out of FAS 157's scope

Scoped-IN:

- ▶ Applies to all other accounting pronouncements that require FV measurements
 - ▶ Limited exceptions; Appendix D of FAS 157
- ▶ Covers items measured at FV
 - ▶ On a recurring basis
 - ▶ Only on initial recognition
 - ▶ Non-recurring subsequent measurement
- ▶ Accounting pronouncements where FV is used as part of a required analysis

Scoped-OUT:

- ▶ Share-based payments under FAS 123(R)
- ▶ Lease transactions under FAS 13
 - ▶ As well as FSP 157-1 and other accounting pronouncements that address FV measurements for purposes of lease classification or measurement under FAS 13
- ▶ Items that require/permit measurements similar to FV, but are not intended to measure FV
 - ▶ Inventory pricing at LOCOM
 - ▶ Vendor-specific objective evidence (VSOE)

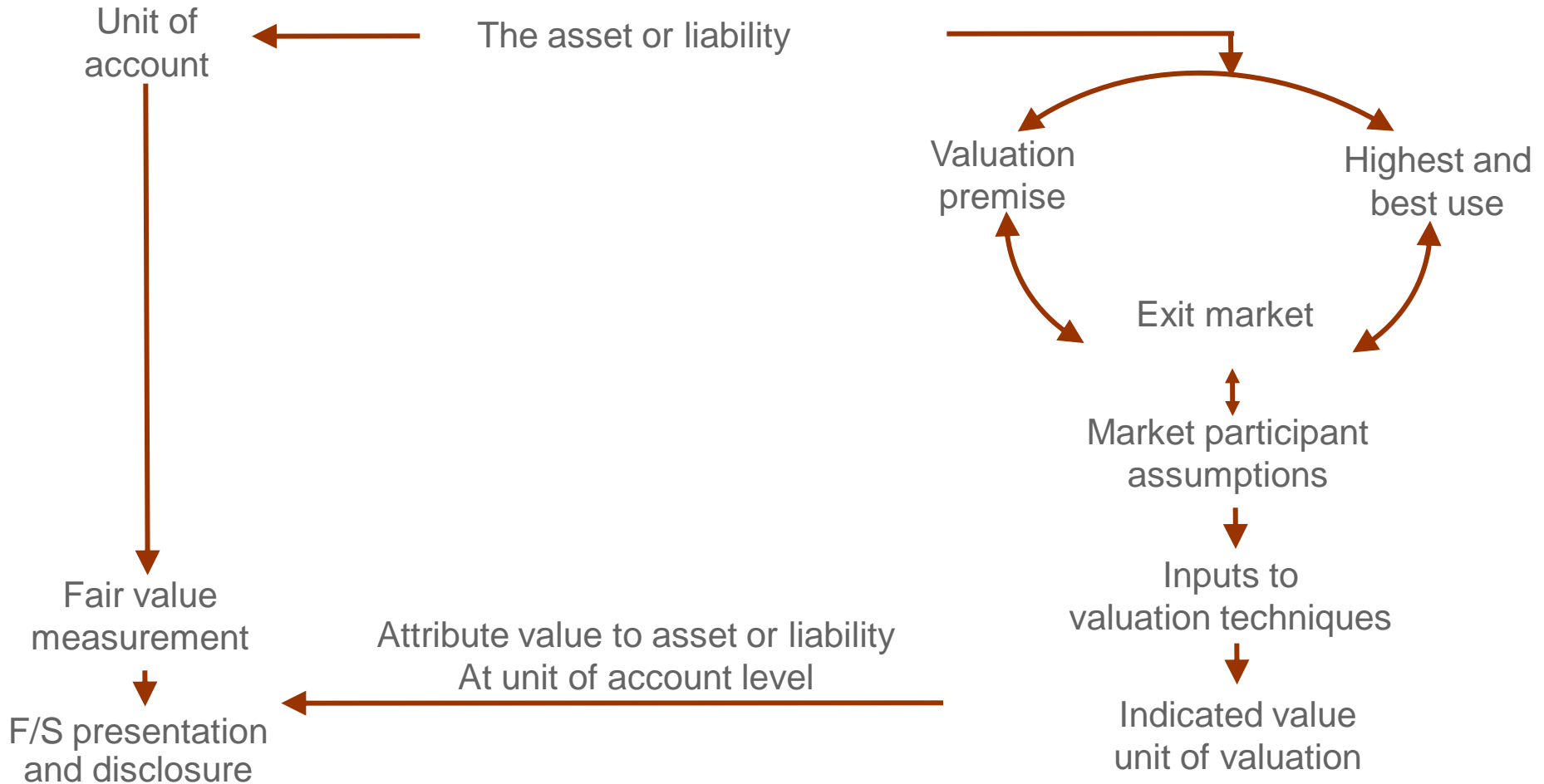
FAS 157: Revised definition of fair value

“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.”

Clarifies a number of key points:

- ▶ Fair value is an **exit price** (conceptually different from a transaction price which is an entry price)
- ▶ An exit price in the **principal market** (or most advantageous market) in which the reporting entity would transact
- ▶ Fair value is a **market-based measurement**, not an entity-specific measurement
 - ▶ **Hypothetical transaction**
 - ▶ **Orderly transaction**

FAS 157: Fair value framework



FAS 157 framework: The asset or liability

- ▶ Attributes of the asset or liability
 - ▶ Consider attributes that are specific to the asset or liability being valued
 - ▶ Restrictions, collateral, guarantees, etc.
 - ▶ Determine the fair value of the asset as it exists
 - ▶ May require adjustment to determine the price a market participant would pay for the asset in its current condition and location
- ▶ Costs that ARE considered in determining fair value
 - ▶ Transformation - Costs to recondition the asset
 - ▶ Transportation - Costs to move the asset
- ▶ Costs NOT considered in determining fair value
 - ▶ Transaction - Incremental direct costs to sell the asset or transfer the liability

FAS 157 framework: Unit of account

- ▶ Unit of account defines what is being measured for financial reporting purposes
 - ▶ Generally identified in accordance with other accounting pronouncements
- ▶ Primarily drives the level of aggregation (or disaggregation) for presentation and disclosure purposes
- ▶ Unit of account vs. Unit of valuation
 - ▶ Unit of account may be the same as the unit of valuation
 - ▶ Classification in fair value hierarchy driven by unit of account

FAS 157 framework: Valuation premise

- ▶ Fair value measurement assumes the highest and best use of the asset
 - ▶ In certain circumstances this concept can be applied to liabilities
- ▶ Highest and best use establishes valuation premise to maximize value from market participant's perspective:
 - ▶ ***In-Use***: Provides maximum value to market participants through its use in combination with other assets
 - ▶ ***In-Exchange***: Provides maximum benefit on a stand-alone basis
- ▶ Highest and best use is not an entity-specific notion, but rather a market participant notion
 - ▶ Entity specific synergies excluded but would consider synergies of market participants

FAS 157 framework: Highest and best use – example

- ▶ A reporting entity acquires land in a business combination
 - ▶ The land is currently developed for industrial use as a site for a manufacturing facility
 - ▶ Nearby sites were recently developed for residential high-rise condominiums
 - ▶ Reporting entity determines land currently used as a site for a manufacturing facility could be developed as residential high-rise condominiums
- ▶ In this instance, the highest and best use of the land would be determined by comparing:
 - ▶ (a) the fair value of the land used in the manufacturing operation (in-use) and
 - ▶ (b) the value of the land as a vacant site for residential use (in-exchange)
- ▶ Highest and best use of the land would be determined based on the higher of those values

FAS 157 framework: Exit market

- ▶ Fair value measurement assumes the transaction occurs in the principal (or most advantageous) market for the asset or liability
 - ▶ The market the reporting entity would sell or transfer with **the greatest volume and level of activity for the asset** (entity vs. market consideration)
 - ▶ If a principal market exists, the fair value measurement represents the price in that market even if the price in a different market is more advantageous
- ▶ In the **absence** of a principal market the most advantageous market is to be used

FAS 157 framework: Exit market

Entity-specific vs. market participant volume of transactions

Market	Price	Entity-specific volume	Total market volume
A	\$30,000	60%	15%
B	\$25,000	Principal market 25%	75%
C	\$20,000	15%	10%

- ▶ Since Market B has the greatest volume for the market as a whole (and the entity has access to it), Market B is deemed the principal market
- ▶ Principal markets can change over time
- ▶ Management intent does not determine principal market
- ▶ May have access to different markets for similar assets

FAS 157 framework: Application to liabilities

- ▶ Non-performance risk
 - ▶ Risk that an obligation will not be fulfilled
 - ▶ Includes a reporting entity's credit risk and may also include other risks
- ▶ Assumes non-performance risk is the same before and after transfer of the liability
- ▶ Impact of own credit risk on the FV of a liability
 - ▶ An entity that experiences a credit deterioration would recognize an accounting gain on a liability measured at fair value, assuming all other inputs to the valuation remain unchanged
 - ▶ Consideration of non-performance risk in the subsequent measurement of a liability at fair value will be a new concept for many of our clients
 - ▶ FV of a liability is affected not only by a change in the reporting entity's credit rating (i.e., the entity experiences a downgrade), but also by changes in credit spreads over time

FAS 157 framework: Market participant assumptions

- ▶ Market participants are **buyers and sellers** in the exit market that are:
 - ▶ Independent of the reporting entity (not related parties)
 - ▶ Knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information
 - ▶ Able to transact for the asset or liability
 - ▶ Willing to transact for the asset or liability
- ▶ Market participant assumptions are those market participants would use in pricing the asset or liability
- ▶ One market participant (e.g., outlier) does not make a market
- ▶ Individual market participants do not need to be identified

FAS 157: Inputs to valuation techniques and the fair value hierarchy

- ▶ One objective is to allow users to assess the relative reliability of fair value measures (quality of earnings)
- ▶ Prioritizes inputs to valuation techniques used to measure fair value
 - ▶ Fair value measurement should maximize the use of observable inputs and minimize the use of unobservable inputs
- ▶ Hierarchy drives disclosures
 - ▶ Level at which measurement is disclosed is based on lowest level input that is “significant” to the overall fair value measure

FAS 157: Fair value hierarchy

Level	Characteristic	Example
Level 1	Quoted prices in active markets for identical assets/liabilities (unadjusted); no blockage factors (i.e., Price X Quantity)	<ul style="list-style-type: none"> ▶ Equity/securities traded on the NYSE ▶ Exchange-traded derivatives
Level 2	Other observable inputs – including quoted prices for similar assets / liabilities (adjusted) and market corroborated inputs; discounts for liquidity can be applied	<ul style="list-style-type: none"> ▶ OTC derivative with value based upon observable LIBOR forward interest rate curves
Level 3	Unobservable inputs – entity’s own assumptions about market participant assumptions, including assumptions about risk, developed based on the best information available in the circumstances (subject to the cost-benefit constraint); may include the entity’s own data; discounts for liquidity can be applied	<ul style="list-style-type: none"> ▶ Private equity investment ▶ Intangible asset ▶ Long-dated financial instrument ▶ Non-binding consensus pricing

FAS 157: Disclosure objectives

- ▶ **Information about fair value amounts:**
 - ▶ Fair value estimates for each major category of assets and liabilities
 - ▶ Re-measured each reporting period on a recurring basis (e.g., trading securities)
 - ▶ Reconciliation of beginning and ending balances for recurring Level 3 measurements (by major category of asset and liability)
 - ▶ Re-measured on non-recurring basis and the reason for re-measurement (e.g., impairment)
 - ▶ Where within the FV hierarchy the estimates fall (Level 1, 2, or 3)
 - ▶ How amounts determined:
 - ▶ Valuation technique used to measure fair value (annual disclosure)
 - ▶ For Level 3 non-recurring measurements a description of the inputs used to develop FV measurements and information used to develop the inputs
- ▶ **Disclosures only apply to fair value measurements subsequent to initial recognition**

FAS 157: Disclosure requirements

- ▶ Items measured at fair value on a recurring basis
 - ▶ Fair value estimates for each major category of assets and liabilities
 - ▶ Where within the FV Hierarchy the estimates fall (Level 1, 2, or 3)
 - ▶ Reconciliation of beginning and ending balances for Level 3 measurements (by major category of asset and liability)
 - ▶ Valuation techniques used to measure fair value
 - ▶ For Level 3 measurements, a description of the inputs used to develop FV measurements and information used to develop the inputs

- ▶ Items measure at fair value on a non-recurring basis
 - ▶ Fair value estimates for each major category of assets and liabilities
 - ▶ Where within the FV Hierarchy the estimates fall (Level 1, 2, or 3)
 - ▶ Valuation technique used to measure fair value
 - ▶ For Level 3 measurements, a description of the inputs used to develop FV measurements and information used to develop the inputs
 - ▶ Reason for re-measurement (e.g., impairment)

ASC 820, *Fair Value Measurements and Disclosures* – *Nonfinancial assets and liabilities*

- ▶ FSP FAS 157-2 allowed for delayed adoption of Statement 157 (codified in ASC 820) for nonrecurring fair value measurements related to nonfinancial assets and liabilities until fiscal years beginning after 15 November 2008
- ▶ Clarifies and expands on present value techniques outlined in Concepts Statement 7
- ▶ Key principles in ASC 820 may affect the valuation of nonfinancial items
 - ▶ Fair value is an exit price which may differ from an entry (transaction) price
 - ▶ Fair value considers the highest and best use of an asset from the perspective of market participants (which may differ from current or intended use by the reporting entity)
 - ▶ A fair value measurement incorporates an adjustment for risk that market participants would require as compensation for uncertainty in cash flows (even if the adjustment is difficult to determine)
 - ▶ While Concepts Statement 7 focused solely on present value techniques, ASC 820 encompasses the income, market, and cost approaches that may be utilized to fair value

FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions that are Not Orderly* (codified in ASC 820)

- ▶ The determination of fair value in illiquid markets continues to prove challenging and requires the use of significant judgment
 - ▶ FSP FAS 157-4 superseded FSP FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*
 - ▶ Unlike FSP FAS 157-3, scope is not limited to financial assets – focus is primarily on assets and liabilities in markets that have experienced a significant decline in transaction volume
 - ▶ Effective for interim and annual reporting periods ending after 15 June 2009
- ▶ Factors to consider in determining whether a market is active or not, as well as when a market has experienced a significant decrease in volume in relation to normal activity
- ▶ Circumstances that may indicate a transaction is not orderly
- ▶ Considerations in weighting the relevance of transactions and quoted prices in markets that have experienced a significant decrease in activity
- ▶ A revised example to illustrate key considerations when applying the principles of ASC 820 in estimating fair value in non active markets

FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions that are Not Orderly* (codified in ASC 820) – Key messages

- ▶ A significant decrease in volume and level of activity is an indication that observed transactions or quoted prices may not be determinative of fair value
- ▶ In these situations, further analysis is required to ascertain whether observed prices are reflective of fair value
 - ▶ Adjustments to quoted prices may be required
 - ▶ Use of multiple valuation techniques may be appropriate
- ▶ When multiple valuation techniques produce a range of values, the objective is to determine the point in the range that is most representative of fair value under current market conditions
 - ▶ A wide range of fair value estimates among different valuation techniques is an indication that additional analysis is needed

FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions that are Not Orderly* (codified in ASC 820) – Key messages

- ▶ The objective of a fair value measurement remains the same even if there has been a significant reduction in volume and activity for the asset or liability and regardless of the valuation technique used
 - ▶ Fair value is an exit price (based on a hypothetical orderly transaction) in the current market
 - ▶ Intent of the reporting entity to hold the asset or liability is not relevant
 - ▶ Fair value should include a risk premium reflecting the amount market participants would demand due to uncertainty in cash flows
- ▶ Use of quoted prices from third parties (e.g., brokers, pricing services) is not precluded when the reporting entity has determined that these prices are determined in accordance with the principles of ASC 820
 - ▶ Entities need to understand the source of the information received from third parties in order to assess its relevance
 - ▶ Less reliance is placed on third party quotes not based on transactions when compared with other indications of fair value that are based on market transactions

- ▶ Requires that the fair value measurement of liabilities with inseparable third-party credit enhancements exclude the effect of the credit enhancement
 - ▶ As a result, issuer considers its own credit standing, not that of the third-party guarantor, in measuring the fair value of a liability with a third-party guarantee
 - ▶ Applies only to liabilities with inseparable third-party credit enhancements carried or disclosed at fair value on a recurring basis
 - ▶ Scope excludes credit enhancements provided by a government or government agency, as well as those provided to a parent or subsidiary
 - ▶ Guidance also does not apply to the investor that holds the guaranteed debt
- ▶ Effective on a prospective basis for reporting periods beginning on or after 15 December 2008
 - ▶ Entities must disclose the valuation technique(s) used to measure liabilities under the scope of Issue 08-5 in the period of adoption and any changes from prior period valuation technique(s)

ASU 2009-05, *Fair Value Measurements and Disclosures (Topic 820)* – *Measuring Liabilities at Fair Value*

- ▶ Amends ASC 820 by providing additional guidance on the measurement of liabilities at fair value
 - ▶ Because liabilities are typically not transferred (or in many instances permitted to be transferred), questions arose regarding the determination of their fair value under ASC 820 (i.e., the price that would be paid to transfer the liability)
- ▶ When a quoted price in an active market for the identical liability (a Level 1 measurement) is not available, fair value of a liability should be measured using one or more of the following approaches:
 - ▶ The quoted price of the identical liability when traded as an asset
 - ▶ Quoted prices for similar liabilities or similar liabilities when traded as assets
 - ▶ Another valuation technique that is consistent with the principles of ASC 820
 - ▶ Irrespective of the valuation technique(s) used, a fair value measurement should maximize the use of relevant observable inputs and minimize the use of unobservable inputs

ASU 2009-05, *Fair Value Measurements and Disclosures (Topic 820)* – *Measuring Liabilities at Fair Value*

- ▶ With respect to fair value hierarchy classification, a quoted unadjusted price for the identical liability when traded as an asset in an active market is considered a Level 1 fair value measurement
 - ▶ However, any required adjustments to the quoted price would render the measure a lower level measurement
- ▶ The fair value measurement of a liability should not include a separate input or adjustment to other inputs for the existence of a contractual restriction that prevents the transfer of the liability
- ▶ Effective for reporting periods beginning after 26 August 2009 (the date ASU 2009-05 was issued)
 - ▶ Entities must disclose any change in valuation technique and related inputs resulting from the application of the amended guidance in the period of adoption, and quantify the total effect, if practicable

ASU 2009-12, *Fair Value Measurements and Disclosures (Topic 820)* – *Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*

- ▶ Amends ASC 820 by providing additional guidance on measuring the fair value of certain alternative investments (e.g., investments in hedge funds or private equity funds)
 - ▶ Provides for a practical expedient whereby entities may estimate the fair value of investments within its scope using the net asset value (NAV) per share of the investment (or its equivalent) as of the reporting entities' measurement dates
 - ▶ Use of the practical expedient is permitted, but not required
 - ▶ Decision to utilize the practical expedient can be made on an investment-by-investment basis, however, it must be generally be applied consistently to an entity's entire position in a particular investment
 - ▶ Scope is limited to investments without readily determinable fair values in entities that calculate NAV consistent with the measurement principles of ASC 946, *Financial Services – Investment Companies* (i.e., entities that measure investment assets at fair value on a recurring basis)
 - ▶ Use of the practical expedient is not permitted for in-scope investments if it is probable as of the measurement date that the entity will sell the investment (or a portion of the investment) for an amount other than NAV

ASU 2009-12, *Fair Value Measurements and Disclosures (Topic 820)* – *Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*

- ▶ Includes clarification on the fair value hierarchy classification of investments measured using the practical expedient
 - ▶ Although ignored when measuring alternative investments using the practical expedient, restrictions on redemptions must be considered when determining classification within the fair value hierarchy
- ▶ Additional disclosures are required for investments within the scope of the amended guidance regardless of whether the fair value of the investment is measured using the practical expedient
 - ▶ By “major category” of investment
 - ▶ Intended to provide financial statement users with additional information regarding the nature and risks of the investments
- ▶ Effective for reporting periods ending after 15 December 2009 (including interim periods)
 - ▶ Entities must disclose any change in valuation technique and related inputs resulting from the application of the amended guidance in the period of adoption, and quantify the total effect, if practicable
 - ▶ Early application is permitted if financial statements for prior periods have not been issued
 - ▶ Entities that elect to early adopt may choose to defer the additional disclosure requirements until the effective date

Disclosures about fair value

- ▶ Additional fair value disclosures are required by both FSP FAS 157-4 (codified in ASC 820) and FSP FAS 107-1 and APB 28-1, *Interim Disclosures About Fair Value of Financial Instruments* (codified primarily in ASC 825-10, *Financial Instruments – Overall* and ASC 270-10, *Interim Reporting – Overall*)
- ▶ FSP FAS 157-4
 - ▶ Requires interim disclosures about inputs and valuation techniques used to measure fair value
 - ▶ Provides additional guidance on the level of disaggregation for debt and equity securities in meeting the disclosure requirements of ASC 820
 - ▶ Defines major categories for ASC 820 disclosures as major security types as described in ASC 320, *Investments – Debt and Equity Securities*
 - ▶ When providing their ASC 820 disclosures for debt and equity securities, financial institutions are required to include the major securities types listed in ASC 942, *Financial Services – Depository and Lending*, although additional categories also may be necessary
- ▶ FSP FAS 107-1
 - ▶ Extends the fair value disclosure requirements for financial instruments under ASC 825-10-50 to interim financial statements for public companies
- ▶ Disclosure requirements are effective for interim and annual periods ending after 15 June 2009
 - ▶ Disclosures are applied prospectively – comparative disclosures are required only for periods ending after initial adoption

ASU 2010- 6, *Fair Value Measurements and Disclosures (Topic 820)* – *Improving Disclosures about Fair Value Measurements*, issued January 2010

- ▶ Requires a number of new fair value disclosures and clarifies certain existing required disclosures
- ▶ New disclosure requirements:
 - ▶ Information about the sensitivity of certain Level 3 fair value measurements
 - ▶ Information about transfers in and/or out of Levels 1 and 2 (presented on a gross basis for each level)
 - ▶ Gross reporting of changes in Level 3 fair value measurements (in the Level 3 roll-forward) attributed to purchases, sales, issuances, and settlements as well as significant transfers into/out of Level 3
- ▶ Clarifications of existing disclosure requirements pertaining to:
 - ▶ Level of disaggregation required for disclosures – would require fair value disclosures to be made by “class” of assets and liabilities instead of “major category”
 - ▶ Disclosures about inputs and valuation techniques for Levels 2 and 3 measurements
- ▶ Effective for interim and annual reporting periods beginning after 15 December 2009, except for the disclosures about purchases, sales, issuances and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after 15 December 2010 and for interim periods within those fiscal years. Early adoption is permitted.

Questions?



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