

SMU COX
SCHOOL OF BUSINESS

Fair Value



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May 4, 2010

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Fair Value

- Definition of fair value under ASC 820
 - Previously known as FAS 157
- Examples of continuing issues in fair value accounting

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Fair Value

SFAS 157 defines fair value as :

“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”

Fair Value

- *Orderly transaction*
- *Hypothetical price*
- *Sell an asset/transfer a liability*
- *Market participants*
- *No adjustment for transaction costs*
- *Principal/most advantageous market*

Fair Value

- *Specific attributes*
- *Standalone/group of asset/liability*

Fair Value

- Assumes highest and best use of asset by market participants on measurement date, considering:
 - Use is physically possible
 - Use is legally permissible
 - Use is financially feasible
- Highest and best use is based on use by market participants:
 - *In Use (when used in a group)*
 - *In Exchange (standalone basis)*

The Fair Value Hierarchy

- **Level 1** – Quoted prices in identical markets
- **Level 2** – Inputs other than quoted prices that are observable
- **Level 3** – Inputs that are not based on observable market data

The Fair Value Hierarchy

- You are auditing the financial disclosures of Wilson, Inc. related to fair value. You note the absence of any Level 3 classifications in the disclosures. You are concerned over this outcome given you know that many of the markets in which the client operates are still relatively unstable. When questioned, the CFO tells you that the classifications are based on the source of the majority of the inputs to the calculation.
- Is she correct?
- If not, what is the procedure she should have followed?

The Fair Value Hierarchy

- The CFO responds to your inquiries that she does not understand your concern. She asserts that the bases for all of her valuations are observable. Therefore, all the measurements are Level 1.
- How do you respond?
- So she says, so what, since even Level 2 inputs require minimal disclosure as compared to Level 3 disclosures.

The Fair Value Hierarchy

- So, she asks, when is an input significant?
- Process:
- Gain a basic understanding of all the inputs to the model.
- What is the relative significance of each input?
- Are the inputs externally verifiable?

Principal or Most Advantageous Market

- Your client has subsidiaries that transact on the NYSE, Greenwich, and Polish stock exchanges. At year end, the closing price and (transaction costs) per share for a specific security is \$78.00 (\$.50), \$79.50 (\$1.00) and \$80.00 (\$3.00). The CFO asks you what price should I use?

Principal or Most Advantageous Market

- What if there is no known market?
- Consider developing the inputs that would be used in a hypothetical market
- What does that mean?
- Assumptions may include:
 - Specific location of the asset.
 - Condition of the asset
- Other characteristics
 - Growth rates
 - Risk premium
 - Are synergies available to other market participants

Who are Market Participants?

- Independent
- Knowledgeable
- Able to transact
- Willing to transact

One Day Gains or Losses

- Walter Corp. purchases some securities from a local bank for \$175,000 on December 30, 2009 which it classified as trading securities. The next day it books a \$27,000 gain based on the “deal” it received.
- How would you evaluate the firm’s ability to book the gain?

Valuation of a Liability

- ASC 820 assumes:
 - The price is a transfer price, not a settlement price
 - Nonperformance risk of the liability does not change with the transfer
- So, your client owes \$750,000 in debt, that is traded on the market at year-end at \$685,000 due to default risk. He wants to value the liability at face value since ultimately it is obligated to pay \$750,000. What do you say?

Valuation Models

- Market approach
 - Market prices or market multiples
- Income Approach
 - Present value
 - Option pricing models
 - Discounted cash flows
- Cost Approach
 - Replacement cost

Observable Inputs

- Your client comes to you and asserts that all of its inputs are observable if someone looks in the right place. Therefore, the CFO concludes that he has no Level 3 disclosures. How do you answer?

Types of Markets

- Exchange market
- Dealer market
- Brokered market
- Principal-to-principal market

Characteristics of Inactive Markets

- a. There are few recent transactions.
- b. Price quotations are not based on current information.
- c. Price quotations vary substantially either over time or among market makers (for example, some brokered markets).
- d. Indexes that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability.

Characteristics of Inactive Markets

- e. There is a significant increase in implied liquidity risk premiums, yields, or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the reporting entity's estimate of expected cash flows, considering all available market data about credit and other nonperformance risk for the asset or liability.
- f. There is a wide bid-ask spread or significant increase in the bid-ask spread.
- g. There is a significant decline or absence of a market for new issuances (that is, a primary market) for the asset or liability or similar assets or liabilities.
- h. Little information is released publicly (for example, a principal-to-principal market).
A reporting entity shall evaluate the significance and relevance of the factors to determine whether, based on the weight of the evidence, there has been a significant decrease in the volume and level of activity for the asset or liability.

Orderly Transactions

- Your client notes that there has been a significant decline in the volume and activity of the market in which he trades. The CFO advises you that the price from that market is no longer relevant (apparently it is too low). How should you determine if the market is orderly and how do you proceed?

Thank You


