

## Application of FAS 157 to NFP Organizations

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attention  
reach  
expertise  
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## Why FAS 157?

- Different definitions
- Limited guidance
- Available guidance widely dispersed
- Users desired level of transparency



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## FAS 157 – Summary

- What it does – three factors
  - ❖ Defines fair value (FV)
  - ❖ Provides valuation framework
  - ❖ Expands disclosures
- Does not require new FV measurements
- Effective for fiscal year-end beginning after 11/15/07
  - ❖ Nonfinancial assets – beginning after 11/15/08 if not measured at FV on recurring basis



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## Definition of FV

- Price that would be received to sell asset or paid to transfer liability in orderly transaction between market participants at measurement date

### Prior Practice

Focus on **entry** price—how much would be **paid** to acquire asset or settle liability?

### FAS 157

Requires use of **exit** price—how much would be **received** to sell asset or paid to transfer liability?



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## Definition of FV (cont.)

- Market participants
  - ❖ Independent of reporting entity
  - ❖ Knowledgeable
    - ✓ Reasonable understanding
    - ✓ Uses all available information based on usual & customary due diligence efforts
  - ❖ Able & willing to transact



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## Definition of FV (cont.)

- Assumes orderly transaction
- Assumes transaction occurs in principal or most advantageous market
  - ❖ **Principal market** – greatest volume of transactions
  - ❖ **Most advantageous** – results in maximum amount received
  - ❖ **Hypothetical** - if no market exists



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## Valuation Framework

- Inputs are market participant assumptions included in valuation models
  - ❖ Observable inputs – inputs based on **independent market data**
  - ❖ Unobservable inputs – inputs reflect organization's **own assumptions**
- Increase use of observable inputs, decrease use of unobservable inputs



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## Valuation Framework (cont.)

- FV hierarchy for inputs
  - ❖ Level 1 – **quoted prices** in active markets for identical assets or liabilities
  - ❖ Level 2 – **observable** inputs, other than Level 1 quoted prices
  - ❖ Level 3 – **unobservable** inputs
  - ❖ Increase Level 1, then Level 2, then Level 3



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## Expanded Disclosures

- Recurring measures
  - ❖ What is measured at FV
  - ❖ Level within hierarchy (level 1, level 2...)
  - ❖ Valuation techniques used
  - ❖ For level 3 – reconciliation of beginning & ending balances & gains/losses for period



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## Expanded Disclosures (cont.)

- Nonrecurring measures
  - ❖ FV measures recorded in period
  - ❖ Why FV measures used
  - ❖ Valuation techniques used
  - ❖ Level 3 – description of inputs & information used to develop inputs



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## What Do We Do Now?

- We now know concepts of FAS 157 – but how to apply them in real world?



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## Step 1

- Determine assets & liabilities subject to FV measurement
- Recurring vs. Nonrecurring



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## Step 1 - Examples

- Recurring
  - ❖ Investments (equity & debt securities, mutual funds)
  - ❖ Alternative investments (hedge funds & private equity funds)
  - ❖ Beneficial interests in charitable trusts
  - ❖ Interest rate swaps & derivatives
- Nonrecurring
  - ❖ Contributions receivable
  - ❖ Goodwill & other intangible assets
  - ❖ Impairments of long-lived assets
  - ❖ Asset retirement obligations



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## Step 2

- Determine principal or, if applicable, most advantageous market for each asset/liability
  - ❖ Example - NFP has investment in common stock of Yellow Co. which is publicly traded on NYSE & Canadian exchange
    - ✓ NYSE price - \$25
    - ✓ Canadian exchange price - \$27
    - ✓ What is FV of common stock?



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## Step 2 (cont.)

- What if there are no known markets?
  - ❖ Examples:
    - ✓ Beneficial interest in charitable trust
    - ✓ Sale of long-lived asset
  - ❖ Identify potential market participants
  - ❖ Develop hypothetical market based on expected assumptions of those market participants

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### Step 3

- Determine what inputs & valuation techniques used for each asset/liability (how FV estimated)



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### Step 3 - Investments

- Need to obtain information from investment managers &/or custodians
- Questions to ask
  - ❖ How investments not traded in active market priced?
  - ❖ Do estimates utilize observable inputs (actively traded index rates), unobservable inputs, or both?
  - ❖ What is FV hierarchy level for each investment?

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### Step 3 - Interest Rate Swaps

- Need to obtain information from instrument counterparty
- Questions to ask
  - ❖ How swap mark-to-market calculated?
  - ❖ Does pricing model utilize observable inputs (actively traded index rates), unobservable inputs, or both?

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### Step 3 - Alternative Investments

- Items to consider
  - ❖ How FV determined?
  - ❖ Does Net Asset Value (NAV) represent FV under FAS 157?
  - ❖ Reliability of NAV received from fund manager
- More information on alternative investments later



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### Step 4

- Determine level within FV hierarchy where predominance of inputs lie for each asset/liability
  - ❖ Level 1 – **quoted prices** in active markets for identical assets or liabilities
    - ✓ Examples: equity securities, mutual funds, U.S. treasury bonds



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### Step 4 (cont.)

- ❖ Level 2 – **observable** inputs do not qualify for Level 1
  - ✓ Quoted prices for **similar** assets or liabilities in active markets
  - ✓ Quoted prices for identical or similar assets/liabilities in markets **not active**
  - ✓ Inputs other than quoted prices observable (*i.e.*, observable interest rate & yield curves)
  - ✓ Inputs derived from or corroborated by observable market data
    - Examples: fixed income securities, some interest rate swaps, some marketable alternative investments



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## Step 4 (cont.)

- ❖ Level 3 – **unobservable** inputs
  - ✓ Little, if any, market activity
  - ✓ Utilizes NFP's own assumptions regarding expected future cash flows & discount rates
    - Examples: beneficial interests in charitable trusts, some interest rate swaps, some alternative investments
- ❖ What if more than one level utilized?
  - ✓ Level based on **lowest level** input significant to FV measurement




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## Example – Received From Investment Manager

Xref Security ID	Asset Type	Security Description 1	Shares/Par	Price		Market Value	CUSIP	Ticker
				Source	FAS 157 Level			
086510101	Equity	Best Buy Inc.	27,200.00	IDSi	1	764,592.00	086510101	BBY
147528103	Equity	Caseys Gen Stores Inc.	3,803.00	IDSi	1	86,594.31	147528103	CASY
24702R101	Equity	Dell Inc.	70,100.00	IDSi	1	717,624.00	24702R101	DELL
349882100	Equity	Fossil Inc.	5,968.00	IDSi	1	100,166.60	349882100	FOSS
64110L106	Equity	Nerflix Com Inc.	598.00	IDSi	1	17,814.44	64110L106	NFLX
999035850	Equity	PIMCO Stockplus LP	19,278.28	Non-vendor	3	877,029.69		
984121103	Equity	Xerox Corp Com	57,100.00	IDSi	1	455,087.00	984121103	XRXX
01959EAA6	Fixed Income	Allied World Assum Co.	250,000.00	IDSi	2	176,247.50	01959EAA6	
31359MNC3	Fixed Income	Federal Natl Mtg Assn	233,000.00	IDSi	2	294,819.65	31359MNC3	
3128JNVF9	Fixed Income	FHLMC Pool #1B-3413	201,991.29	S&P	2	208,496.76	3128JNVF9	
31368HMY6	Fixed Income	FNMA Pool #0190375	5,279,891.19	S&P	2	5,428,044.94	31368HMY6	
912828JQ4	Fixed Income	US Treasury Note	269,000.00	IDSi	1	286,065.36	912828JQ4	
912828ET3	Fixed Income	US Treas-CPI Inflation Index	3,297,512.13	IDSi	1	3,158,917.70	912828ET3	
999037861	Fixed Income	VIA US Core Plus LLC.	1,034,653.73	Non-vendor	3	994,586.00		
92976WB14	Fixed Income	Wachovia Corp Global Med	44,000.00	IDSi	2	43,508.96	92976WB14	
						<u>13,569,794.92</u>		

Summary by FAS 157 Level		
1	5,587,061.41	
2	6,121,117.81	
3	1,861,615.70	
		<u>13,569,794.92</u>

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## Step 5

- Accumulate disclosure information
  - ❖ Level 3 – reconciliation of beginning & ending balances & gains/losses for period
  - ❖ See previous section for other required disclosures




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## Unique Considerations for Alternative Investments

- Net Asset Value (NAV)
  - ❖ Represents estimated FV of **underlying** assets & liabilities
- FV of alternative investments
  - ❖ FV of interest in fund itself **not** FV of underlying assets/liabilities
  - ❖ NAV may represent FV of interest in fund, but does it reflect **exit price**?

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## Determining FV of Alternative Investments

- NAV generally most appropriate starting point
- Determine if adjustments to NAV are necessary
  - ❖ Consider investment attributes including any restrictions or illiquidity on disposition of interest



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## Common Investment Attributes

- **Structure of fund** – open ended vs. limited life
- **Lock-up provisions** – restrictions on investor's ability to redeem fund interest for specified time period
- **Redemption fees** – fees imposed on withdrawal or redemption of interest by investor
- **Notice periods** – specified prior written notice to submit redemption request after any lock up period
- **Side pockets** – fund investment in illiquid securities in which investor owns interest
- **Holdbacks** – percentage of investor proceeds not currently distributed
- **Gates** – fund restriction on redemptions

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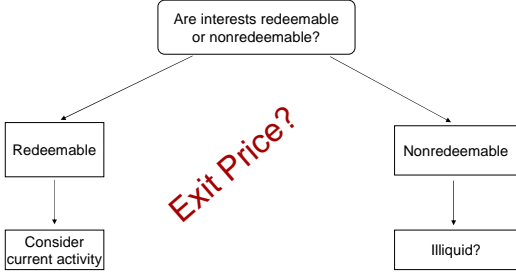
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## Potential Adjustments to NAV



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## Redeemable Interests

- Current subscriptions & redemptions at NAV?
- Current subscriptions but no redemptions?
- Current redemptions but no subscriptions?
- No subscriptions or redemptions?



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## Nonredeemable Interests

- Observable transactions?
- "Lack of marketability" discount



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## Other Considerations

- Reliability of NAV received from fund manager (if audited financial statement not obtained)
  - ❖ Fund's processes & controls
  - ❖ Use of independent third-party valuation experts
  - ❖ Marketability (or lack thereof) of underlying investments
  - ❖ History of audit adjustments



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## Resources

- AICPA Practice Aid – *Alternative Investments – Audit Considerations*
- AcSEC draft issues paper – *FASB Statement No. 157 Valuation Considerations for Interests in Alternative Investments*



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## FASB News Release (2/18/09)

- New FASB agenda projects
  - ❖ Application guidance to determine FV
    - ✓ Active vs. inactive markets
    - ✓ Distressed transactions
    - ✓ Interests in alternative investments
    - ✓ Anticipated completion by end of Q2
  - ❖ Disclosure of FV estimates
    - ✓ Anticipated completion by year-end



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## Questions?

- Enter them using GoToWebinar toolbar
- Contact Information:

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## Next BKD Webcast

- "Red Flag" Compliance Deadline – Are You Ready?
  - ❖ Presented by BKD's Tom Grundy & Matt Lathrom and Mitchell Williams' Todd Newton
  - ❖ Thursday, April 16
  - ❖ 10-11 a.m. Central time
  - ❖ Register now at [www.bkd.com/webcast!](http://www.bkd.com/webcast!)



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