# Challenges with Fair Value Measurements for Not-for-Profits

A Governmental Audit Quality Center Web Event
*November 1, 2011*

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- Must have registered for CPE credit prior to this event; a link to the CPE Credit Approval Form was e-mailed to you
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- If you are not receiving CPE for this call, ignore the CPE codes that we announce, but please answer the polling questions



Presenter

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## What we will cover

- FAS 157 (ASC Topic 820): Brief Overview and Common Myths
- AICPA Financial Reporting Whitepaper titled: ***Measurement of Fair Value for Certain Transactions of Not-for-Profit Entities***

## FAS 157: Some Common Myths

- **FAS 157 doesn't apply to contributions receivable and split-interest obligations since they're already at FV based on discounted cash flows**
- **All contributions receivable and split-interest obligations should be measured under FAS 157 FV concepts**
- **Under FAS 157, donor restrictions on assets contributed to a not-for-profit entity always/generally affect FV**



## FAS 157: Some Common Myths

- **All assets and liabilities measured at FV must be included in the tabular disclosures required by FAS 157, categorized by level**
- **In categorizing investments in funds as to level, one should look through to how the underlying investments are categorized by the investment manager**



## FAS 157: Overview

## Where FV is currently used for NFPs

- **Initial measurements:**
  - Contributions, split-interest obligations
  - Acquisitions of businesses, other NFPs (FAS 164)
- **Initial measurement and recurring subsequent measurements:**
  - Investments
  - Beneficial interests
  - Contributions, split-interest obligations (if Fair Value Option elected)
- **Non-recurring subsequent measurements:**
  - Asset impairments

## FAS 157: Overview

## FV Measurement Approach

- **From the Valuation Profession:**
  - Consider all available valuation approaches
    - Market, income, (replacement) cost approaches
  - Restrictions that are an attribute of the asset affect FV
    - Entity-specific restrictions do not
  - Build in risk premium for valuation uncertainty
- **Built upon Previous Accounting Literature:**
  - Consider relative credit standing for liabilities (CON 7)
  - Maximize use of observable inputs
    - FV Hierarchy: Level 1, Level 2, Level 3 inputs

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## AICPA Financial Reporting Whitepaper: *Measurement of Fair Value for Certain Transactions of Not-for-Profit Entities*

**Where can I find a copy of the white paper:**

- **http://www.aicpa.org/InterestAreas/FRC/IndustryInsights/Pages/FV_and_Disclosures_NFP.aspx**
- **Free to all AICPA members**
- **Available to non-members for purchase**

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## AICPA Financial Reporting Whitepaper: *Measurement of Fair Value for Certain Transactions of Not-for-Profit Entities*

**Focus on fair value of:**

- **Contributions (pledges) receivable of cash or other financial assets**
- **Beneficial interests in trusts**
- **Split–interest agreements**

**Need for Whitepaper due to challenges in measuring FV because markets for these assets and liabilities generally do not exist**

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## Contributions Receivable (Promises to Give)

- **Because no market exists for these assets, assumptions about what a hypothetical acquirer would pay are necessary**
- **Excluded from scope are:**
  - Promises to give non-financial assets
  - Contributions expected to be collected in less than 1 year
- **Unit of account—individual (stand-alone) promise to give**
  - No need to consider additional credit risk as a result of hypothetical change in ownership of the promise



## FV Measurement of Contributions Receivable

- **Present value technique**
- **Need to consider risk and uncertainty associated with:**
  - amount
  - timing

  **of cash flows because market participants expect compensation for these uncertainties (risk premium)**



## Risk Factors to Consider in Measuring FV

- **Ability of donor to pay (credit risk)**
- **Donor specific factors**
- **Factors affecting certain groups of donors**
- **NFP's prior collection experience**
- **Funding mechanism such as irrevocable trust**

## Present Value Techniques

| | DRA | EPV Method 1 | EPV Method 2 |
|---|---|---|---|
| **Cash Flows** | Single set of cash flows (contractual or promised, most likely).<br><br>The single set of cash flows are conditional cash flows (in other words, contractual or promised cash flows are conditional on the event of no default by the debtor). | Expected (probability-weighted) cash flows (or expected value), adjusted for general market (systematic) risk by subtracting the cash risk premium.<br><br>The risk-adjusted expected cash flows represent a certainty-equivalent cash flow.<br><br>The risk-adjusted expected cash flows are not conditional upon the occurrence of specific events because they are probability weighted. | Expected (probability-weighted) cash flows (or expected value).<br><br>The expected cash flows are not conditional upon the occurrence of specific events because they are probability weighted. |

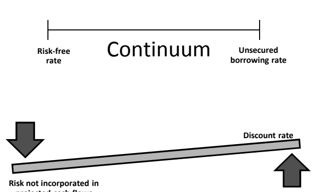


## Present Value Techniques (cont'd)

| | DRA | EPV Method 1 | EPV Method 2 |
|---|---|---|---|
| **Discount Rate** | Risk-adjusted discount rate derived from observed rates of return for comparable assets or liabilities that are traded in the market (that is, a market rate of return that corresponds to an observed market rate associated with such conditional cash flows and that, therefore, represents the amount that market participants would demand for bearing the uncertainty inherent in such cash flows). | Risk-free interest rate (for example, yield to maturity on U.S. Treasuries). | Risk-free interest rate (for example, yield to maturity on U.S. Treasuries), adjusted for general market (systematic) risk by adding risk premium. The risk-adjusted discount rate represents the expected rate of return that corresponds to an expected rate associated with such probability-weighted cash flows. |



## Discount Rates



## Choice of Method Doesn't Impact FV

- **Conceptually, the three PV methods give the same FV measure.**
- **Certain methods may be easier, more practical, or more appropriate.**
- **Example: A promise to give $100 in one year. The NFP believes that there is a 70% chance that it will collect the full amount, a 20% chance that it will collect $80, and a 10% chance that it will collect $0.**



## Choice of Method Doesn't Impact FV

- **Expected cash flows are:**
  70%($100) + 20%($80) + 10% ($0) = 70 + 16 + 0 = **$86**
- **Promised cash flow is $100.**
- **Most likely cash flow is $100.**
- **EPV uses expected cash flows.**
  - $86 discounted back 1 year at 2% = $84.31
- **DRA uses promised or most likely cash flows**
  - $100 discounted back 1 year at 18.6% = $84.31
- **Default risk is built into the expected cash flows in EPV methods and into the rate in DRA methods.**
  - Interest rates used are for this example only.



## Primary Changes for Using PV Techniques

- **If using DRA, apply risk-adjusted discount rate to promised cash flows**
  - Individuals-starting point might be unsecured consumer lending rate
  - Corporations-yield on publicly traded debt
  - Private foundations-yield on publicly traded debt
- **Day 2 challenges in using this method due to need to understand default rates incorporated in discount rates**

### Primary Changes for Using PV Techniques

- **If using DRA, apply discount rate that considers uncertainty in cash flows to most likely cash flows**
  - Difficulty in ascertaining discount rate; higher than risk-free rate and lower than rate that would be applied to promised cash flows
- **EPV 1**
  - Rate is easy to determine = risk-free rate
  - Determining certainty-equivalent cash flows typically would be impracticable



### Primary Changes for Using PV Techniques

- **If using Expected Present Value Method 2, expected cash flows are discounted using risk-free rate adjusted for general market risk**
  - Need to determine expected (probability weighted) cash flows
  - Need to adjust the risk-free rate for general market risk (risk premium)



### Beneficial Interests in Trusts Held by Others

- **Perpetual trusts**
- **Non-perpetual trust**
  - Charitable reminders trusts
  - Charitable lead trusts

**Unit of account is the beneficial interest in the trust—not the assets of the trust itself**

### Perpetual Trusts Held by Others

- **Generally measured using FV of assets contributed to the trust**
- **If facts and circumstances indicate FV may differ from assets contributed to the trust, use income approach**
- **Should be categorized as Level 3 measure**



### Non-Perpetual Trusts Held by Others

- **Use income approach**
- **Measurement = PV of future distributions projected to be received discounted at appropriate rate**
- **Cash flows from the trust to NFP beneficiary are at least as risky as cash flows within the trust**
  - Discount rate greater than or equal to assumed rate of return on the trust assets
- **FV of interest in the trust should not exceed the FV of the trust assets**



### Split-Interest Agreements Held by NFP

- **Initial measurement of split-interest agreements is at FV for assets, liabilities and contribution**
  - FV of assets – FV of liabilities = contribution
  - Most NFPs have used income approach for all split-interest agreements

## Primary Changes for Split-Interest Agreements

- **Market approach for certain gift annuities**
- **In situations other than those described for market approach, continue to use income approach**
  - Need to consider risk premium hypothetical acquirer demands for uncertainty in cash flows
  - Can't use risk-free discount rate
- **Caution when using IRS tables or planned giving software to estimate FV of fixed payment obligations**
- **In practice, NFPs have used average rate of return on investment portfolio or average borrowing rate**
  - Need to consider risk that actual cash flows may differ from those assumed and incorporate that risk in the discount rate



## Market Approach to Value Liabilities of Certain Fixed Payment Agreements

- **Similarities between annuities with fixed payments sold by insurance companies and NFPs**
- **Market approach should be used if risk of non-performance (credit standing) is the same**
- **Market quotes for fixed payment annuities offered by insurance companies will be most representative if**
  - Annuity is funded from an irrevocable trust
  - Credit standing similar to insurance company (investment grade), or
  - NFPs hold a commercially available annuity providing stated cash flows for entire term



## Income Approach to Measure Liabilities of Other Split-Interest Agreements

- **Use income approach**
  - CRUTs and CLUTs
  - Any fixed payment agreements that do not meet a criterion
- **Cash flows from the trust are at least as risky as cash flows of the trust investments**
- **Best practice is to use same rate for discount rate and rate of return**
- **Rate can be either risk-neutral rate or projected earnings rate on trust assets**

## Example: Charitable Remainder Unitrust

- Assets transferred=$100,000
- Payments = 6% of fair value
- Life expectancy = 10 years
- Investment return = 7% annual
- Discount rate: 7% annual
- Income approach
- Life expectancy information can be found in the National Center of Health Statistics life tables.



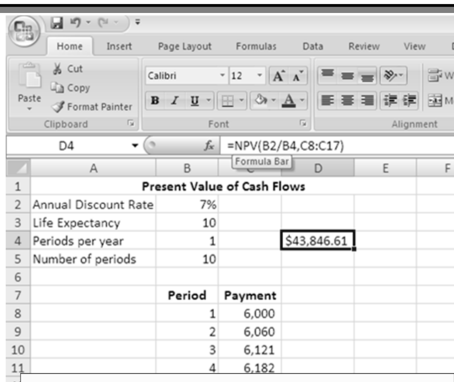
## Example: Charitable Remainder Unitrust

- Compute projected payments

| Year | Projected Trust Income | Projected Payment | Projected Fair Value of Trust—End of Year |
|---|---|---|---|
| 1 | $7,000 | $6,000 | $101,000 |
| 2 | 7,070 | 6,060 | 102,010 |
| 3 | 7,141 | 6,121 | 103,030 |
| 4 | 7,212 | 6,182 | 104,060 |

and so forth through year 10






=NPV(B2/B4, C8:C17)

## Subsequent Measurement of Obligations

- If NFPs opts FV in subsequent period, use same method as used in initial recognition
- If not using FV in subsequent period, no change in discount rate—only other actuarial assumptions

**Caution: If using market quotes, need to use the same imputed discount rate as in initial measurement**



## Changes in Valuation Technique

- If a change in valuation technique or its application, account for as change in estimate
- Disclosure provisions for change in estimate are not required for change in valuation technique or its application



## Questions ?????

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- GAQC mission is to help improve governmental audit quality.
- Governmental audits include single audits and financial statement audits of both governments & NFPs.
- Visit www.aicpa.org/GAQC to learn more about the center's mission and membership.
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