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Moss Adams Construction Group Newsletter

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Building a Way to Determine Fair Value

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Over the past year, we've heard a great deal about the new accounting guidance for determining fair value in financial statements presented in accordance with generally accepted accounting principles. Reporting asset and liability balances at fair value isn't new to financial reporting. However, it had never been consistently defined. That changed three years ago.

In September 2006 the Financial Accounting Standards Board issued Statement 157, which establishes a framework for measuring fair value, improves reporting related to the quality of earnings, enhances disclosures surrounding fair value, and provides a single 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."

So how to determine that price? There are three different valuation methods businesses can use:

- **Market approach:** Uses prices and other information generated by market transactions involving identical or comparable assets or liabilities—for example, comparable sales data for real estate transactions in the same area.
- **Income approach:** Uses valuation techniques—such as a discounted cash-flow model—to convert future amounts to a single present amount.
- **Cost approach:** Uses the amount it would currently cost to replace the asset.

When determining fair value, companies might want to use a combination of these approaches, depending on the circumstances.

Also new to the consideration of fair value is a hierarchy of the types of assumptions (inputs) used in any of these three

approaches. There are three types, or levels, of inputs that factor into the determination of fair value:

- **Level 1:** Quoted prices in active markets for identical assets or liabilities. An active market is one in which transactions occur with sufficient frequency and volume—such as a stock exchange—to provide pricing information on an ongoing basis.
- **Level 2:** Quoted prices for similar assets or liabilities in active or inactive markets as well as external factors such as interest rates, credit risks, and default rates.
- **Level 3:** Unobservable inputs for the asset or liability. These inputs will reflect management's own assumptions about the assumptions market participants would use in pricing the asset or liability, based on the best information available. For example, management could use a capitalization rate taken from a recognized journal to put together a discounted cash-flow analysis that arrives at a concluded fair value.

In their financial statements, companies must disclose the approach and the inputs they use to determine fair value. These disclosures include:

- Fair value measurements at the reporting date
- The level within the hierarchy (1, 2, or 3) where their fair value measurements fall
- If Level 3 inputs are used, a reconciliation of the beginning and ending balances
- Amount of total gain or loss for the period
- The valuation techniques used to measure the fair value

If you'd like to discuss some techniques to help you determine the fair value of financial assets or liabilities, please contact a Moss Adams professional.

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