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FAQs about fair value in accounting

In recent years, accounting rule makers have issued guidance that requires certain items on the balance sheet to be reported at "fair value." Here are some answers to frequently asked questions about this standard of value and how it's measured.

What is fair value?

Under U.S. Generally Accepted Accounting Principles (GAAP), fair value is "the price that would be received to sell an asset or pay to transfer a liability in an orderly transaction between market participants at the measurement date." The use of the term "market participants" refers to buyers and sellers in the item's principal market. This market is entity specific and may vary among companies.

Fair value estimates are used to report such assets as derivatives, nonpublic entity securities, certain long-lived assets, and acquired goodwill and other intangibles. These estimates specifically exclude entity-specific considerations, such as transaction costs and buyer-specific synergies.

Does fair value differ from fair market value?

Although fair value is similar to fair market value, the terms aren't synonymous. The most common definition of fair market value is found in IRS Revenue Ruling 59-60. The IRS defines fair market value as "[T]he price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."

The Financial Accounting Standards Board (FASB) chose the term "fair value" to prevent companies from applying IRS regulations or guidance and U.S. Tax Court precedent when valuing assets and liabilities for financial reporting purposes. The use of this term also shouldn't be confused with its use in certain legal situations — for example, when valuing a business for a divorce or a shareholder buyout. Statutory definitions of fair value typically differ from the definition provided under GAAP.

How is fair value measured?

The FASB recognizes three valuation approaches: cost, income and market. It also provides the following hierarchy for valuation inputs, listed in order from most important to least important:

1. Quoted prices in active markets for identical assets and liabilities,
2. Observable inputs, including quoted market prices for similar items in active markets, quoted prices for identical or similar items in active markets, and other market data, and
3. Unobservable inputs, such as cash-flow projections or other internal data.

Valuation specialists are often used to estimate fair value. But ultimately, management can't outsource *responsibility* for fair value estimates. Management has an obligation to understand the valuator's assumptions, methods and models. It also must implement adequate internal controls over fair value measurements, impairment charges and disclosures.

How do auditors assess fair value measurements?

External auditors evaluate accounting estimates as part of their standard audit procedures. They may inquire about the underlying assumptions (or inputs) that were used to make estimates to determine whether the inputs seem complete, accurate and relevant.

Whenever possible, auditors try to recreate management's estimate using the same assumptions (or their own). If an auditor's estimate differs substantially from what's reported on the financial statements, the auditor will ask management to explain the discrepancy. Don't be surprised if auditors ask questions related to fair value estimates or request additional documentation to support your conclusions in today's uncertain marketplace.

For more information

Contact us about any additional questions you may have about fair value measurements. We can help ensure that you're meeting your financial reporting responsibilities.