A BRIEF ANALYSIS-ABOUT THE CORONA VIRUS AND FAIR VALUE MEASUREMENTS

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Abstract

Fair value refers to the actual value of an asset a product, stock, or security that is agreed upon by both the seller and the buyer. It is determined in order to come up with an amount or value that is fair to the buyer without putting the seller on the losing end. Market value fluctuates more than fair value. With fair value accounting, valuations are more accurate, such that the valuations can follow when prices go up or down. Fair value accounting is a type of accounting in which companies measure and report certain assets and liabilities at prices equal to their fair value. Fair value means that assets are reported at the price the company would receive if they sold them and liabilities are reported at the value the company would receive if they were relieved of them. The purpose of this method is for creating realistic financial statements. Companies reporting under this method have financial statements that are more accurate than those not using this method. When assets and liabilities are reported for their actual value, it results in more realistic financial statements. The corona virus disease ***2019 (COVID-19)*** *is throwing a wrench into fair value measurements. Even the basic definition of fair value requires a closer look. Which assumptions would a market participant use? Are those assumptions incorporated into your valuation technique? Are you missing something? Also, when is the last time you calibrated your valuation technique? Calibration is important to make sure your valuation technique reflects current market conditions. Calibration can also help you identify a missing element.*

Keywords:- *Fair Value, Market Value, GAAP, Covid-19, Accuracy of valuation, Incomparability.*

INTRODUCTION

Fair value refers to the actual value of an asset a product, stock, or security – that is agreed upon by both the seller and the buyer. Fair value is applicable to a product that is sold or traded in the market where it belongs or under normal conditions and not to one that is being liquidated. It is determined in order to come up with an amount or value that is fair to the buyer without putting the seller on the losing end.

Definition of Fair Value

Fair value is the price that an entity would receive to sell an asset (or pay to transfer a liability) in an orderly transaction that occurs as of the measurement date between market participants in the principal market (or most advantageous market) for the asset or liability. For nonfinancial assets, fair value is determined based on an asset's highest and best use.

Fair Value vs. Market Value

Market value is also different from fair value in the following points:

- Market value fluctuates more than fair value.
- It may be based on the most recent pricing or quotation of an asset. For example, if during the last three months, the value of a share in Company A was $30 and during the most recent evaluation, it went down to $20, then its market value is $20.
- Market value is dependent on supply and demand in the market where the asset is bought and sold. For example, a house that is to be sold will see its price determined by existing market conditions in the local area.

If the owner tries to sell a property for $200,000 during a low time in the real estate market, then it might not get sold because the demand is low. But if it is offered for $500,000 during a high time, it may get sold at that price.

Advantages of Fair Value Accounting

Fair value accounting measures the actual or estimated value of an asset. It is one of the most commonly used financial accounting methods because of its advantages, which include:

1. Accuracy of valuation
With fair value accounting, valuations are more accurate, such that the valuations can follow when prices go up or down.
2. True measure of income
With fair value accounting, it is total asset value that reflects the actual income of a company. It doesn't rely on a report of profits and losses but instead just looks at actual value.
3. Adaptable to different types of assets
Such a method is able to make valuations across all types of assets, which is better than using historical cost value which may change through time.
4. Helps businesses survive
Fair value accounting helps businesses survive during a financially difficult time because it allows asset reduction (or the act of declaring that the value of an asset that is included in a sale was overestimated).

Fair value accounting is a type of accounting in which companies measure and report certain assets and liabilities at prices equal to their fair value. Fair value means that assets are reported at the price the company would receive if they sold them and liabilities are reported at the value the company would receive if they were relieved of them. The purpose of this method is for creating realistic financial statements.
5. Reduced Net Income
Using fair value accounting, when values of assets decrease, the company's calculated net income decreases. When the company's value of liabilities increase, the company's calculated net income also decreases. Net income is the bottom line of a company's Income Statement.

This amount reflects the amount the company pays taxes on. This is an advantage to companies because a lower net income results in lower taxes. These affects to assets and liabilities also cause a decrease in the equity of the company. A lower equity results in less money a company must decide what to do with. This usually results in less employee bonuses, which means more money in the company's pocket.
6. Realistic Financial Statements
Companies reporting under this method have financial statements that are more accurate than those not using this method. When assets and liabilities are reported for their actual value, it results in more realistic financial statements. When using this method, companies are required to disclose information regarding changes made on their financial statements. These disclosures are done in the form of footnotes. Companies have an opportunity for examining their financial statements with actual fair values, allowing them to make wise choices regarding future business operations.
7. Investors Benefit
Fair value accounting offers benefits for investors as well. Because fair value accounting lists assets and liabilities for their actual value, financial statements reflect a clearer picture of the company's heath. This allows investors to make wiser decisions regarding their investment options with the company. The required footnote disclosures allow investors a way of examining the effects of the changes in statements due to fair values of the assets and liabilities.

Disadvantages of Fair Value Accounting
Fair value accounting is the process of periodically adjusting an item's value in accounting books. Assets and investments are the most common items that apply under this accounting principle. This principle changes the traditional accounting reporting method, which used historical costs to value items on a company's books. Significant disadvantages exist in fair value accounting.

1. **Frequent Changes**

In volatile markets, an item's value can change quite frequently. This leads to major swings in a company's value and earnings. Accountants typically write off losses on items against a company's earnings. Publicly held companies find this difficult as investors may find it difficult to value the company with such swings in place. Additionally, the potential for inaccurate valuations can lead to audit problems.

2. **Less Reliable**

Accountants may find fair value accounting less reliable than historical costs. For example, accountants typically look to the market when finding a new value for assets or investments. When an item has different values in different regions, however, accountants must make a judgment call on valuing items on the books. If a company with similar assets or investments values items differently than another, issues may arise because of the accountant's valuation method.

3. Inability to Value Assets

Businesses with specialized assets or investment packages may find it difficult to value these items on the open market. When no market information is available, accountants must make a professional judgment on the item's value. Accountants must also make sure that all valuation methods used are viable and take into account all technical aspects of the item. Essentially, companies must have strong reasons for placing values on assets and investments.

4. Reduces Book Value

A company's book value is the total of all assets owned. Historically, a company's book value changed when a company purchased new assets and/or disposed of old assets. Fair value accounting now changes a company's book value for seemingly arbitrary issues. For example, if an asset or investment experiences a significant drop in value for a short time period, a company may need to make accounting adjustments. If the value goes back up, the adjustment did nothing but drop the company's book value for a small time period.

5. Out-dated Figures

The figures for assets contained in the statement of financial position are based on cost at the time of acquisition. They are, thus, unlikely to show present day values because these figures cannot just be added together. Users of financial statements will not be able to realistically predict future cash flows related to those assets.

6. Overstatement of Figures

If profit is dependent on measure of capital at different dates, then profit measurement can be considered the result of comparing two meaningless totals, as the capital figure does not reflect shareholders' purchasing power. In addition, the profit that results is usually considered overstated and any ratio employed, including return on capital, will be overstated.

7. Misleading Operational Levels

Historic cost gives a misleading impression of the ability of a company to continue to operate at a given level since the assets are undervalued. By adjusting for inflation and net realizable value, accountants attempt to maintain the shareholders' capital in terms of the general or consumer purchasing power.

8. Incomparability

A series of historic cost accounts can give a misleading impression of the financial trends of a company. Only if the results of different years are restated by adjusting to general price levels can comparability between years be valid. All items in the profit and loss account are expressed in terms of year-end purchasing power, while the same will be true in the balance sheet.

The Fair Value Hierarchy

GAAP [Generally Accepted Accounting Principles] **provides a hierarchy of information sources that range from** Level 1 (best) to Level 3 (worst).

The general intent of these levels of information is to step the accountant through a series of valuation alternatives, where solutions closer to Level 1 are preferred over Level-3.

The Features of the three levels

- **Level 1.** This is a quoted price for an identical item in an active market on the measurement date. This is the most reliable evidence of fair value, and should be used whenever this information is available. When there is a bid-ask price spread; use the price most representative of the fair value of the asset or liability. This may mean using a bid price for an asset valuation and an ask price for a liability. When you adjust a quoted Level 1 price, doing so automatically shifts the result into a lower level.
- **Level 2.** This is directly or indirectly observable inputs other than quoted prices. An example of a Level 2 input is a valuation multiple for a business unit that is based on the sale of comparable entities. This definition includes prices for assets or liabilities that are (with key items noted in bold):
  - For similar items in active markets; or
  - For identical or similar items in inactive markets; or
  - For inputs other than quoted prices, such as credit risks, default rates, and interest rates; or
  - For inputs derived from correlation with observable market data.
- **Level 3**. This is an unobservable input. It may include the company's own data, adjusted for other reasonably available information. Examples of a Level 3 input are an internally-generated financial forecast and the prices contained within an offered quote from a distributor.

These three levels are known as the fair value hierarchy. Please note that these three levels are only used to select inputs to valuation techniques (such as the market approach). The levels are not used to directly create fair values for assets or liabilities.

The corona virus disease **2019 (COVID-19)** is throwing a wrench into fair value measurements. Even the basic definition of fair value requires a closer look. In particular, let's revisit the following concepts:

- **Orderly transactions:** Fair value is based on orderly transactions. A transaction is not orderly if it is forced. Companies in many industries are showing signs of financial strain, such as hotels, restaurants, airlines, cruise lines, construction entities, oil and gas companies, and theme parks. As such, distress sales and forced liquidations may become more common.
- **Measurement date:** A fair value measurement must be determined as of the measurement date. Recent market volatility highlights the importance of determining fair value on the right date. The biggest point drop for the Industrial Average in history occurred on **March 16, 2020** with the Dow dropping a whopping **2,997** points. Just today, the Industry shot up over **2,100** points. With these swift and dramatic movements, prices become stale extremely quickly. Therefore, it is crucial to determine fair value as of the measurement date.
- **Market participants:** Fair value must be based on the assumptions market participants would use. Market conditions are changing daily, making it difficult to pinpoint the assumptions a market participant would use. To obtain information about market participants, you are not required to undertake exhaustive efforts, but must consider reasonably available information. Be sure to document your conclusions, along with the basis for those conclusions.
- **Principal or most advantageous market**: Some common channels for selling goods and services have been shut down or impeded. For instance, retailers have been required to shutter physical stores temporarily to prevent spread of the virus. Could the principal or most advantageous market for your asset or liability have changed? Also, prices may differ in the principal market versus the most advantageous market. We have to use prices in the principal market, even if the price in another market is more advantageous at the measurement date.
- **Highest and best use:** A fair value measurement for a nonfinancial asset considers the asset's highest and best use. The corona virus is forcing companies to repurpose assets. For example, some cruise lines and hotels have offered their facilities as makeshift hospitals. Manufacturers have revamped equipment to help supply health care workers with medical essentials. Could the highest and best use of your asset have changed?
- The highest and best use is determined based on the perspective of a market participant.
- The highest and best use must be physically possible, legally permissible, and financially feasible.
- The way a reporting entity is currently using a nonfinancial asset is assumed to be the highest and best use, unless factors suggest otherwise. At the moment, no one can foresee how long the pandemic will last or how long its effects will linger. We could start to see a light at the end of the tunnel in a few weeks. Or conditions could worsen or persist for months. As of today, it may be too soon to conclude that your highest and best use is different… but will that always be the case?

Valuation Approaches, Techniques, and Inputs

We can't discuss the accounting effects of the corona virus on fair value measurements without digging deeper into valuation approaches, techniques, and inputs.

Fair value generally is determined using one of the following valuation approaches:

- A market approach;
- A cost approach;
- An income approach (such as a present value technique).

An entity also must determine the appropriate inputs for its valuation technique (such as discount rates, credit risk, expected cash flows, and bid/ask prices). Topic 820 requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs. Unobservable inputs must be developed using assumptions a market participant would use.

In light of the corona virus, remember the following:

- **Valuation techniques:** Which assumptions would a market participant use? Are those assumptions incorporated into your valuation technique? Are you missing something? Also, when is the last time you calibrated your valuation technique? Calibration is important to make sure your valuation technique reflects current market conditions. Calibration can also help you identify a missing element.
- A reporting entity generally must apply the same valuation technique consistently each reporting period. However, certain factors may warrant a change in the valuation technique, such as a shift in market conditions, an improvement in valuation techniques, or information that is no longer available.

- **Discount rates:** Discount rates typically are determined by taking a risk-free rate and adding a risk premium for uncertainty and illiquidity. The Reserve has made emergency rate cuts in recent weeks, lowering risk-free rates. At the same time, uncertainty is through the roof. Make sure to involve your actuaries in determining suitable discount rates that incorporate appropriate risk-free rates and risk premiums.
- **Credit risk:** Today's economic landscape reminds some of the 2008 financial crisis. Many companies the world thought were too big to fail are suddenly under severe strain. Industries that were booming weeks ago are now lobbying for a government bailout. Gauging the level of credit risk associated with an asset may be difficult. And remember that an entity must consider nonperformance risk when measuring the fair value of its liabilities as well.
- **Expected cash flows:** Reporting entities must revisit expected cash flow assumptions. For instance, if you are using a present value technique to measure the fair value of a debt instrument, have the expected principal or interest payments changed? This includes both the timing and the amount of the payments. For instance, a debtor under financial strain may take longer to make a payment. Also, you may need to revise the amount of expected interest payments on a variable-rate debt due to recent changes in market interest rates.
- **Bid and ask prices:** A number of valuations (such as commodities or financial instruments) may use bid and ask prices as inputs. Substantial differences may exist between bid and ask prices. For instance, sellers of oil hoping for a market rebound may set asking prices well above the bid prices buyers are willing to pay. It may be difficult to determine the price within the bid-ask spread that is most representative of fair value. Permits, but does not require, the use of bid prices for asset positions and ask prices for liability positions. Also allows the use of mid-market pricing or another method used by market participants to determine fair value within the bid-ask spread.
- **Significant drops in market activity:** The volume or level of market activity may have significantly decreased for a particular asset or liability. As a result, an adjustment to a transaction or quoted price may be necessary. The adjustment could be significant to the fair value measurement. It also may be appropriate to update your valuation technique or use multiple valuation techniques.
- **Costs:** Transaction costs are not factored into a fair value measurement. Transportation costs, however, must be considered if location is a characteristic of the asset (such as for a commodity) and transportation costs would be incurred to move the asset from its current location to market. If transportation methods and routes are impacted by the corona virus, this may also affect the amount of transportation costs that need to be reflected in the fair value measurement.
- **Use of third parties:** Many companies get quoted prices from third parties. Make sure you have processes and controls in place to evaluate the valuation methods and inputs used by third parties. A reporting entity must ensure that the quoted prices have been developed according to Topic 820. In particular, ask your third party vendors how they've considered the effects of COVID-19

CONCLUSON.

When performing valuations, make sure to document the basis for our conclusions. Having adequate supporting documentation for assumptions, estimates, and judgments is critical.

Topic 820 provides some practicability exemptions. For instance, an entity is not required to measure the fair value of a financial instrument for which it is not practicable to do so or a nonmonetary asset for which fair value is not reasonably determinable. Under current circumstances, you may have additional assets or liabilities for which fair value cannot be determined.

As a practical expedient, also permits an entity to estimate the fair value of certain investments using the net asset value per share (or its equivalent). Companies may need to convert assets to cash. You can't use the practical expedient to measure an investment at net asset value per share if, as of the measurement date, it is probable you will have to sell the investment for a different amount. Specifies criteria under which a sale would be considered probable.

The accounting effects of the corona virus on fair value measurements may be significant**.** **COVID-19** is a rapidly evolving situation. In the coming weeks and months, we may witness additional accounting effects as the full impact of this disease manifests itself. We encourage you to stay informed on accounting and financial reporting developments.

REFERENCES

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