

Currency

A newsletter for bank executives

Grant Thornton 



The new fair value standard: What you need to know

by Accounting Principles Group Senior
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Early next year, most companies will be required to adopt a new accounting standard issued by the FASB entitled *Fair Value Measurements* (also referred to as Statement 157). Since fair value is pervasive in the financial reporting of most financial institutions, it is expected to have a significant impact on the industry. While it may not significantly change the reported fair value amounts, it will affect the processes, controls and disclosures relating to those fair value measurements. Thus, Statement 157 warrants an institution's attention well in advance of the required effective date.

Prior to Statement 157, there were various definitions of fair value and limited guidance in the application of those definitions. Statement 157 creates a single definition of fair value along with a framework to measure fair value to increase consistency and comparability in fair value measurements. In this regard, the statement also requires enhanced disclosures surrounding an institution's fair value measurements.

Since many of the concepts addressed by Statement 157 are not new, but rather clarifications of previously issued guidance, institutions may be tempted to consider the statement to be business as usual, and place a low

priority on its implementation. It is important to note that there are a number of significant changes resulting from these clarifications, some of which may require considerable management time and effort. The financial statements of a financial institution will be impacted by Statement 157 in several areas, as discussed below.

Investment securities classified as available for sale

Investment securities classified as available for sale (AFS) are required to be recognized at fair value in an institution's balance sheet. Whether these AFS investments are valued by outside service providers or internally, financial institutions >



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will need to ensure that the measurement process is compliant with the new standard. Additionally, the expanded disclosure requirements of Statement 157 for items recognized at fair value on the institution's balance sheet will require the institution to have a better understanding of how its investments are measured in order to meet those requirements.

Allowance for loan losses

Potentially, the most significant change under Statement 157 is the concept of "exit value." Fair value calculations will not be based on the purchase price of an asset, but rather on what would be received by the financial institution to transfer or sell the asset to a third party, i.e., the exit value. This change will impact loans that are individually evaluated for impairment pursuant to Statement 114, *Accounting by Creditors for Impairment of a Loan*. For example, when impairment is measured by comparing the fair value of the underlying collateral to the loan's net carrying amount, the fair value measurement of the collateral must take into account this exit value assumption.

Intangible assets and goodwill

Financial institutions that have grown by acquisition, goodwill and certain intangible assets are required to be tested annually for impairment. As discussed above, management will need to ensure that outside appraisers and/or internal experts are familiar with the impact and requirements of Statement 157 on this measurement process and the disclosures that may be triggered in the event impairment is identified.

Servicing rights

Effective January 1, 2007, Statement 156, *Accounting for Servicing of Financial Assets*, requires all servicing rights to be initially measured at fair value and permits a company to choose to subsequently measure servicing rights using either the amortization method or the fair value measurement method. Regardless of the method used, the fair value measurement will need to comply with Statement 157. Institutions that elect to measure servicing rights at fair value will need to consider the interaction of the disclosure requirements of Statement 156 and Statement 157. Additionally, companies that choose the amortization method may become subject to certain disclosure requirements in Statement 157 in the event that the servicing right becomes impaired.

Statement 107 disclosures

Statement 107, *Disclosures about Fair Value of Financial Instruments*, requires many financial institutions to disclose the fair value of both financial assets and financial liabilities recognized and not recognized at fair value on a company's balance sheet. In addition to the items required to be measured at fair value in the institution's balance sheet, this requires institutions to disclose the fair value of financial assets and liabilities, such as loans, deposits and debt. The Statement 157 definition and framework will also apply to these disclosures.

Concluding remarks

The good news regarding Statement 157 is that many inconsistencies in the definition and application of fair value measurement have been clarified and corrected. However, these changes will require financial institutions to place a high priority on understanding and implementing these new provisions. The time to prepare for Statement 157 is now. ■