

Calculation and Application of Fair Values

Accounting standards define *fair value* as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants as of a measurement date (typically an entity's year-end). There are three different acceptable valuation techniques used to calculate fair value: the market approach, the income approach, and the cost approach. A key assumption in the measurement of fair value, regardless of the approach utilized, is that the exchange of an asset or liability is done so in an orderly transaction between market participants to sell the given asset or liability at the measurement date. Market participants, then, are buyers and sellers in the principal market for that asset or liability.

In applying fair value accounting, the valuation technique used should be applied on a consistent basis from period to period. These techniques are based upon *inputs*, which are broadly defined as the assumptions a market participant would use in pricing an asset or liability. The inputs used in determining fair value may be either observable or unobservable. Observable inputs are data obtained from independent sources, while unobservable inputs are judgments about market participant assumptions that have been developed based upon the best available information at the time given the circumstances surrounding those assumptions.

The standards also define a *fair value hierarchy* that prioritizes these inputs, broken down into three levels:

Level 1 – Quoted prices in active markets for an identical asset that an entity has the ability to access at the measurement date.

Level 2 – Observable inputs other than quoted prices for the asset, either directly or indirectly observable, that reflect assumptions market participants would use to price the asset based on market data obtained from sources independent of the entity.

Level 3 – Unobservable inputs that reflect the entity's own judgments regarding assumptions market participants would use in pricing an asset or liability.

Once an entity determines where the inputs fall within the hierarchy, an appropriate valuation technique can be applied and the calculation of the fair value of an asset or liability can be completed.