

Not-for-profit healthcare, higher education  
and other not-for-profit organizations

# Fair value option considerations\*

A guide for not-for-profit organizations

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## Introduction

Historically, an organization's ability to use fair value accounting has been limited to a handful of assets and liabilities. Issued in February 2007, FASB Statement No. 159 (FAS 159), *The Fair Value Option for Financial Assets and Financial Liabilities*, expands the ability to select fair value as the basis of measurement for certain financial assets and liabilities, referred to as the fair value option (FVO). This guide introduces key concepts of FAS 159 using a case-study approach to assist management and audit committees of not-for-profit organizations (NPOs) in understanding the implications of this important standard.

Bob Garner is CFO of ABC Health System (ABC), a not-for-profit organization. ABC is comprised of ABC Hospital and its subsidiary, ABC Nursing College (the College). As a health care organization, ABC prepares its financial statements in accordance with the requirements of the AICPA Audit and Accounting Guide, *Health Care Organizations* (AAG-HCO)<sup>1</sup>; however, ABC also issues separate subsidiary financial statements for the College that are prepared in accordance with the AICPA Audit and Accounting Guide, *Not-for-Profit Organizations* (AAG-NPO).

ABC participates in a 50-50 joint venture with DEF Health System (an unrelated organization) to operate MRI Inc., a mobile MRI business. ABC also has interests in the net assets of two financially-interrelated<sup>2</sup> foundations (Foundation X and Foundation Y). ABC does not control these foundations (thus, they are not consolidated); however, they were established to receive contributions that solely benefit ABC.

ABC's fiscal year ends on September 30. FAS 159 is effective for fiscal years beginning after November 15, 2007. Since FAS 159 requires adoption as of the beginning of the year, ABC would have to adopt FAS 159 on October 1, 2008 in order to elect to measure any of its eligible assets and liabilities at fair value. In light of this relatively short window, Bob's challenge is to quickly gain an understanding of the standard's key provisions; determine what assets and liabilities are eligible; and establish the key considerations for determining whether FVO election(s) would be advantageous.

## Understanding the key provisions

FAS 159 provides an opportunity for ABC to measure many financial assets and liabilities at fair value that are currently measured using other bases of accounting. Bob determines the following:

- The FVO is a one-time election for eligible assets and liabilities on ABC's balance sheet at the time it adopts FAS 159. If ABC does not elect the FVO for those assets and liabilities at that time, it will not have another opportunity to do so (unless those assets or liabilities are subsequently affected by certain remeasurement events).
- The FVO is irrevocable. If ABC elects the FVO for any asset or liability, it remains in effect for as long as ABC holds that asset or liability.
- The FVO can only be adopted for financial assets and liabilities. Generally speaking, financial assets and liabilities are those that can be settled in cash or with other financial instruments; all other assets and liabilities are considered nonfinancial (e.g., property and equipment, obligations to deliver goods or services).
- FAS 159 permits application of the FVO on an instrument-by-instrument basis, with some exceptions.<sup>3</sup> Therefore, ABC can elect the FVO for certain instruments but not others within a group of similar items (e.g., for a single alternative investment, rather than for all alternative investments).
- ABC will be required to measure fair values based on the framework established in FASB Statement No. 157 (FAS 157), *Fair Value Measurements*.

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<sup>1</sup> With conforming changes as of March 1, 2008.

<sup>2</sup> As defined in paragraph 13 of FASB Statement No. 136 (FAS 136), *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*.

<sup>3</sup> See paragraph 12 of FAS 159.

- Any adjustments required for the adoption would be reported by ABC as a cumulative-effect adjustment to the opening balances of the appropriate net asset classes.
- Because ABC is a not-for-profit healthcare organization, all subsequent changes in fair value for the elected items would be reported within ABC's performance indicator (as defined in the AAG-HCO). This is not a consideration for the College's separate financial statements since the College does not report a standardized performance indicator.
- To address comparability concerns, FAS 159 requires extensive disclosures related to any asset or liability for which the FVO is elected. Organizations that elect the FVO must either report separate line items in the balance sheet for fair value and non-fair-value amounts, or aggregate the fair value and non-fair-value amounts and parenthetically disclose the carrying amounts on the balance sheet. In addition, such organizations must disclose the amount of gain or loss related to changes in fair value, including where they are reported in the statement of operations/activities. Items for which the FVO is adopted also are subject to FASB Statement No. 157 (*FAS 157 Fair Value Measurements*) FAS 157's disclosure requirements related to recurring fair value measurements.

## Identifying eligible assets and liabilities

Whether it would be beneficial for ABC to adopt the FVO for any of ABC's financial assets or liabilities depends on the nature of the specific assets and liabilities that are eligible.

ABC's most recent interim balance sheet (summarized) appears as follows:

### ABC Balance Sheet

(in thousands)

<b>Assets</b>		<b>Liabilities</b>	
Investments:		Split-interest obligations—held in-house	\$ 22,000
Trading securities	\$ 10,000	Derivative liabilities	19,000
Available-for-sale securities	215,000	Government loan liability	75,000
Alternative investments—equity method	140,000	Bonds payable	250,000
Alternative investments—cost	75,000	Lease obligations	50,000
Alternative investments—fair value*	55,000	Other liabilities	150,000
	<u>495,000</u>	<b>Total liabilities</b>	<u>566,000</u>
Investments in joint ventures	22,000	<b>Net Assets</b>	
Contribution receivable, net	2,500	Unrestricted	232,500
Student loan receivable, net	90,000	Temporarily restricted	257,500
Derivative asset	4,000	Permanently restricted	125,000
Split-interest—held by third party	7,500	<b>Total net assets</b>	<u>615,000</u>
Interests in financially-interrelated organizations	50,000		
All other assets	510,000		
<b>Total assets</b>	<u>\$ 1,181,000</u>	<b>Total liabilities and net assets</b>	<u>\$ 1,181,000</u>

\* Represents ABC Nursing College's investments

Bob's analysis of which financial assets and liabilities on ABC's balance sheet would potentially be eligible for FVO elections appears as follows:

Potentially eligible for FVO	Not eligible for FVO
<ul style="list-style-type: none"><li>• Available-for-sale securities</li><li>• Alternative investments</li><li>• Noncontrolling interests in joint ventures or partially-owned related entities</li><li>• Contributions receivable (e.g., multi-year promises to give cash)</li><li>• Obligations arising under split interest agreements for which ABC serves as trustee</li><li>• Interest in net assets of financially-interrelated organization</li><li>• Student loan receivables</li><li>• Long-term debt (e.g., bonds payable)</li><li>• Derivative assets (e.g., interest rate swaps)</li></ul>	<ul style="list-style-type: none"><li>• Investments in consolidated subsidiaries</li><li>• Employee benefit-related obligations</li><li>• Financial assets and financial liabilities recognized pursuant to leases (e.g., lease obligations)</li></ul>

## Key considerations for eligible items

For each eligible financial asset and liability, Bob next must identify the key considerations in evaluating whether electing the FVO would be advantageous.

### Marketable securities

**Observation:** NPOs that do not report a standardized performance indicator would derive no benefit from electing the FVO for marketable securities since their reporting in the statement of activities would not change.

ABC has \$225 million of marketable equity and debt securities that are accounted for under FASB Statement No. 124 (FAS 124), *Accounting for Certain Investments Held by Not-for-Profit Organizations*. For those securities classified as trading (\$10 million), Bob determines that there would be no reason to make a FVO election, as trading securities are already carried at fair value with changes reflected within the performance indicator. However, for those classified as available-for-sale (\$215 million), election of the FVO may simplify recordkeeping and result in more symmetrical accounting for gains and losses. This is because realized gains and losses (including other-than-temporary impairment losses (OTTI)<sup>4</sup>) must be reported within the performance indicator,<sup>5</sup> while unrealized gains and losses must be excluded from the performance indicator. If ABC has significant unrealized losses on marketable securities that are deemed to be other-than-temporary, such losses are required to be recognized within the performance indicator as realized losses, while all unrealized gains remain below the performance indicator. Election of the FVO would change this reporting to require all gains and losses (both unrealized and realized) to be reported above the performance indicator. Investments designated under FAS 159 in effect will be accounted for similar to FAS 115/124 “trading” securities.

<sup>4</sup> Based on the guidance in FASB Staff Position FAS 115-1/124-1 (FSP FAS 115-1/124-1), The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments.

<sup>5</sup> AAG-HCO, par. 4.14.

Bob also evaluated the merits of making the election for marketable securities reported in the College's stand-alone financial statements. Unlike its parent health system, the College is not required to report a standardized performance indicator and, thus, does not have the same OTTI considerations related to its marketable securities (since realized and unrealized gains are not segregated). Therefore, Bob determined there would be little benefit for the College to elect the FVO for its marketable securities, as no change in the presentation of gains or losses in the statement of activities would result.

**Observation:** For healthcare organizations, electing fair value measurement for alternative investments could be challenging, since many of those investments are not readily marketable and there is limited transparency into the underlying holdings.

### Alternative investments

ABC owns noncontrolling investments in several alternative investment partnerships and LLCs (e.g., private equity funds, hedge funds, etc.). The method of accounting used for those investments is based on the extent of ABC's ability to influence the investee. If ABC can exercise significant influence over the investee, the equity method<sup>6</sup> of accounting is used; if it cannot, the cost method is used.

Currently, the accounting for ABC's \$140 million portfolio of equity method investments is relatively straightforward. Bob simply records ABC's share of each security's income/loss (the "equity pickup") based upon the audited (or in some cases, interim) financial statements received from the investment company or fund. For many of ABC's alternative investments that apply investment company accounting,<sup>7</sup> measurements obtained using the equity method have closely approximated their pre-FAS 157 fair values (based on net asset values (NAVs)), so there is little if any balance sheet difference between equity method carrying value and fair value. However, once FAS 157 is adopted, Bob knows that the fair values may be different than carrying value under the equity method, particularly if the investments have liquidity restraints or other restrictive covenants that may affect measurements under the FAS 157 framework.

**Observation:** Under the FAS 157 framework, organizations making the FVO for investments in LPs and LLCs that have restrictive terms such as lockups, holdbacks, or side pockets (i.e., liquidity constraints), must consider whether an adjustment (i.e., a discount) to NAV is required for those constraints when determining fair values.

Similar considerations apply with respect to ABC's \$75 million portfolio of cost-method alternative investments. Bob estimates that that portfolio has an aggregate fair value of approximately \$110 million based upon net asset values (NAVs). Thus, ABC's balance sheet is potentially undervalued by approximately \$35 million relative to those investments. Currently, the statement of operations reflects only the dividend and interest income earned rather than mark-to-market adjustments each period. Additionally, the accounting, recordkeeping, and internal control requirements associated with cost-method investments are much less complex than they are for either equity method or fair value investments.

Therefore, in determining whether electing the FVO for ABC's alternative investments would be beneficial, Bob will need to evaluate whether the time and effort (and, in some cases, expense) required to determine the fair value of each investment and to explain the increased volatility in the statement of operations (particularly in relation to cost-method investments) to users of the financial statements would outweigh any benefits to be derived from fair value measurement in the form of balance sheet enhancement. Further, carrying those investments at fair value would require ABC to assess its system of internal control over financial reporting for investments in order for Bob to be able to appropriately estimate and monitor fair value.

<sup>6</sup> Based on the guidance in Accounting Principles Board (APB) Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock; AICPA Statement of Position 78-9, Accounting for Investments in Real Estate Ventures; EITF Issue No. 03-16, Accounting for Investments in Limited Liability Companies; and FASB Staff Position SOP 78-9-1, Interaction of AICPA Statement of Position 78-9 and EITF Issue No. 04-5.

<sup>7</sup> In accordance with the AICPA Audit and Accounting Guide, Investment Companies.

**Observation:** If the FVO is elected by NPOs that carry their “other investments” at cost or equity under AAG-NPO, the election can be made on an instrument-by-instrument basis without jeopardizing the accounting policy of carrying the remaining “other investments” at cost or equity.

Bob also evaluated the merits of making the election for alternative investments reported in the College's stand-alone financial statements. The College's \$55 million portfolio of alternative investments already are reported at fair value under the option allowed in Chapter 8 of AAG-NPO (which allows such investments to be carried at fair value only if that election is made for all alternative investments). Similar to the considerations for the College's marketable securities, Bob determines that there appear to be no potential benefits associated with electing the FVO for the alternative investments. If the College did not follow this option and instead carried alternative investments at cost or equity, the considerations discussed above for ABC Health System would apply to the College's investments as well.

### Joint ventures/operating investments

ABC accounts for its participation in the MRI joint venture using the equity method of accounting. Bob estimates that the fair value of ABC's 50% interest is roughly \$50 million, based upon a recent offer made by a third-party to acquire ABC's interest. The difference between the fair value of \$50 million and the carrying value of \$22 million is primarily due to the fact that certain significant assets (e.g., property, plant and equipment) of the venture are carried at historical cost, rather than at fair value. Therefore, making the FVO election for the joint venture would initially boost ABC's balance sheet by \$28 million. However, instead of recording ABC's share of the venture's income/loss (“equity pickup”) each period thereafter, Bob would have to estimate the fair value of the 50% venture interest and reflect the entire mark-to-market adjustment through income.

The benefits of electing the FVO for operating investments such as joint ventures will vary depending on the facts and circumstances surrounding the investment. Similar to alternative investments, Bob will need to evaluate whether the time, effort, and expense required to estimate the fair value of the venture under the FAS 157 fair value framework would outweigh any benefits resulting from the balance sheet enhancement. Estimating fair value will require Bob to gather inputs at each measurement date based on looking to comparable public entities, recent transactions, and/or cash flow analysis, any or all of which may be difficult to perform or costly to obtain. In particular, obtaining market comparables or looking to transactions of similar organizations poses unique challenges in the NPO environment, since many transactions involving NPOs do not involve fair value exchanges.

### Contributions receivable

ABC's balance sheet reflects net unconditional multi-year promises to give cash (i.e., contributions receivable) totaling \$2.5 million. Under FASB Statement No. 116 (FAS 116), *Contributions Received and Contributions Made*, unconditional promises to give are initially recorded at fair value. ABC measures the fair value of the unconditional promises to give using the present value of the future cash flows, discounted using a risk-free rate (as required by AAG-NPO for periods prior to adoption of FAS 157).<sup>8</sup> In conformity with paragraph 12 of APB Opinion No. 21 (APB 21), *Interest on Receivables and Payables*, the discount rate determined at the time a pledge is initially recognized is not revised subsequently. Since market discount rates change period-to-period and the discount rate used is not adjusted each period to reflect these changes, the subsequent measurements of the unconditional promise to give do not represent fair value.

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<sup>8</sup> When ABC adopts FAS 157, AAG-NPO's requirement to use a risk-free rate of return is superseded by the requirement to use FAS 157's present value techniques, including the discount rate adjustment technique, in which the rate should be based upon the rate a market participant would demand (e.g., endowment or investment return). The period associated with the discount rate should be consistent with the term of the promise to give. For instance, a two-year promise to give will likely be valued using a different discount rate than that used for a ten-year promise to give.

**Observation:** The FVO is permissible on an instrument-by-instrument basis; therefore the election can be made on individual promises to give without having to make the election for all promises to give.

In order to comply with APB 21's requirement that the discount on pledges be amortized between the date the promise is initially recognized and the date the cash is received, Bob maintains spreadsheets of all of ABC's long-term pledges, all with varying discount rates based on the year of receipt. Bob determines that an election to measure some or all of ABC's pledges at fair value on a recurring basis (through the FVO) may simplify recordkeeping, because all pledges for which the FVO is elected would be remeasured each period using a discount rate reflective of the term of the pledge (i.e., the discount rate in effect at each measurement date), rather than the individual discount rates in effect at the date of each gift. However, Bob must weigh the advantages of simplified recordkeeping against the additional administrative burden associated with FAS 159, in particular the increased disclosure requirements that are required under FAS 157. If the FVO is not elected, ABC will not have any FAS 157 pledge-related disclosures since pledges are only initially recognized at fair value. If the FVO is elected, however, pledges will become recurring fair value measurements, which must be included in FAS 157 tabular disclosures each year. If the measurement of pledges is determined to require Level 3 inputs (as is likely to be the case), disclosure requirements would be even more extensive.

### Split-interest agreements

**Observation:** The FVO is only available for split interest obligations where the NPO serves as trustee.

ABC is a party to a number of split-interest agreements. These agreements come in several forms (e.g., charitable lead annuity trusts, charitable remainder annuity trusts, charitable lead unitrusts, etc.). At present, ABC serves as trustee for split-interest agreements with trust assets of \$50 million<sup>9</sup> and trust obligations (to lead or remainder beneficiaries) of \$22 million. ABC also has \$7.5 million of beneficial interests in split-interest trusts administered by third-party financial institutions.

Whether ABC serves as trustee will dictate whether the FVO election is available for split-interest trusts. If a third-party institution (rather than ABC) serves as the trustee, ABC's beneficial interest in the trust is already required to be measured at fair value on a recurring basis<sup>10</sup> and, thus, the FVO would not be useful. When ABC is the trustee, however:

- ABC recognizes the assets contributed to the trust at fair value, recognizes a liability to the beneficiaries of the lead or remainder interests based on the present value of the estimated payments to be made over a fixed period or their estimated remaining lives, and recognizes the difference as contribution revenue when the agreement is initially executed.
- The trust agreements generally require ABC to invest the trust assets in marketable securities, which are measured at fair value on a recurring basis (as discussed on page 3).
- The trust's liabilities payable to other beneficiaries are measured at fair value only at the time of initial recognition. In subsequent measurements, the present value calculation retains the same discount rate as was used at initial recognition and, thus, are not fair value measurements.

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<sup>9</sup> Included in the \$215 million of marketable securities reported in ABC's balance sheet.

<sup>10</sup> In accordance with paragraph 15 of FAS 136.

Consequently, the FVO election would be available for measuring the trust obligations in circumstances where ABC serves as trustee under the agreement. Similar to the considerations for promises to give, electing this option may simplify recordkeeping, as ABC would remeasure its obligations at fair value each period by adjusting the discount rates to reflect market conditions (as is currently done for beneficial interests in trusts administered by third parties). However, Bob must weigh the advantages of simplified recordkeeping against the additional administrative burden associated with fair value disclosures, especially the increased disclosure requirements that will be required for recurring fair value measurements under FAS 157. Additionally, recurring fair value measurement of the liability must also incorporate considerations associated with nonperformance risk. If the FVO election is not made, there are no additional disclosures required by FAS 157, since the liability is only initially measured at fair value. If the FVO is elected, however, the liability would be subject to recurring fair value measurements and thus, would need to be included in the FAS 157 tabular disclosures each year. If the fair value measurement is determined to involve Level 3 inputs, the recurring disclosures required would be even more extensive.

### **Interests in net assets of financially-interrelated organizations**

ABC reports its interests in the net assets of its financially-interrelated foundations (Foundation X and Foundation Y) of \$50 million in accordance with FAS 136, periodically adjusting those interests for ABC's share of the changes in the Foundations' net assets using a method similar to the equity method of accounting. Because this method does not involve fair value measurement, Bob wishes to consider the merits of electing the FVO for those assets.

In evaluating the pros and cons of electing fair value measurement, Bob determined that the nature and complexity of a particular foundation's mix of assets and liabilities would directly impact the level of difficulty associated with determining that foundation's fair value and would likely determine the extent to which ABC would be inclined to pursue the FVO election.

Bob's FVO analysis related to these interests revealed the following:

**Foundation X** is comprised entirely of marketable securities (carried by the foundation at fair value) and cash. Historically, the carrying value of ABC's interest has been equivalent to the pre-FAS 157 fair values of the Foundation's assets. Although ABC's asset is its interest in the net assets of Foundation X and not the Foundation's underlying assets themselves, Bob believes it is reasonable to assume that the fair value of ABC's interest would, on an ongoing basis, approximate the fair value of the underlying assets. This is because (a) all of Foundation X's holdings are marketable securities (measured at fair value) or cash, and (b) ABC has the ability to influence the timing and amount of the distributions it receives from Foundation X.<sup>11</sup>

Despite the ease of estimating fair value for this interest, Bob determines that little if any benefit would be gained from electing the FVO, as there is little difference between the carrying value of the interest and its fair value. Further, electing the FVO would cause the entire change in fair value of the interest to be included in ABC's performance indicator, potentially subjecting the statement of operations to additional volatility.<sup>12</sup> At present, since ABC has the ability to influence the amount and timing of distributions from Foundation X, the portion of the change in fair value of the interest attributable to unrealized gains and losses on Foundation X's investments is excluded from the performance indicator. (In other words, ABC is able to "look through the foundation" and report the investment activity in the same geographic classifications as it would if it held the investments directly.)

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<sup>11</sup> See AICPA Technical Practice Aid 6400.42 for a discussion of how a healthcare organizations that can influence the timing and amount of distributions from a financially-interrelated foundation should report changes in its interest in the net assets of that foundation that are attributable to unrealized gains and losses on the foundation's marketable securities.

<sup>12</sup> This would not be a concern for NPOs that do not report a standardized performance indicator.

Foundation Y has a more complex balance sheet comprised of investments (some of which are readily marketable, others which are not), property and equipment, and a capital lease obligation. Similar to the considerations noted above for ABC's investment in a joint venture, because Foundation Y has balance sheet items that are not measured at fair value (e.g., the alternative investments, fixed assets, and capital lease obligation), the fair value of ABC's interest in Foundation Y's net assets may differ significantly from its carrying value. Despite the fact that measuring the interest at fair value potentially could impact ABC's balance sheet, there are drawbacks, such as the time, effort and, in some cases, expense required to determine fair value on an ongoing basis. As was the case with Foundation X, electing the FVO would cause the entire change in fair value of the interest to be included in ABC's performance indicator, thus resulting in additional volatility in the statement of operations.

## Student loans

The College's student loan receivables (currently reported at their net realizable value of \$90 million) are financial assets eligible for the FVO. The effect of measuring these loans at fair value instead of net realizable value will result in volatility in the loans' fair value due to differences between market interest rates and stated interest rates on the loans. Thus, if volatility is a concern (e.g., because it could require additional efforts to explain to financial statement users), ABC would need to evaluate whether those concerns would outweigh the benefits.

Additionally, \$75 million of the College's student loans were funded with Perkins Loan program funds.<sup>13</sup> Funds received from the Federal government for this purpose are accounted for as advances (a financial liability also eligible for the FVO). Because there may be legal restrictions limiting the College from transferring the assets and/or liability associated with the Perkins Loan program, this would need to be considered in determining fair value. In addition, if ABC elected the FVO for both the assets and the liability, there may be little if any meaningful impact on the financial statements (that is, any fair value adjustments associated with the gross-up in the balance sheet would offset, so that there is no impact on the statement of activities other than perhaps adjustments to the liability for nonperformance risk).

## Long-term debt and interest rate swaps

### Fixed-rate debt

**Observation:** Derivatives not used in a hedging relationship (e.g., options, futures, etc.) are already carried at fair value and marked-to-market each period. The changes in fair value are recorded within the performance indicator. Therefore, there would be no reason to elect the FVO for non-hedging derivatives.

As an issuer of \$150 million of fixed-rate municipal bonds, ABC is exposed to the risk that changes in interest rates could negatively impact the fair value of its bonds. To mitigate this risk, ABC entered into an interest rate swap that effectively converts the fixed-rate liability into a variable-rate liability. ABC has designated the swap as a fair value hedge of the debt in accordance with FASB Statement No. 133 (FAS 133), *Accounting for Derivatives Instruments and Hedging Activities*. In this type of hedge, the change in the fair value of the derivative is offset by a portion of the change in the fair value of the hedged debt.

Accounting for hedges under FAS 133 is complicated. The FVO provides ABC an opportunity to reduce the efforts required in hedging the risk of changes in the fair value of its debt. FAS 133 already requires the swap to be carried at fair value in the balance sheet (at present, a \$4 million asset); by electing the FVO for the fixed-rate debt, ABC may be able to achieve a "natural hedge" (i.e., changes in fair value of the debt will be offset by changes in the fair value of the swap) without having to apply the often onerous hedging requirements of FAS 133.

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<sup>13</sup> This is a federal government program which provides funding to higher education institutions to enable them to make low-interest student loans available.

However, while the FVO potentially could provide some relief from the rigors of FAS 133 hedge accounting, additional volatility could result. A perfect offset of the changes in fair value between the debt and the derivative will not occur in a "natural hedge" due to the following factors:

- In a FAS 133 fair value hedge, only that portion of the long-term debt attributable to the risk being hedged (e.g., interest rate risk) must be reported at fair value. However, if the FVO is elected for the hedged debt, the entire debt issue must be recorded at fair value.
- Under FAS 133, any changes in fair value of the hedged debt attributable to ABC's changes in credit standing are ignored if the interest rate risk is the designated item. Under the FVO, however, ABC would be required to reflect the impact of changes in its credit standing/nonperformance risk in determining the fair value of its debt. The swap's fair value will be affected by credit standing/nonperformance risk of the swap counterparty (i.e., the financial institution that is party to the contract). Therefore, since the swap is in an asset position, the fair value will reflect the credit standing/nonperformance risk of the counterparty while the fair value of the debt will reflect ABC's credit standing/nonperformance risk. In this case, the fair value changes of the two financial instruments may not offset, creating potential ineffectiveness.

Other pertinent considerations related to electing the FVO include:

- Once elected, the FVO is irrevocable; the debt would have to be measured at fair value throughout the life of the issue. ABC's fixed-rate bonds mature in 30 years; thus, Bob potentially would be committing to fair value measurement for a very lengthy period. Under the FAS 133 fair value hedging rules, Bob can elect to discontinue application of hedge accounting (and therefore, of fair value measurement of the debt) at any time.
- Currently, deferred financing costs are treated as part of the carrying value of ABC's debt, and are amortized over the life of the debt as part of the effective interest cost. FAS 159 requires removal from the balance sheet of any differences between the carrying value and the fair value of items for which the FVO is elected. Thus, all of ABC's unamortized issuance costs associated with the fixed-rate debt would need to be written off as part of the cumulative effect adjustment at transition when the election is made. If the FVO were subsequently elected for any new debt issuances, the associated deferred financing costs would need to be expensed immediately.
- In addition to providing the long-term debt disclosures currently required by FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, election of the FVO would require ABC to provide the ongoing disclosures required for recurring fair value measurements under FAS 157, as well as FAS 159 disclosures.

#### Variable-rate debt

**Observation:** Electing the FVO for variable-rate debt held by non-healthcare NPOs would not be beneficial. Because those NPOs are not permitted to use cash flow hedge accounting, their changes in net assets already are subject to volatility associated with swings in the fair value of the swap, just as they would be if the FVO were elected. Thus, even though there would be no financial statement impact associated with electing the FVO, the NPO would assume the burden of having to provide ongoing FAS 157 disclosures for recurring fair value measurements.

ABC also has \$100 million of variable rate debt that pays LIBOR +2%. ABC is exposed to the risk that the interest rate on its bonds (and therefore ABC's interest costs) could increase. To mitigate this risk, ABC entered into a variable-to-fixed interest rate swap (currently in a liability position of \$19 million) which effectively converts the variable-rate liability into a fixed-rate liability. ABC has designated the swap as a cash flow hedge in accordance with FAS 133.<sup>14</sup> In a cash flow hedge, the effective portion of changes in the fair value of the swap are excluded from the performance indicator until such time as the forecasted transaction affects earnings, thus shielding ABC from some or all of the volatility associated with changes in fair value of the swap.

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<sup>14</sup> FAS 133 cash flow hedge accounting is available to not-for-profit health care organizations because they report a standardized performance indicator. NPOs that do not report a standardized performance indicator cannot utilize cash flow hedge accounting.

Bob determined that electing the FVO for ABC's variable rate debt would not likely be practicable. Changes in the fair value of variable rate debt are reflected as changes in the variable interest rate, not as changes in the amount of liability reported in the balance sheet.<sup>15</sup> Thus, adopting the FVO would subject ABC's operating results to volatility associated with swings in the fair value of its swap, with no offsetting impact of changes in the fair value of the debt other than adjustments for changes in the underlying credit/nonperformance risk of ABC.

### **Other considerations**

Other broader considerations that Bob must keep in mind with respect to FVO elections include:

- Situations identified by the AICPA's Center for Audit Quality in which making a FVO election could be deemed inappropriate if the election is not considered substantive.<sup>16</sup>
- The extent to which changes to internal controls would be required for accounts for which the FVO is elected.
- The potential impact of FVO elections on restrictive covenants (e.g., in debt agreements).
- The expanded disclosures that are associated with the FVO. In addition to robust disclosure requirements under FAS 159, ABC will also have to comply with FAS 157's disclosure requirements for recurring fair value measurements.<sup>17</sup>

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<sup>15</sup> Variable rate debt by its nature is issued and trades in the market at par, with changes in the interest rate reflecting changes in the market for the debt.

<sup>16</sup> An Alert was issued by the Center for Audit Quality Alert in April 2007 (CAQ Alert No. 2007-14), when some companies were early adopting FAS 159. Certain proposed applications of FAS 159 that were deemed inappropriate were observed during the period of early adoption. Such applications would similarly not be considered acceptable upon adoption by ABC in fiscal 2009.

<sup>17</sup> Appendix B of FAS 159 includes an example of a disclosure that integrates FAS 159's disclosure requirements with the requirements in both FAS 157 and FAS 107. The example is for illustrative purposes only and does not present the only method to comply with the disclosure requirements.

## Key questions

Prior to making any FVO elections, Bob must consider the following:

- Would increased volatility in its statement of operations be a concern? For example, would that increased volatility have implications for any restrictive covenants (e.g., associated with debt agreements)?
- Is creating symmetry in the accounting for gains and losses on FAS 124, available-for-sale investments, important to ABC (i.e., eliminating OTTI)?
- How significantly would simplifying recordkeeping for investments, contributions, split-interest agreements, etc. benefit ABC?
- Would the benefits of "natural hedges" outweigh the downsides?
- Overall, do the potential benefits of electing the FVO outweigh the burden associated with the expanded disclosure requirements that would be required?
- By changing the measurement basis to fair value, what implications would applying FAS 157/159 have for ABC and for the audit?

## Appendix—Summary of considerations

The following table summarizes the significant pros and cons associated with electing the fair value option for assets and liabilities discussed in this guide.

Asset or liability	Pros	Cons
Trading securities	<ul style="list-style-type: none"> <li>None, as mark-to-market adjustments are already reported within the performance indicator.*</li> </ul>	<ul style="list-style-type: none"> <li>None, as mark-to-market adjustments are already reported within the performance indicator.*</li> </ul>
Available-for-sale securities	<ul style="list-style-type: none"> <li>Simplified record keeping.</li> <li>Symmetrical reporting of gains and losses (realized and unrealized would both be reported within the performance indicator*).</li> <li>Eliminates the necessity of evaluating other-than-temporary impairments.</li> <li>Unrealized gains will be included within the performance indicator.*</li> </ul>	<ul style="list-style-type: none"> <li>Increased volatility within the performance indicator* will require: <ul style="list-style-type: none"> <li>Assessment of impact on internal budgeting and forecasting, contractual arrangements (e.g., debt covenants, compensation arrangements, etc).</li> <li>Communication/disclosure to users of financial statements to improve their ability to interpret the affects of volatility.</li> </ul> </li> </ul>
Alternative investments carried under the equity method or at cost	<ul style="list-style-type: none"> <li>More faithful representation of value on balance sheet.</li> </ul>	<ul style="list-style-type: none"> <li>Increased volatility within the performance indicator* will require: <ul style="list-style-type: none"> <li>Assessment of impact on internal budgeting and forecasting, contractual arrangements (e.g., debt covenants, compensation arrangements, etc).</li> <li>Communication/disclosure to users of financial statements to improve their ability to interpret the affects of volatility.</li> </ul> </li> <li>Requires internal control assessment to ensure adequate controls are in place to support fair value assertions.</li> <li>Time, effort and cost associated with fair value measurement.</li> <li>Increased disclosure requirements.</li> </ul>
Alternative investments carried at fair value**	<ul style="list-style-type: none"> <li>None, as they are already carried at fair value.</li> </ul>	<ul style="list-style-type: none"> <li>None, as they are already carried at fair value.</li> </ul>
Contribution receivable—Multi-year promises to give cash	<ul style="list-style-type: none"> <li>Some simplification of record keeping.</li> </ul>	<ul style="list-style-type: none"> <li>Time, effort and cost associated with fair value measurement.</li> <li>Increased disclosure requirements.</li> </ul>

\* Performance indicator as defined in AAG-HCO.

\*\* Applies only to “other investments” carried at fair value under Chapter 8 of AAG-NPO.

Asset or liability	Pros	Cons
Noncontrolling interest in joint venture (or partially owned entities)	<ul style="list-style-type: none"> <li>• More faithful representation of value on balance sheet.</li> </ul>	<ul style="list-style-type: none"> <li>• Increased volatility within the performance indicator* will require:               <ul style="list-style-type: none"> <li>- Assessment of impact on internal budgeting and forecasting, contractual arrangements (e.g., debt covenants, compensation arrangements, etc).</li> <li>- Communication/disclosure to users of financial statements to improve their ability to interpret the affects of volatility.</li> </ul> </li> <li>• Requires internal control assessment to ensure adequate controls are in place to support fair value assertions.</li> <li>• Time, effort and cost associated with fair value measurement.</li> <li>• Increased disclosure requirements.</li> </ul>
Obligations under split-interest agreements—NPO serves as trustee	<ul style="list-style-type: none"> <li>• Some simplification of record keeping.</li> </ul>	<ul style="list-style-type: none"> <li>• Increased volatility within the performance indicator* and/or temporarily restricted net assets will require:               <ul style="list-style-type: none"> <li>- Assessment of impact on internal budgeting and forecasting, contractual arrangements (e.g., debt covenants, compensation arrangements, etc).</li> <li>- Communication/disclosure to users of financial statements to improve their ability to interpret the affects of volatility.</li> </ul> </li> <li>• Requires internal control assessment to ensure adequate controls are in place to support fair value assertions.</li> <li>• Time, effort and cost associated with fair value measurement.</li> <li>• Increased disclosure requirements.</li> </ul>
Interest in net assets of financially-interrelated organization	<ul style="list-style-type: none"> <li>• More faithful representation of value on balance sheet.</li> </ul>	<ul style="list-style-type: none"> <li>• Increased volatility within the performance indicator* and/or temporarily restricted net assets will require:               <ul style="list-style-type: none"> <li>- Assessment of impact on internal budgeting and forecasting, contractual arrangements (e.g., debt covenants, compensation arrangements, etc).</li> <li>- Communication/disclosure to users of financial statements to improve their ability to interpret the affects of volatility.</li> </ul> </li> <li>• Requires internal control assessment to ensure adequate controls are in place to support fair value assertions.</li> <li>• Time, effort and cost associated with fair value measurement.</li> <li>• Increased disclosure requirements.</li> </ul>

\* Performance indicator as defined in AAG-HCO.

\*\* Applies only to “other investments” carried at fair value under Chapter 8 of AAG-NPO.

Asset or liability	Pros	Cons
Long-term debt and derivatives (e.g., interest rate swaps)	<ul style="list-style-type: none"> <li>• May eliminate need to pursue FAS 133 hedge accounting.</li> </ul>	<ul style="list-style-type: none"> <li>• Increased volatility within the performance indicator* and/or temporarily restricted net assets will require: <ul style="list-style-type: none"> <li>- Assessment of impact on internal budgeting and forecasting, contractual arrangements (e.g., debt covenants, compensation arrangements, etc).</li> <li>- Communication/disclosure to users of financial statements to improve their ability to interpret the affects of volatility.</li> </ul> </li> <li>• Requires internal control assessment to ensure adequate controls are in place to support fair value assertions. <ul style="list-style-type: none"> <li>- Time, effort and cost associated with fair value measurement.</li> </ul> </li> <li>• Increased disclosure requirements.</li> <li>• Changes in the fair value of the debt will not be fully offset by changes in a swap.</li> </ul>
Student loans	<ul style="list-style-type: none"> <li>• More faithful representation of value on balance sheet.</li> </ul>	<ul style="list-style-type: none"> <li>• Increased volatility within the performance indicator* and/or temporarily restricted net assets will require: <ul style="list-style-type: none"> <li>- Assessment of impact on internal budgeting and forecasting, contractual arrangements (e.g., debt covenants, compensation arrangements, etc).</li> <li>- Communication/disclosure to users of financial statements to improve their ability to interpret the affects of volatility.</li> </ul> </li> <li>• Requires internal control assessment to ensure adequate controls are in place to support fair value assertions.</li> <li>• Time, effort and cost associated with fair value measurement.</li> <li>• Increased disclosure requirements.</li> </ul>

\* Performance indicator as defined in AAG-HCO.

\*\* Applies only to “other investments” carried at fair value under Chapter 8 of AAG-NPO.

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