

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

Impact of FAS 157 on contribution accounting*

A guide for not-for-profit organizations

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Introduction

FASB Statement No. 157 (FAS 157), *Fair Value Measurements*, is a broad principle-based standard that provides a consistent model for determining fair value measures. Over time, the concept of fair value and the requirement to use fair value to report amounts in financial statements have been incorporated into numerous accounting standards. However, in practice, both the methods used to measure fair value and the nature and extent of the disclosures describing fair value measures have varied, leading to a lack of comparability in financial reporting. FAS 157 was issued to address these concerns. FAS 157 does not require a fair value measurement for any assets or liabilities that are not currently carried at fair value. Instead, it provides a comprehensive, consistent framework for measuring and disclosing fair value whenever the use of fair value is required (or, where applicable, has been elected¹) by another accounting standard.

Observation: From a practical perspective, in many cases, the transaction price may equal the exit price and, therefore, represent the fair value of the asset or liability.

FAS 157 introduces a number of new concepts. Under FAS 157, preparers and auditors must throw out the historical "entry price" notion that was typically used for previous fair value measurements (i.e., that fair value is evidenced by the price paid to acquire an asset or received to assume a liability). Instead, fair value is based upon an "exit price" notion—the price that would be received to sell an asset or paid to transfer a liability. They must also throw

out the idea that fair value is an entity-specific measurement. Consistent with an exit price notion, fair value under FAS 157 is a market-based measurement; that is, it is measured based on what an asset's "highest and best use" would be in the hands of a "market participant."

Understanding these concepts and applying them to the measurement of certain assets and liabilities—for example, equity securities traded in active markets—is relatively straightforward. However, applying these concepts in measuring assets and liabilities for which there is no observable market—for example, those associated with charitable contributions—is likely to present challenges as well as implementation issues.

Observation: PwC's Guide to Fair Value Measurements (the "Guide") provides further guidance regarding the application of FAS 157 to other accounts relevant to not-for-profit organizations. Appendix A includes cross references to that Guide.

Using a case study format, this guide provides a high-level overview of the FAS 157 framework and then explores how FAS 157 could be applied to contribution-related fair value measurements.

FAS 157 is effective for fiscal years beginning after November 15, 2007, with the exception of certain nonfinancial assets and liabilities for which the effective date is fiscal periods beginning after November 15, 2008.²

¹ Two accounting standards, FASB Statement No. 159 (FAS 159), *Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115* and FASB Statement No. 155 (FAS 155), *Accounting for Certain Hybrid financial Instruments*, provide for an election to measure certain financial assets and liabilities at fair value.

² FSP FAS 157-2, *Effective Date of FASB Statement No. 157*, delayed the effective date of FAS 157 for all nonrecurring nonfinancial assets and liabilities until fiscal periods beginning after November 15, 2008.

Meet Marty Balletta

Marty Balletta, CFO of Nonprofit University System (the "System"), is preparing for a meeting with the System's Finance Committee in which the accounting and reporting implications of FAS 157 for the System's contributions will be discussed. The System's fiscal year ends on June 30. Since FAS 157 requires a beginning of the year adoption, the System must adopt FAS 157 on July 1, 2008.

Observation: An NPO may elect to early adopt the provisions of FAS 157 for nonfinancial assets and liabilities that are recognized or disclosed at fair value on a nonrecurring basis and for which application of FAS 157 was deferred by FSP FAS 157-2. However, if FAS 157 is early adopted, it must be adopted for ALL items covered by the FSP.

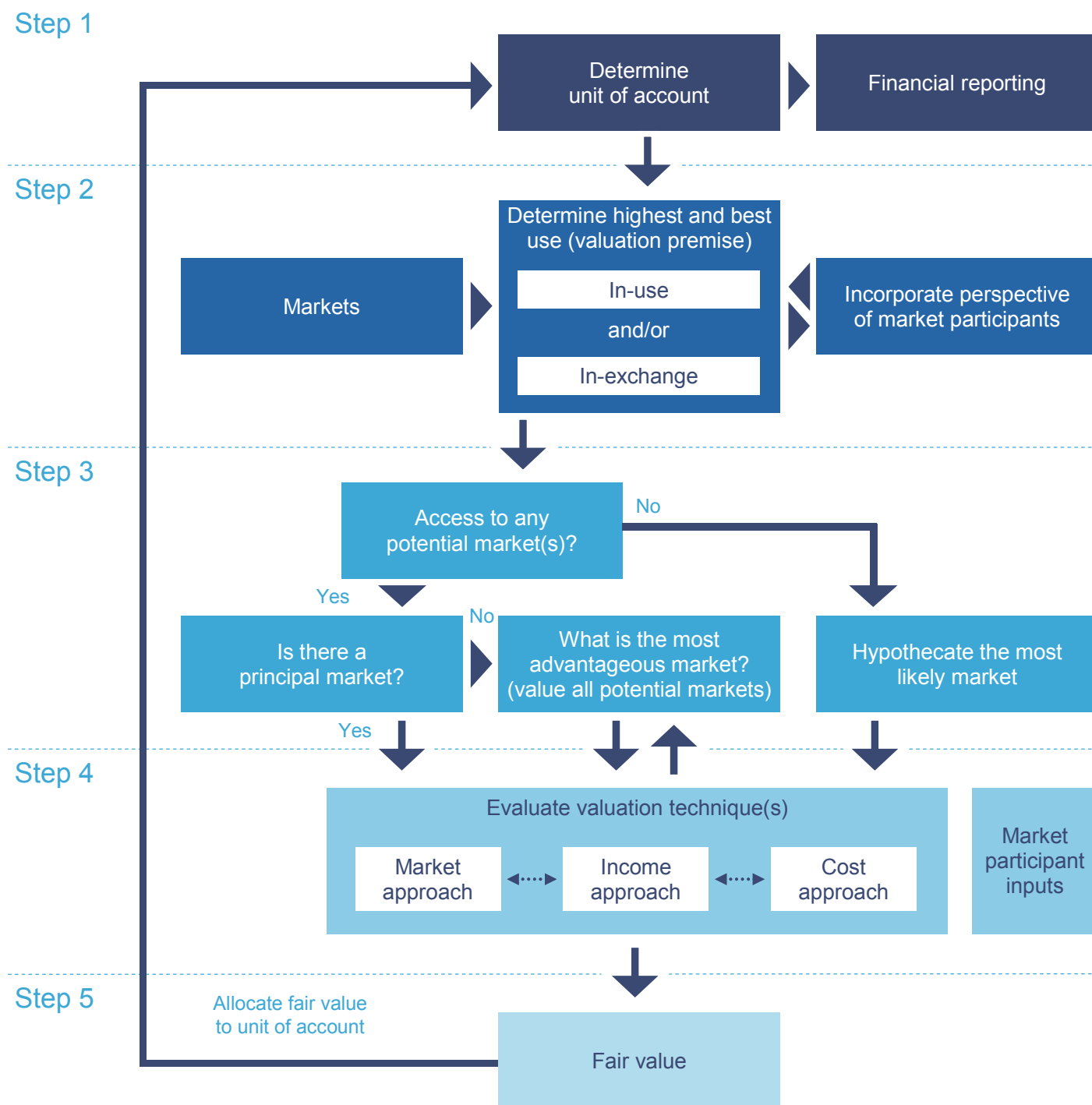
Marty became aware that FAS 157 has a dual-implementation date based upon the type of asset or liability and the frequency of fair value measurement. For all financial assets and liabilities and for nonfinancial assets and liabilities measured at fair value on a recurring basis, the effective date for the System is July 1, 2008. However, for nonfinancial assets and liabilities that are measured at fair value on a nonrecurring basis, the FASB delayed the effective date for one year (i.e., 7/1/09 for the System). Marty determined that the difference between "financial" and "nonfinancial" is pretty intuitive, with financial assets and liabilities generally being those that settle in cash or other financial instruments, while nonfinancial assets and liabilities are those that do not. Measurement of an asset or liability at fair value at least annually is considered to be a recurring fair value measurement, while those measurements that occur only upon initial

recognition are considered to be nonrecurring fair value measurements. Examples of contribution-related transactions that fall into the various categories are as follows:

	Recurring fair value measurements	Nonrecurring fair value measurements
Financial assets/liabilities	Not eligible for deferral (e.g., Beneficial interest in charitable trust)	Not eligible for deferral (e.g., Pledges receivable)
Nonfinancial assets/liabilities	Not eligible for deferral (e.g., Contributed real estate reported as "other investments" under AICPA Audit and Accounting Guide, Not-for-Profit Organizations (AAG-NPO) at fair value)	Eligible for deferral (e.g., Contributed real estate not reported as an "other investment" under AAG-NPO; gifts-in-kind)

Overview of the FAS 157 framework

The following flowchart depicts the five step process that the System has decided to follow in making fair value measurements.



Step 1: Determine what is being measured (the "unit of account" and its attributes for each asset or liability)

Marty will first determine the "unit of account" (i.e., what is being measured) for each item. As discussed in FAS 157, paragraph 6, the unit of account is determined based on other applicable GAAP and considers the attributes of the asset/liability when measuring fair value. For example, FASB Statement No. 116 (FAS 116), *Accounting for Contributions Received and Contributions Made*, requires the System to measure each promise to give individually and therefore each promise to give would represent a unit of account.

The attributes of the specific asset or liability being measured include its nature and composition (e.g., a stream of future cash flows, a security evidencing ownership in another organization, a physical asset), and any restrictions or legal limitations associated with selling the asset. A key attribute of donor-related assets is an inability to transfer those assets into the for-profit sector.³

Step 2: Determine valuation premise for the asset or liability

FAS 157 requires the fair value of an asset or liability to be determined based on a hypothetical sale of the asset or hypothetical transfer of the liability. The valuation premise provides information about the "hypothetical" exchange that forms the basis for the fair value measurement. For assets, it considers how "market participants" would use the asset to maximize its value (i.e., the asset's "highest and best use"), taking into account the asset's characteristics and considering only those uses of the asset that are physically possible, legally permissible, and financially feasible.

From whose perspective is the "highest and best use" of an asset determined? It's not from the System's perspective—in fact, how the System intends to use the asset is irrelevant. Rather, the perspective that matters is what a market participant—an unbiased, impartial, independent party who is a hypothetical buyer in the market for the asset—might be willing to pay to acquire the asset based on what it would view as the most profitable use of the asset.

When evaluating the "highest and best use" of an asset, Marty must also consider whether a market participant would likely transact for the asset in connection with other assets (an "in-use" valuation premise) or on a standalone basis (an "in-exchange" valuation premise). Marty learns that generally, a presumption exists that financial assets will be valued "in-exchange." Non-financial assets, on the other hand, can't always be separately exchanged or may have more value when used with complementary assets and, thus, may have an "in-use" valuation premise. Assets that are not likely to transfer apart from a business combination (e.g., donor list intangibles) also would be presumed to have an "in-use" valuation premise.

Observation: Whether a restriction on use transfers to a market participant may require the System to have conversations with donors or legal counsel to clarify the nature of the restriction.

When determining the valuation premise, a restriction on the use of an asset should be considered if the restriction is an attribute of the asset that would transfer to a market participant. The determination of whether a restriction exists (legal or otherwise) may require the advice of legal counsel and/or considerable management judgment. An example of a restriction that should be considered as part of the valuation premise would be one that is legally incorporated into the deed of contributed real estate. Therefore, if the property

were sold to a third party, the restriction would transfer with the real estate. Alternatively, if a piece of equipment was contributed with only a donor's restriction that it be used for a specified purpose while held by the System, that restriction would not transfer to subsequent owners and thus, its impact on fair value at the date of donation should not be considered.⁴

³ State Attorneys General are vigilant in scrutinizing "for-profit conversions" to ensure that net assets irrevocably committed to a charitable purpose do not move into the for-profit sector. Specifically, the organization and subsequent operation of "charitable conversion" foundations or similar entities (e.g., foundations formed with the proceeds from the sale of a not-for-profit hospital to a for-profit hospital) are rigorously examined.

⁴ See FAS 157, Appendix A, example 9, for an illustration of the consideration of restrictions on contributed assets when determining fair value.

Liabilities are valued based on the price that a market participant would require to assume the liability on the measurement date.

Step 3: Identify market(s) and market participants

Next, Marty will need to identify the appropriate markets for the asset or liability being measured.

The purest form of fair value measure involves observable prices associated with sales or transfers in a "principal market" (meaning the market where the entity generally purchases or sells the asset/liability with the greatest volume or level of activity). So the normal starting point for this part of the analysis is to determine whether the System normally purchases or sells the asset and, if so, in which market that normally occurs. For example, if the asset being measured is a marketable equity security, the principal market would be the stock market where the System would normally purchase and sell such securities. Existence of a principal market simplifies measurement—fair value is generally represented by the price in that market. No consideration is given to any other existing or potential markets, as they are considered inferior to the principal market.

Observation: With the exception of promises to give and split-interest agreements, most contribution-related assets will have a principal market (e.g., debt and equity markets or real estate markets) that the System will utilize in measuring fair value.

If no principal market exists, Marty would next consider whether a "most advantageous market" exists (i.e., an existing market in which the System is capable of selling the asset or transferring the liability to a credit equivalent market participant) that would maximize the amount received for the asset (or minimize the amount required to be paid to transfer the liability).

If the asset or liability being measured does not have a principal or most advantageous market, Marty will need to develop a "hypothetical market." For example, certain not-for-profit assets arising from contributions (such

as promises to give and beneficial interests in trusts) typically transfer only in not-for-profit business combination transactions (e.g., mergers between not-for-profit organizations or acquisitions of one not-for-profit organization by another). In constructing a hypothetical market, Marty would need to identify parties hypothetically interested in transacting with the System for the assets or liability. Thus, a not-for-profit university located in a service area that both for-profit and not-for-profit universities are looking to enter may have a wide range of potential market participants to consider when establishing valuation assumptions. However, Marty must also keep in mind the fact that the sale of charitable assets is limited to only those to whom such transfers would be legally permissible (see Step 2). Thus, even though generally speaking a for-profit entity could hypothetically transact with a not-for-profit organization, if the asset being measured could not be legally transferred to a for-profit entity, then the hypothetical market used in valuation assumptions for that asset shrinks to include only those market participants that are eligible to receive a transfer of such assets, such as not-for-profit (and potentially, governmental) organizations.

Unlike the determination of the "highest and best use" of the asset described in Step 2, the identification of markets and market participants should be considered from the perspective of the System, thereby allowing for differences between and among entities that may have different levels of market access, or that may be involved in different activities.

Step 4: Apply the appropriate valuation technique(s) for the asset or liability

Under FAS 157, Marty will consider the appropriateness of three techniques for valuing the asset or liability: the market approach, the income approach, and the cost approach.

- **Market approach**—uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.
- **Income approach**—uses valuation techniques to convert future amounts (e.g., cash flows) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. FAS 157 does not prescribe the use of one present value technique to measure fair value, but does provide examples of two possible techniques, the "discount rate adjustment" and the "expected present value."
- **Cost approach**—bases valuation on the amount that currently would be required to replace the service capacity of a physical asset.

These approaches are not new; they have been used in valuation estimates for many years. What differs in the FAS 157 framework is that they are applied from the market participants' perspective, rather than from the reporting entity's perspective. For example, if the System were to utilize the income approach in valuing an asset, the discount rate used would be a rate that is attributable to hypothetical market participants who might be interested in acquiring the asset, rather than the System's own discount rate.

Each of these valuation techniques employs different types of data inputs. The quality of the inputs is based on a presumption that, given the same economic circumstances, independent market prices are more reliable and comparable than entity-specific estimates based on the reporting entity's internal data. FAS 157 embodies this notion by establishing a three-level "fair value hierarchy" that gives the highest priority to quoted prices unadjusted in active markets for identical assets (i.e., observable inputs) and the lowest priority to inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances (i.e., unobservable inputs):

- **Level 1** inputs are quoted prices of identical items in active markets.
- **Level 2** inputs involve adjusting data from similar items traded in active markets, or from identical or similar items in markets that are not active.
- **Level 3** inputs are "unobservable" and are generated by the entity itself (i.e., using the entity's own data). In this situation, the entity's own assumptions/ data represent the starting point, but those assumptions must be adjusted if information is reasonably available that indicates that market participants would make different assumptions in pricing the asset or liability.

The attributes of the specific asset or liability being measured coupled with the quality/reliability of inputs available determines which valuation technique (or techniques) will ultimately be used to estimate fair value. Marty will consider each valuation technique that is appropriate in the circumstances and for which market participant pricing inputs can be obtained without undue cost and effort. In some analyses, a single valuation technique will be appropriate; in others, multiple valuation techniques should be considered. If multiple valuation techniques can be used, the results should be evaluated or weighted and a point within the range that is most representative of the fair value should be used.

Determining whether a fair value measurement is based on Level 1, Level 2, or Level 3 inputs is important because disclosure requirements are significantly expanded for contributions that are recurring fair value measurements that use Level 3 inputs. The level in the fair value hierarchy at which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is significant to the measurement. Determining the significance of a particular input to a fair value measurement is a matter of judgment with no bright line for making that determination. Given the level of judgment that may be involved, Marty should document his rationale when the determination of the classification of inputs in the fair value hierarchy is not straightforward.

Step 5: Determine Fair Value

Taken together, the determination of a market and market participants, and the application of valuation technique(s), will result in a fair value measurement. If the valuation relates to an asset that was valued on an "in-use" premise (i.e., as part of a group), the total fair value must be allocated to each unit of account in the asset grouping based on the specific facts and circumstances. Organizations should adopt a reasonable, practical policy to allocate adjustments to individual units of account and should apply the policy consistently.

Applying the FAS 157 framework to contributions

Now that Marty has a feel for the overall FAS 157 framework, he considers how adoption of FAS 157 will impact existing contribution-related assets, liabilities, and disclosures, and also how the accounting for contributions received subsequent to adoption of FAS 157 will change. In some cases, adoption of FAS 157 will require significant changes to the process by which the System has historically determined fair value; in others, there may be little difference.

Marty believes that the concept of "markets" makes sense when talking about physical assets or financial instruments, such as stocks or bonds. However, contribution-related assets and liabilities are not sold or transferred in markets—in fact, Marty wonders if it would even be possible to transfer them to another party. Nonetheless, the FAS 157 framework requires Marty to construct a hypothetical market in which such transactions might be possible. Due to the charitable nature of the assets and liabilities, the hypothetical market participants that Marty identifies typically would be other NPOs (or possibly, governmental entities) that might be interested in acquiring the System's assets and liabilities.

The examples on the following pages apply the FAS 157 framework to different types of contributions.

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Example 1—Promises to give (pledges)

The carrying amount of the System's existing promises to give would not be impacted by adoption of FAS 157, unless the System elects the FAS 159 fair value option for those assets. However, during the current fiscal year, the System expects to receive an unconditional promise to give \$500,000 in cash over each of the next three years (\$1.5 million total). There are no collectibility concerns with respect to the prospective donor.

Step 1: Determine unit of account	FAS 116 requires the System to measure each promise to give individually. Therefore, the unit of account is the individual promise to give.
Step 2: Evaluate valuation premise	The determination of the valuation premise for promises to give cash presents conceptual challenges. A promise to give cash represents a stream of future cash in-flows. Because it is an asset that is expected to be settled in cash, a pledge is considered a financial asset. A presumption exists in FAS 157 that the valuation premise for a financial asset will be "in-exchange" even though some believe that the valuation premise may arguably be "in-use" since promises to give would only be transferred with other assets of the organization (e.g., in a business combination). From a practical perspective, the valuation premise selected will likely not significantly change the fair value measurement since the System will use the same valuation technique (income approach).
Step 3: Assess access to markets	In this situation there would not be a principal market for the asset on a standalone basis, nor would there be a most advantageous market; instead, Marty would need to hypothecate a market of NPOs (or possibly, governmental entities) that might be interested in acquiring the assets. (See discussion on page 5.)
Step 4: Consider valuation technique	For the reasons discussed in Step 3 above, there is no ability to apply the market approach. Neither can the cost approach be applied, as the promise to give is a financial asset (versus physical assets) and therefore does not have a "service capacity" for which a replacement cost can be estimated. Thus, the fair value of the promise to give will continue to be measured using a single valuation technique—the income approach.
Step 5: Determine fair value	<p>On its face, using the income approach is consistent with the System's prior practice for valuing pledges and is therefore familiar. However, under the FAS 157 model, the key input that will likely change is the discount rate used to convert the expected future cash flows associated with the pledge to a single present value amount. Previously, the AAG-NPO prescribed the use of the risk-free rate, while under FAS 157's discount rate adjustment technique the rate should be based upon the rate a market participant would demand. One potential rate would be the market participant's endowment or investment return (which may be similar to the System's endowment/investment return). The timeframe 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.</p> <p>When estimating the expected future cash flows, the System should continue to incorporate the following considerations: when the promise to give is expected to be collected, past collection experience, organization's policy on enforcing promises to give, creditworthiness of the donor, and any other relevant factors.</p>
Hierarchy/disclosure considerations	Assuming the System has not elected the fair value option for measuring promises to give, pledges will involve fair value measurement only upon initial recognition. Thus, there will be no additional disclosure requirements under FAS 157, since additional disclosures are only required if there is a fair value measurement subsequent to initial recognition.

Example 2—Noncash contributions of physical assets

The System sometimes receives gifts of tangible physical assets, such as real estate. Marty decides to identify FAS 157 considerations in light of a recent gift of an office building located in an area that is zoned for both commercial and residential purposes.

Step 1: Determine unit of account	The unit of account is the contributed office building under FAS 116.
Step 2: Evaluate valuation premise	<p>In the eyes of different market participants, physical assets such as buildings could potentially have alternative uses. An acquired building could be placed into service or, alternatively, torn down and the underlying land used for a different purpose. Given the variety of potential alternatives for using physical assets, the appropriate valuation premise (in-exchange or in-use) will need to be determined on a gift-by-gift basis.</p> <p>In this case, Marty determines that a market participant would most likely be willing to pay to acquire the donated land and building on a standalone basis (i.e., in-exchange), rather than as part of an acquisition of a larger group of complementary System assets (i.e., in-use).</p>
Step 3: Assess access to markets	<p>In this example the System does not have a principal market because it does not regularly transact in real estate. Since no principal market exists, the fair value measurement will be based on prices in both the commercial and residential markets, which are considered the most advantageous markets under FAS 157.</p>
Step 4: Consider valuation technique	<p>Market approach—While the real estate markets generally do not involve sales of identical assets, they do involve sales of similar assets, with adjustments made for differences in characteristics. Thus, Marty could obtain market comparable data for the real estate (via an appraisal or otherwise). When obtaining market comparables, Marty must keep in mind the “highest and best use” concepts by determining whether the building has greater potential value to market participants as a commercial property (e.g., as a medical office building) or as residential property (e.g., condos). When considering market comparables for residential use, Marty will need to incorporate the cost of converting the building since it is currently designed for commercial use.</p> <p>Income approach—Marty could perform a discounted cash flow analysis based upon expected future cash inflows using market rental rates and outflows based on expense forecasts for both the residential and commercial use because the cash flows are likely to be different (including any cost to convert to residential purposes).</p> <p>Cost approach—Marty could estimate the replacement cost of the building; this is a common valuation method used for real estate.</p> <p>Many times independent appraisers will utilize all of these techniques in their estimates of fair value. Marty will need to determine which of these techniques or combination thereof will result in the most representative fair value from a market participant’s perspective after consideration of highest and best use. Additionally, since the valuations performed may be prepared for both the commercial and residential markets, Marty would need to consider the higher fair value of both these valuations.</p>
Step 5: Determine fair value	<p>Marty concludes that since all three valuation approaches provide meaningful data points, the System should use all three approaches in determining fair value. Therefore, fair value is determined using a weighted average approach (market 50%, income 25%, and cost 25%). The weighted average is determined based upon management’s judgment and discussions with the external appraiser.</p>
Hierarchy/disclosure considerations	<p>Unless the contributed real estate represents an “other investment” that is carried at fair value by the System on a recurring basis in accordance with Chapter 8 of AAG-NPO, the contribution is only measured at fair value at initial recognition. Thus, there will be no additional disclosure requirements under FAS 157, since additional disclosures are only required if there is a fair value measurement subsequent to initial recognition.</p> <p>Note: For organizations that report alternative investments at fair value under AAG-NPO, the disclosures under FAS 157 for recurring measurements would be required.</p>

Example 3—Charitable split-interest trusts (System is trustee)

For purposes of this example, assume that the System serves as trustee on all irrevocable charitable remainder annuity trusts (CRATs) of which it is a beneficiary, and that the trust agreements require investment of trust assets in marketable securities. According to Chapter 6 of AAG-NPO, the System recognizes the assets contributed to the trust at fair value, recognizes a liability to the beneficiaries of the lead interests based on the present value of the estimated payments to be made over the estimated remaining life of those beneficiaries, and recognizes the difference as contribution revenue. Thereafter, the trust assets are measured at fair value on a recurring basis. The obligation to the lead beneficiaries continues to be determined utilizing the same measurement technique (present value) and the same discount rate for subsequent measurements as were used at initial recognition and, thus, is not measured at fair value on a recurring basis.

With respect to the existing CRATs carried on the System's books at the time FAS 157 is adopted, Marty determines that there is no impact beyond those pertaining to the ongoing valuation of marketable securities (which are outside the scope of this guide). However, Marty has recently been notified that the System is a beneficiary of a new CRAT under which the donor's spouse will receive an annuity payment of a specified dollar amount for the remainder of the spouse's life. Thus, considerations related to that gift are discussed below.

Step 1: Determine unit of account	When an organization serves as a trustee of a charitable trust of which it is also a beneficiary, there are two units of account to consider ⁵ : the trust assets (investments) and the liability to the noncharitable beneficiary. In this fact pattern, the trust assets are invested in marketable securities and, thus, fair value considerations related to FASB Statement No. 124, Accounting for Certain Investments Held by Not-for-Profit Organizations, would apply. (The remainder of this example focuses on considerations related to measurement of the liability side of the split-interest agreement. The unit of account is the liability as defined by AAG-NPO.)
Step 2: Evaluate valuation premise	The obligation to the widower is a financial liability (a stream of future cash outflows); therefore, the valuation premises for a financial liability will be "in-exchange."
Step 3: Assess access to markets	Marty determines that there is no principal or most advantageous market. Therefore, Marty will consider the most likely (hypothetical) a market in which the System could transfer its obligation.
Step 4: Consider valuation technique	<p>Market approach—Marty is aware that certain NPOs may transfer split-interest annuity obligations to insurance companies. The System, however, has never entered into such transactions and has no existing relationships to facilitate obtaining market quotes. Based upon the potential undue cost and burden of obtaining quoted prices from insurance companies, Marty determines that utilizing a market valuation technique would be impractical.</p> <p>Income approach—Marty could perform a discounted cash flow analysis based on the expected annuity payments to be made over the beneficiaries expected remaining life. Although the trust (rather than the System) is the primary obligor for the liability (i.e., the obligation is fully secured (collateralized) by the assets in the trust), defaulting to the risk-free discount rate would be inappropriate. However, the risk-free rate could be a starting point from which market participants might make adjustments for servicing costs and risks inherent in the cash flows (e.g., servicing, mortality, and other uncertainties).</p> <p>Cost approach—Not applicable to valuation of a liability.</p>
Step 5: Determine fair value	Marty determines that the income approach provides the best estimate of fair value. When determining the appropriate discount rate under this approach, Marty starts with the risk-free rate and adjusts it for the costs associated with servicing the assets and for mortality risk (i.e., risk that lifespan of the spouse is different than expected) and servicing risk (i.e., risk that the cost of servicing will change). No adjustment was made for the System's nonperformance risk since the liability is fully collateralized.
Hierarchy/disclosure considerations	The split-interest obligation is measured at fair value only at the inception of the agreement (i.e., on a nonrecurring basis) and, therefore, there will be no additional disclosure requirements under FAS 157, since additional disclosures are only required if there is a fair value measurement subsequent to initial recognition.

⁵ Some may question why "contribution revenue" isn't the unit of account, as it too is initially measured at fair value. FAS 157 focuses solely on valuation of assets and liabilities. In the case of the charitable trust, contribution revenue is the "residual" of the asset minus the liability and therefore, fair value considerations related to contribution revenue are inherent in the measurement of the asset and liability.

Example 4—Charitable split-interest trusts (third-party trustee)

For purposes of this example, assume that all charitable unitrusts of which the System is a beneficiary are administered by third-party trustees, such as financial institutions. According to paragraph 15 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*, a beneficiary with an unconditional right to receive specified cash flows from a charitable trust must report its beneficial interest in the trust (initially and subsequently) at fair value. Marty determines that adoption of FAS 157 therefore will affect the existing charitable remainder unitrusts (CRUTs) carried on the System's books at the time FAS 157 is adopted as well as beneficial interest received in new CRUTs subsequent to adoption. Those considerations are discussed below.

Step 1: Determine unit of account	There is a single unit of account. In accordance with FAS 136, it is the System's beneficial interest in the cash flows from the trust.
Step 2: Evaluate valuation premise	A beneficial interest represents a stream of future cash in-flows. Because it is an asset that is expected to be settled in cash, a beneficial interest is considered a financial asset. A presumption exists in FAS 157 that the valuation premise for a financial asset will be "in-exchange," even though some believe that the valuation premise may be "in-use" since the beneficial interest would only be transferred with other assets of the organization (e.g., business combination). From a practical perspective, the valuation premise selected will likely not significantly change the fair value measurement since the System will use the same valuation technique (income approach).
Step 3: Assess access to markets	In this example the System would not have a principal market for the interest on a standalone basis, nor would it have a most advantageous market; instead, Marty would need to hypothecate a market of NPOs (or possibly, governments) that might be interested in acquiring the System's beneficial interest. (See discussion on page 5.)
Step 4: Consider valuation technique	For the reasons discussed in Step 3 above, there is no ability to apply the market approach. Neither can the cost approach be applied, as beneficial interests are financial assets (versus physical assets) and therefore do not have a "service capacity" for which a replacement cost can be estimated. Thus, the fair value of the beneficial interest would be measured using a single valuation technique—the income approach.
Step 5: Determine fair value	On its face, using the income approach is consistent with the System's prior practice for valuing its beneficial interests in charitable trusts. When estimating the expected future cash flows, Marty will continue to consider the pattern of expected payments to beneficiaries (other lead and remainder interests). However, under FAS 157, the key input that will likely change is the discount rate used to convert the expected future cash flows from the trust to a single present amount. When determining the appropriate discount rate under this approach, Marty starts with the risk-free rate and adjusts for the inherent risk in the underlying assets held in trust, since distributions are based upon a percentage of fair value of total assets held in trust (in this example the trust held a diversified portfolio of equity securities, which presents higher inherent risk than a diversified debt portfolio), and the risk of nonperformance of the trustee (which likely would be nominal given that the trust is protected from general creditors).
Hierarchy/disclosure considerations	<p>Beneficial interests utilize significant unobservable inputs in estimating fair value due to their unique features, including no active market for selling the beneficial interests. However, beneficial interests may have inputs into the valuation technique at both Level 2 and Level 3. Market returns for similar assets would be considered a Level 2 input while all other unobservable market inputs into the present value technique would be Level 3 inputs. Therefore, since there are significant inputs at both Level 2 and Level 3, the overall measurement of beneficial interest would likely be classified at Level 3 in the hierarchy.</p> <p>Beneficial interests utilize a recurring fair value measurement and therefore should be included in both the tabular disclosure as well as in the Level 3 rollforward. A description of the inputs and the information used to develop the inputs should also be disclosed annually.</p>

Example 5—Perpetual Trust (third-party trustee)

The System also holds a beneficial interest in a perpetual trust. The trust invests in marketable securities that are actively traded. As previously discussed, a beneficiary with an unconditional right to receive specified cash flows from a charitable trust (including charitable perpetual trusts) must report its beneficial interest in the trust (initially and subsequently) at fair value in accordance with FAS 136. According to Chapter 6 of AAG-NPO, the fair value of the contribution could be measured at the present value of the estimated future cash receipts from the trust's assets. That value may generally be measured by the fair value of the assets contributed to the perpetual trust, unless facts and circumstances indicate that the fair value of the assets contributed to the trust differs from the present value of the expected future cash flows. Considerations related to the impact of FAS 157 adoption on the beneficial interest are discussed below.

Step 1: Determine unit of account	The unit of account, in accordance with FAS 136, is the beneficial interest in the cash flows generated by the trust.
Step 2: Evaluate valuation premise	A beneficial interest represents a stream of future cash in-flows. Because it is an asset that is expected to be settled in cash, a beneficial interest is considered a financial asset. A presumption exists in FAS 157 that the valuation premise for a financial asset will be "in-exchange" even though some believe that the valuation premise may be "in-use" since the beneficial interest would only be transferred with other assets of the organization (e.g., business combination). From a practical perspective, the valuation premise selected will likely not significantly change the fair value measurement since the System will use the same valuation technique (income approach).
Step 3: Assess access to markets	The System does not have access to any existing markets in which its beneficial interests could be bought or sold. Therefore, there is no principal or most advantageous market. Instead, Marty hypothecates a market of potential market participants that might be interested in acquiring the beneficial interest. (See discussion on page 5.)
Step 4: Consider valuation technique	<p>For the reasons discussed in Step 3 above, there is no ability to apply the market approach. Neither can the cost approach be applied, as beneficial interests are financial assets (versus physical assets) and therefore do not have a "service capacity" for which a replacement cost can be estimated. Thus, the fair value of the beneficial interest would be measured based upon a discounted cash flow analysis of the expected income derived from its interest in the trust—i.e., the income approach.</p> <p>The discount rate should represent the return market participants would expect on similar assets. Generally, a perpetual trust is similar to an endowment fund and therefore a comparable rate of return on endowment/investments would be expected by market participants (which may be similar to the System's endowment/investment return). A market participant will likely only pay for future cash flows at an amount less than what they could earn on their own investment portfolio.</p> <p>Many NPOs have estimated their expected future cash flows for a beneficial interest in a perpetual trust by fair valuing the underlying assets contributed to the trust. Technically, this is a proxy for the present value technique (i.e., income approach). Continuing to use the fair value of the underlying assets will require an assessment for consistency with the FAS 157 framework.</p>
Step 5: Determine fair value	Marty determines the fair value of the beneficial interest in the perpetual trust by estimating future cash flows from the trust (which holds a diversified portfolio of debt and equity securities) and discounting them into perpetuity using a market participant's expected return on endowments or investments.
Hierarchy/disclosure considerations	<p>Beneficial interests in perpetual trusts would typically utilize significant unobservable inputs (Level 3) in estimating fair value. Therefore, the overall measurement of beneficial interest would likely be classified at Level 3 in the hierarchy.</p> <p>Beneficial interests utilize a recurring fair value measurement and therefore should be included in both the tabular disclosure as well as in the Level 3 rollforward. A description of the inputs and the information used to develop the inputs should also be disclosed annually.</p>

Appendix A—References to PwC's "Guide to Fair Value Measurements"

Account (listing of account/transaction impacted by FAS 157)	Standard (used to determine unit of account)	FV measurement frequency (either one-time/nonrecurring or recurring)	PwC's Guide to Fair Value Measurements reference
Investments in marketable securities	FAS 124	Recurring	Section 8.1
Alternative/other investments	AAG-NPO	Recurring	Section 8.1
Assets in pension and OPEB plans	FAS 87/158 & 106	Recurring	Sections 8.1 and 8.6
Derivatives, primarily interest rate swaps	FAS 133	Recurring	Section 8.3
FAS 107 disclosures (e.g., long-term debt fair value)	FAS 107	Recurring	Section 8.5, Question 5-2
Asset retirement obligations*	FAS 143, FIN 47	Nonrecurring, at initial measurement and when estimate increases (new layers)	Section 9.4
Impairments of long-lived assets*	FAS 144	Nonrecurring, when triggering event occurs	Section 9.3
Exit and disposal activities*	FAS 146	Nonrecurring, at initial measurement	No. 22, page 174

* These accounts would qualify for the one-year deferral under FSP FAS 157-2.

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