Fussing and fuming about fair value and financial institutions

FACT OR FICTION?

By Thomas Porter

Financial institutions have faced a long-standing requirement to report investments in most financial instruments at "fair value" when they prepare financial statements. "Fair value" was generally regarded as the amount at which an instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. There had been little complaint about the use of fair value in financial reporting until the recent credit crisis when markets collapsed and quoted market prices, a common source for determining fair value, plummeted. Lower valuations caused enormous write-downs of financial assets that were "mark-to-market,"[1] causing a massive shrinkage of reported capital and prompting a need for additional liquidity.

Just prior to the meltdown of the markets, the Financial Accounting Standards Board released the Statement of Financial Accounting Standard No. 157, Fair Value Measurements (SFAS 157). Most companies were required to adopt it as of January 1, 2008 — right after the markets began to collapse. Critics claim that the requirements of SFAS 157 contributed to the credit crisis and called for its rescission. Their argument was that heightened liquidity needs could only be satisfied by fire sales at depressed prices, which then led to a further spiraling down of prices, all of which could have been avoided if SFAS 157 had never been issued.

There is no empirical evidence that supports the critics' arguments. Indeed, there is evidence to the contrary.[2] Unfortunately, the uproar caused by the critics was so distracting that users of financial information failed to appreciate

1. "Mark-to-market" is not synonymous with "fair value." As will be discussed later, market values may not be indicative of fair value as that term is defined in SFAS 157.

that SFAS 157 gave them exactly what they had long been clamoring for — heightened transparency. They also seemed to miss the fact that SFAS 157 did not require any new fair value measurements; the standard itself states "this Statement does not require any new fair-value measurements."[3] This article will highlight how SFAS 157 provides better information to users because it increases and standardizes (across firms) disclosures about fair-value accounting measurements, providing users with more transparency about how reported amounts are determined.

SFAS 157

SFAS 157 is one of many standards that FASB has issued that comprise generally accepted accounting principles. When it was issued, FASB said that SFAS 157 "responds to investors' requests for expanded information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings."[4] In short, the expanded information required by SFAS 157 increases transparency. Prior to SFAS 157, users had limited and comparatively inconsistent information about the manner in which fair value was determined. It could have been the latest quote from an active market, a quote from brokers or dealers if an instrument was thinly traded, or it could be entirely estimated.

SFAS 157 made two major improvements to GAAP. First, it provided a single definition of "fair value" that, in some cases, distinguishes fair value from "mark-to-market." Second, it requires structured disclosure in the notes to the financial statements using a hierarchy that communicates how fair value is determined. Is fair value the latest market quote? Is fair value an adjusted market quote? Or, is fair value estimated? If it is estimated, how was it estimated? SFAS 157 provides the answers to those questions.

A single definition of fair value

Previous accounting standards that require "fair value" have defined that term differently. SFAS 157 defines it as follows:

"Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."[5]
The definition of fair value in prior standards has been replaced with the above definition and it is contemplated the same definition of fair value will be used in future standards.

It is important to note that to determine the fair value of an asset or liability, one must consider a hypothetical transaction in which an asset or liability is disposed of in an orderly transaction. Since the asset or liability is not really disposed of, preparers of financial statements must determine the price at which the transaction would take place if it were disposed of — even if the entity has no intention of disposing of the asset immediately, later or ever. Further, this definition accommodates the potential for concluding that the current market price is not representative of fair value. Because the hypothetical transaction should be construed as an orderly transaction, if there are indications that a market is not functioning normally, then current market prices would not provide a measure of fair value under SFAS 157.[6]

Fair value hierarchy

The hypothetical exit price used to measure fair value can be determined using different types of information. It can be the market price for the latest transaction for an identical item, the adjusted market price of a similar item or it can be completely estimated. SFAS 157 requires companies to disclose how they determined fair value by describing the inputs that are used.

SFAS 157 defines a three-level hierarchy of inputs. The levels are creatively named level one, level two and level three. "Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities…"[7] If a particular asset or liability has an identical twin that is currently trading in an active market that is functioning in an orderly fashion, the latest transaction price is representative of its fair value.

"Level 2 inputs are inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly."[8] If a particular asset or liability does not have an identical twin that is currently trading, then the price of a similar item may be used. Adjustments may be made to that price to account for the differences in the item.

"Level 3 inputs are unobservable inputs for the asset or liability."[9] In cases in which there are no identical or similar assets trading, an entity may use unobservable inputs (i.e., assumptions) to determine the fair value of a particular asset. Those inputs are used to model the amount at which an asset would be priced if it were to be sold in an active market. This approach is often referred to as "mark-to-model."

SFAS 157 requires that entities include, in the notes to their financial statements, information that enables users to assess the inputs, by level, that are used to determine fair value. That way, a user can decide if a fair value amount that is reflected in the financial statements is based on a quoted market price, an adjusted market price or is completely estimated.

Mark-to-market may not be fair value

An underlying assumption of the hypothetical transaction on which fair value is based relies on the existence of an active market and an orderly transaction. If the market for a particular item is not active, or if there is reason to believe that market prices are not representative of fair value, SFAS 157 permits the use of an alternative measurement approach, including estimation. That means that the current market quote may not be the fair value. Unlike prior standards, the disclosure requirements of SFAS 157 reveal how the amounts were estimated and thereby yield more transparency about how fair value is determined.

Bank of America example

The Bank of America provides a good example of the additional disclosure that SFAS 157 requires. The Bank of America adopted SFAS 157 as of January 1, 2007.[10] A comparison of the amount of disclosure on either side of its adoption date highlights the contribution of SFAS 157.

In its Form 10-K for the fiscal year ended December 31, 2006, the Bank of America devotes about a single page to its description of fair value for its financial instruments.[11] It provides brief descriptions, in general terms, about how fair value amounts were determined for its various groups of financial instruments.

In its Form 10-K for the fiscal year ended December 31, 2007, the note related to fair value measurements is four and one-half pages long.[12] In addition to a table that shows the level of inputs used to determine fair value for each class of financial instruments, there are detailed descriptions of each class of financial instruments, the inputs and models used to determine their fair value and the amounts of unrealized gains and losses that resulted from changes in those fair-value measurements.

Conclusions

SFAS 157 cannot be blamed for causing the credit crisis, mainly because it did not require any new fair-value measurements. One of its main contributions to GAAP is the expanded and standardized disclosure requirements about fair value. Further, because SFAS 157 and its subsequent interpretations accommodate the possibility of imperfect markets, the timing of its release (as the markets were collapsing) was almost perfect. As a result of its structured and expanded disclosure requirements, users now have more and better information about when firms depart from "mark-to-market" accounting when fair value measurements are required.

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2. See Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting, Securities and Exchange Commission, October 18, 2008 (http://www.sec.gov/news/studies/2008/marktomarket123008.pdf) and Laux and Leuz, Did Fair-Value Accounting Contribute to the Financial Crisis?, NBER working paper 15515 (http://www.nber.org/papers/w15515).

3. Statement of Financial Accounting Standards No. 157, Fair Value Measurements, Summary.

4. FASB News Release, September 16, 2006.

5. Ibid., paragraph 5.

6. When one ignores the status of the market, current market quotes are frequently referred to as "fair market value," which is not equivalent to SFAS 157's notion of "fair value."

7. Ibid., paragraph 24.

8. Ibid., paragraph 28.

9. Ibid., paragraph 30.

10. Firms were encouraged to adopt SFAS 157 prior to its stated effective date.

11. Bank of America, Inc., Form 10-K, December 31, 2006, pp. 161–162.

12. For the fiscal year ended December 31, 2008, there are almost six pages of disclosures about fair value.