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point of view

Fair value accounting:
Is it an appropriate measure of value for today's financial instruments?

The use of fair value accounting for measuring the value of financial instruments has been a source of controversy.

Highlights

1. The impact of fair value measurements—whether positive or negative on a company—is the result of market forces.

2. Fair value of financial Instruments, despite concerns, is the best available method to reflect market conditions. Current conditions call into question whether we are ready for fair value accounting for certain non-financial items.

3. Investors benefit when companies disclose their views on the impact of market illiquidity in their financial reporting.

What are the benefits and challenges of fair value measurements?

Reflect current market conditions
Financial statements reflect the impact of current market conditions on financial instruments.

More transparency
Investors and other users have greater insight into management's views as to ultimate settlement amounts.

Reliability in illiquid markets
Lack of market prices requires the use of models to determine fair value.

Market volatility introduces uncertainty
Reported earnings are less predictable.

The impact of fair value accounting

Some claim that only realized gains and losses should be recorded.

For many years, standard setters have grappled with the issues associated with accounting for financial instruments. Decisions with regard to what valuation method should be applied have been difficult and in some cases controversial.

In 1994, FAS 115 was introduced into U.S. GAAP as a partial solution. It required fair value accounting for many investments. In 2000, FAS 133 was introduced to improve the accounting model for derivatives by requiring fair value measurement. FAS 157, issued in 2007, established a common definition of fair value. Then FAS 159 expanded the ability of companies to elect fair value as their measurement basis for certain financial assets and liabilities.

Recently the U.S. markets began experiencing significant illiquidity and volatility, creating conditions that made fair value assessments more controversial. The value of today's innovative and complex financial instruments, such as derivatives, mortgage-backed securities and other structured financial products is subject to market illiquidity and volatility. Although fair value accounting could apply to other assets and liabilities, the focus of this piece is on financial instruments (particularly financial assets).

Implications of fair value accounting

While many agree that fair value yields a more relevant measure than historical cost, it is not perfect. Two controversies surround fair value measurements today: (1) the application of fair value accounting in illiquid markets, and (2) how and when modeling should be used as the method to determine fair value.

Fair value measurements in illiquid markets

Recent credit market conditions have resulted in large write-downs through the application of fair value measurements. Most of the charges have occurred within the banking and broker-dealer industries.

Companies providing credit protection through credit default swaps on the underlying asset, as opposed to insurance contracts, have been impacted by fair value measurements. Even though the default that would trigger protection may not have occurred, companies are required to recognize unrealized losses on the contract when the fair value of the underlying assets has significantly decreased. Also affected have been some corporations with investments in auction rate securities which suffered declines.

The requirements to use fair value measurements have been criticized for producing inaccurate results in the unusual market conditions recently experienced. Such results, it is argued, hurt the company in the long run. If a company must record losses in such an environment, critics claim, it signals bad news to investors that may ultimately be misleading. Therefore, they say, it is preferable to record only realized gains and losses.

In considering this controversy, it is important to recognize that accounting principles such as fair value are developed with the objective of providing information that will best serve the interests of investors, businesses and policy makers over the long term.

Fair value, while not perfect, is the best method to reflect market conditions when accompanied by appropriate disclosure

Fair value increases the transparency of the impact of market forces on financial information.

We are sympathetic to the concerns about fair value measurements that have grown out of the recent market illiquidity and volatility. In response to these market conditions, it has been suggested that fair value accounting be suspended or changed for certain financial instruments, or that businesses should apply their own models, which may show a less volatile long-term scenario. The current market, it is contended, is an anomaly. However, these concerns must be balanced against investors' desires to know the **current values** of these assets.

Balancing the factors, fair value still represents the most effective method to reflect the economic realities of market conditions. If fair value were suspended or replaced with some method based on historical cost, investors would be left to their own devices to determine the current value of these instruments—which would be less reliable and could delay any market recovery.

Those contending that the current market is an anomaly may be correct. If they are right, the market will eventually recognize that, return to "normal," and bid up the price of their holdings. However, in the interim, we encourage companies to present the basis of **their views** of the instrument's value and ultimate settlement amount in their financial analysis disclosures.

Where models are used to determine fair value

Although investors in general believe that fair value is appropriate for measuring financial instruments, they and companies are concerned about the use of fair value when it is unclear how to determine market pricing. Fair value measures require (a) applying market prices regardless of how erratic the market may be, or (b) referring to prices of similar securities. When neither of those alternatives exists, companies employ models to determine fair value.

Earnings volatility sometimes occurs when markets become illiquid and market prices are not available. When the methods described above for determining fair value are applied, the effect on earnings may be as unpredictable as the market. Like a pendulum suddenly knocked out of its cycle, financial instruments may fluctuate as a result of market realities revealed in fair value assessments.

The effect of fair value measurements on long-term value is another concern. But whether any particular application of fair value measurements accurately reflects long-term value can only be decided in the long term. Fair value measurements enable financial statements to reveal how financial instruments are being affected by current market conditions, resulting in increased transparency to investors and others.

Summary

Although it has generated controversy, fair value continues to represent the best available methodology for determining and reporting the value of financial instruments. Markets naturally respond to financial information that fair value provides. The impacts of such measurements—whether positive or negative on a given company—are the results of market forces, not accounting methodologies. When market conditions result in volatility in values and earnings, investors benefit when companies transparently report on these circumstances and their impact on financial reporting.

Investors, regulators and the general public are affected by fair value accounting

Q&A

Q: Does the application of fair value accounting for financial assets present economic reality?

A: Fair value is the best available method to measure and report financial assets. Fair value is based on market measures or, in limited cases, estimates of them. Some have contended that current market valuations of some complicated securities do not reflect eventual long-term reality—for example, in cases where the market for these instruments has become illiquid. We understand that complex issues of valuation are open to reasonable arguments on both sides. So we encourage those whose views about ultimate settlement amount conflict with the application of fair value measurements to disclose their views within their financial analysis.

Q: What are the merits of using cost accounting versus fair value accounting for financial instruments?

A: Cost accounting would value financial instruments at their acquisition price—not at their value if sold in the market. Most investors prefer current valuation because it is more relevant. Historical cost information for financial assets has no economic relevance to the buy, sell, hold decisions management must make each day.

Q: Has the SEC taken any action in response to current market conditions regarding fair value accounting?

A: The SEC is concerned about the quality and consistency of the assumptions and judgments inherent in fair value measurements. Through a direct request to a number of companies, the SEC is looking for greater transparency in disclosures around related valuation methods and assumptions, especially at major financial institutions.

Q: What industries have been most impacted by the large write-downs that were required by fair value accounting?

A: Most have occurred in the banking and broker-dealer industries and in some Insurance companies. That reflects their significant investments in debt securities and derivatives, including securitized interests.

Q: As more businesses use IFRS, will that mean a greater use of fair value than we see in U.S. GAAP?

A: For financial instruments, IFRS and U.S. GAAP are generally consistent. However, for non-financial assets and liabilities IFRS generally encourages greater use of fair value than does U.S. GAAP.

Q: Do you support expanding the use of fair value measures to non-financial assets and liabilities?

A: We believe that recent events have pointed out the challenges that exist in using fair value accounting when markets are not sufficiently liquid to help establish fair values. For non-financial assets and liabilities, those challenges may be exacerbated. Current conditions call into question whether we are ready for fair value accounting for certain non-financial assets and liabilities.

Contact Information

To have a deeper discussion about how fair value information might affect your business, please contact:

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