“I’m a mark-to-market valuation guy….The strength of fair value is that it is a more objective basis, it impounds current information, and it must be forward looking. However, I like to be able to check value calculations. I want something more robust than this rule.” Robert Herz, chairman of the Financial Accounting Standards Board (FASB), made this statement at the 2007 Annual Conference & Exposition of the Institute of Management Accountants (IMA®). He also indicated that there are two qualities of a good standard: The rule is absolutely necessary, and the rule satisfies information needs. Herz said that a Standard on fair value is absolutely necessary but asserted that Statement of Financial Accounting Standards No. 157 (SFAS No. 157), “Fair Value Measurements,” doesn’t do a good job of satisfying the information need. Such remarks suggest that its implementation won’t be easy or inexpensive. Nevertheless, the Standard is in force, and fair value has suddenly become a “hot topic” in accounting circles again.

SFAS No. 157 is effective for financial statements issued
for fiscal years beginning after November 15, 2007, and interim periods within those years. Clearly, given the current intricate U.S. economic structure, corporate management should understand the complexity and costliness of using fair value measurements. Accordingly, we provide a brief summary of SFAS No. 157 in which we highlight the “fair value hierarchy” and offer explanations and illustrations, along with examples from a private company, regarding its implementation. Finally, we identify and discuss the potential benefits and costs that may result from the implementation of this Standard.

**WHAT IS FAIR VALUE ACCOUNTING?**

Fair value accounting is the practice of accounting that values certain assets and liabilities at their current market value. Theoretically, fair value accounting seeks to capture and report the present value of future cash flows associated with an asset or a liability. Businesses and market participants should understand this measure to represent “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.” (SFAS No. 157, par. 5)

The relevance of historical-cost-based financial statements has been the center of significant controversy among theoreticians, academicians, and business practitioners in corporate America for more than a decade. This debate has sparked discussions about replacing historical cost with fair value. In addition, the push to fair value is fueled by the movement of international accounting regulation toward the harmonization of standards. The International Accounting Standards Board (IASB) updated their fair value standard in 2004, 2006, and 2007 with IAS 39, “Financial Instruments: Recognition and Measurement”; IAS 40, “Investment Property”; and IAS 41, “Agriculture,” respectively. The FASB and IASB are working on joint projects examining the feasibility of using fair value measurement for certain classes of assets and liabilities. This focus on fair value accounting continues to attack the historical cost concept and has resulted in the FASB producing financial accounting standards that require the use of fair values rather than historical cost values (such as SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities”; SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities”; SFAS No. 141, “Business Combinations”; SFAS No. 142, “Accounting for the Impairment or Disposal of Long-Lived Assets”; SFAS No. 157; and SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities—including an amend-ment of FASB Statement No. 115”).

In practice, the FASB requires that intangibles acquired in a business acquisition be valued at fair value (SFAS No. 141). SFAS No. 144 requires that the test for impairment of certain assets must incorporate fair values as a major determinant in the impairment decision. The accounting for derivative instruments requires the use of fair values (SFAS No. 133). These and other applications of fair value accounting highlight the FASB’s continued objective to establish a methodology for fair value accounting that is consistent with the existing Conceptual Framework, U.S. Generally Accepted Accounting Principles (GAAP), and International Accounting Standards (IAS).

**SFAS NO. 157**

SFAS No. 157 is a framework for fair value measurement that is designed to make the definitions of fair value, fair value measurement, and fair value disclosures more consistent. In addition, the Standard was established to increase comparability and improve the relevance and reliability of fair value measures. Although SFAS No. 157 covers valuation issues for all assets and liabilities, there isn’t much deliberation over fair value measurement for certain physical and intangible assets, such as inventories and goodwill, and noncontractual liabilities, such as income tax payable. The application of the Standard isn’t as challenging for these types of assets and liabilities as it is for certain derivative financial instruments, such as options or exchange futures. Therefore, our examples and discussions will focus on financial instruments, such as options, futures, forwards, and swaps, that are typically more difficult to evaluate using the Standard.

**Fair Value Measurement Inputs and the Hierarchy**

SFAS No. 157 places heavy emphasis on the inputs used in fair value measurement. Appropriate implementation of fair value accounting requires a knowledge and understanding of the characteristics that identify these inputs. Specifically, fair value inputs should be (1) based on timely information, (2) generated from independent sources, and (3) used by marketplace participants in pricing decisions. SFAS No. 157 prioritizes fair value measurement inputs, thereby setting the standard that fair value measurement inputs used should be those at the highest priority level. Consequently, this accounting Standard groups fair value inputs into three broad levels, establishing a “hierarchy.”

The determinants or qualities of inputs in the hierarchy address whether the inputs are (1) “observable” or
“unobservable,” (2) based on identical or similar assets or liabilities being valued, (3) derived from active or inactive markets, (4) quoted or other than quoted prices, and/or (5) “unobservable” inputs, corroborated by other market data. The various dimensions of complex financial instruments’ intricacies require a model or framework that facilitates the valuation of these financial instruments. This fair value hierarchy set forth in SFAS No. 157 provides guidelines that can be applied to complex financial instruments. A model of the fair value hierarchy established in SFAS No. 157 is shown in Figure 1.

**THE FAIR VALUE HIERARCHY**

**Level 1 Inputs**

Level 1 of the hierarchy identifies the highest priority of inputs to be used in fair value measurement. Determinants or qualities of these inputs are optimal. First, these inputs are “observable,” or based on market data obtained from sources independent of the reporting entity. Next, prices (inputs) used are (1) quoted from the market and (2) for an identical (rather than similar) asset or liability. In addition, the market from which the inputs are obtained is an active market where quoted prices are readily and regularly available.

As an example, consider a private commodities company that we will refer to as ROC, Inc., for confidentiality purposes. ROC, Inc., one of the 50 largest private companies in the U.S., has investments in various types of securities. The valuation of some of its over-the-counter (OTC) options, for example, is based on published bid-ask quotations. These quotations reflect the prices at which broker/dealers would buy or sell a security. Other OTC quotations are obtained from Bloomberg or Reuters, organizations that provide financial news and data. Additionally, the valuation of certain exchange futures is derived by exchange closing and/or mid quotes obtained from Bloomberg, Reuters, and/or other commodity-specific exchanges (such as the European Clearing Exchange).

**Level 2 Inputs**

Second in priority, Level 2 of the hierarchy defines inputs that may have one of four combinations of qualities that are below the optimal inputs defined in Level 1. The first combination represents inputs that are observable, quoted, and for identical assets or liabilities, but the market from which these inputs are obtained is an inactive market. Alternatively, a second combination of inputs may be observable and quoted, but for similar rather than identical assets or liabilities in an active or inactive market. A third combination of input qualities reflects inputs that are observable but that don’t reflect quoted prices. The fourth combination of input qualities identifies inputs that are neither observable nor derived through extrapolation or interpolation but are corroborated by other market data.

Again let’s consider ROC, Inc., which engages in forward contracts and swaps. While the valuation of these securities could generally follow the Level 1 hierarchy, often the nature of certain swaps and forwards indicates that valuation follows Level 2. Specifically, the valuation of certain forwards is derived by obtaining a forward rate from Bloomberg or Reuters and downloading those rates into a computer program that ROC, Inc., has designed. In situations where rates aren’t directly obtainable from Bloomberg/Reuters, valuation is based on interpolated rates that are derived by company-specific algorithms, and there is market data that adequately corroborates these interpolated rates. Also, the valuation of certain swaps is derived from month-end prices or broker quotes that are downloaded into established models, such as Black-Scholes, or company-specific models.
Figure 1: FAIR VALUE HIERARCHY

Legend: (Arrow-flows into Levels)

Observable inputs are developed based on market data obtained from sources independent of the reporting entity.

Unobservable inputs reflect the reporting entity’s assumptions of market inputs, developed based on its own data, adjusted to exclude factors specific to the reporting entity if information is available that indicates that market participants would use different assumptions.

<table>
<thead>
<tr>
<th>Level</th>
<th>Description</th>
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<tbody>
<tr>
<td>1</td>
<td>Observable market input that reflects quoted prices for identical asset/liability in an active market</td>
</tr>
<tr>
<td>2</td>
<td>Observable market input that reflects quoted prices for identical asset/liability in an inactive market</td>
</tr>
<tr>
<td>3</td>
<td>Observable market input that reflects quoted prices for similar asset/liability in an active or inactive market</td>
</tr>
<tr>
<td>[D]</td>
<td>Observable market input other than quoted prices</td>
</tr>
<tr>
<td>[E]</td>
<td>Unobservable market input derived principally from or corroborated by other observable market data</td>
</tr>
<tr>
<td>[F]</td>
<td>Unobservable market input not derived principally from or corroborated by other observable market data</td>
</tr>
</tbody>
</table>
Level 3 Inputs

Level 3 of the hierarchy represents the lowest priority of input combinations to be used in fair value measurement. The inputs are not observable (i.e., not obtained from independent sources) but are instead derived through extrapolation or interpolations. More critically, these inputs can't be corroborated by other market data.

Once again, consider ROC, Inc., which has some securities requiring that valuation be based on future expectations as far out as five to 10 years. The valuation of these “exotic” securities is based on inputs that are fed to company-specific models that perform the extrapolations and interpolations. Because of the extended future horizons reflected in these inputs, it’s unlikely that there is any current market data to corroborate the securities value.

We hope you can see from the previous discussion and true-to-life examples that the fair value hierarchy established in SFAS No. 157 will bring about consistency and provides guidelines regarding fair value measurement. The implementation of the Standard requires that all existing securities valuation be classified according to the hierarchy and disclosed appropriately. More important, the Standard provides guidelines for the valuation of future investments not currently held by the company that require fair value measurement and disclosure. But the benefits of implementation aren’t without cost, which we’ll discuss later.

Valuation Techniques

Fair value measurement requires the use of valuation techniques that are deemed appropriate in the circumstance. It may be appropriate for a reporting entity to use multiple techniques as opposed to the use of one technique per reporting entity. Here are some valuation techniques:

- **Market Approach**—Uses prices and other relevant information generated by market transactions.
- **Income Approach**—Uses valuation techniques to convert future amounts (e.g., cash flows or earnings) to a single present amount (discounted).
- **Cost Approach**—Based on the amount that currently would be required to replace the assets, i.e., current replacement cost.

Consistent application of these techniques is required for all reporting entities.

Expanded Disclosure

SFAS No. 157 requires more disclosure. Generally, these mandated disclosures should include information that will allow financial statement users to assess the fair value measurement inputs used to develop those measurements. Specifically, disclosure should focus on:

- Inputs used to measure fair value,
- Recurring and nonrecurring items,
- FVM effects on income or on changes in net assets,
- Qualitative information on unobservable input usage, and
- The combination of new disclosures with existing disclosures.

Disclosures should also be individually distinct for recurring items and nonrecurring items. For these items, disclosure should identify the hierarchy level in which the measure falls, the period gain/loss, and the valuation technique used to measure fair value. In addition, disclosure should clearly describe the Level 3 inputs used in measurement.

Changes in Concepts and Practice

Here are some of the noteworthy changes in concepts and practices resulting from the implementation of SFAS No. 157:

- Fair value is a market measure that should (a) include all market participants’ assumptions and (b) exclude entity-specific factors not considered by market participants.
- Fair value for a liability is based on the assumption that the liability can be transferred to a market participant of comparable credit standing that would perform similarly.
- The fair value of a large position (block) should be measured as the product of the quoted price times the quantity held, precluding use of a blockage factor. A blockage factor is defined as a premium or discount that could be applied in the estimation of the fair value of an investment. The premium or discount is based on factors like the ownership interest in the investment.
- The fair value of a restricted security should be based on the quoted price for an otherwise identical unrestricted security of the same issuer, adjusted appropriately for the effect of the restriction.

Benefits and Costs

Even though SFAS No. 157 is in effect, the application of fair value in accounting is still being debated—particularly the costs vs. the benefits. Those in favor of SFAS No. 157 argue that in order for balance sheets to be relevant to
investors, creditors, and rating agencies, the historical cost of assets and liabilities should be replaced with fair value. Other supporters cite the disparity between market value of publicly traded firms on the New York Stock Exchange and the net asset values in financial statements. On average, market values are approximately five times the net asset value of publicly traded companies. Supporters of fair value accounting insist that this disparity between market value and net book value is due to the irrelevance of the historical cost of assets and liabilities. Finally, supporters argue that, in today’s economy, the real assets of any business are “soft” assets such as concepts and ideas and not physical resources. These “softer” assets require measurement techniques that are beyond the scope of historical cost.

But what about the costs? Many companies and industries have specific valuation issues that they must deal with when establishing fair value estimates. For example, ROC, Inc., has several divisions that have their own inventory of securities. A major concern is the uniformity in valuation policies across those divisions. Consequently, the company will have to review and evaluate these policies in order to reach a satisfactory degree of uniformity regarding policy format, content, and valuation procedure (i.e., hierarchy) for its total portfolio of securities.

Moreover, companies will find it necessary to repeatedly address many concerns that may include:

◆ When should the company use fair value, and when should it stick to historical cost?
◆ Which assets and liabilities will be included in which level of the fair value hierarchy?
◆ What market should be identified as the primary market of the asset or liability?
◆ What external factors could potentially affect changes in fair market value?

To address these and many other factors, companies may have to hire consultants and, in some cases, additional accounting staff. ROC, Inc., hired a consultant to help the accounting department develop an in-depth understanding of SFAS No. 157 and has an entire group of accounting specialists in place to implement the Standard.

The Role of the Auditor

When opponents to the Standard argue that fair value was the main tool unscrupulous managers used to commit fraud (like those at Enron), supporters suggest that the auditor (unlike Arthur Andersen) should assure investors and creditors that the fair value estimates are based properly on legitimate information. Thus, one of the immediate direct costs will be increased auditor fees. The audit profession is currently in crisis over the limited resources it has to spread over both internal control and financial statement audits. Auditors must make judgment calls about high-risk areas and use statistical procedures to determine where to invest engagement time. Considering the magnitude of uncertainty surrounding Level 3, fair value inputs will always have to be investigated. Levels 1 and 2 will deserve some degree of higher attention, considering the choices of markets and appraisers. The additional time and risk associated with auditing these fair value measures will certainly lead to additional audit fees.

The Role of Appraisers and Experts

SFAS No. 157 supporters don’t advocate that auditors use their own judgment about the validity of fair value estimates. Instead, they want experts’ opinions to be used to establish the fair value estimate and those experts’ opinions to be referenced for support of auditor assurance. Some certified public accountants are neither qualified nor willing to judge fair value, which necessitates the use of appraisers and valuation experts. It also adds another information provider to the already complicated financial reporting landscape.

The cost of experts’ opinions will be the financial burden of both the company and its auditor. Expert opinions don’t come cheaply, nor do they resolve the uncertainty surrounding asset and liability valuation. For instance, in practice there is no single fair value, nor is there a consensus among experts as to the best fair value. Depending on the purpose of the estimate, most appraisers will admit that there are at least four fair value estimates: purchase value, selling value, replacement value, and auction value. (See Alfred King’s article, “Fair Value Accounting, Its Time Has Come and Gone,” Strategic Finance, September 2003.) In addition, fair value changes rapidly, and with each change or each new reporting date comes a new appraisal and additional expert fees. (See Alfred King, “Why Fair Value Accounting Can’t Work,” Financial Executive, July-August 1999.)

Although appraisers are currently regulated, their information is going to be used more widely than ever
before, and the importance of their estimates will be magnified significantly. Since we can’t assume that valuation experts are more independent or ethical than auditors, the additional use of such experts should also affect the level of regulation and scrutiny of the appraisal industry. The additional workload and additional responsibility will certainly affect the industry regulation and cost indirectly.

**Use of Fair Value Information**

Proponents of fair value accounting further believe that fair value estimates will lead to more relevance and clarity in financial reporting and that fair value can address the knowledge-based economy better than historical cost can, which was established in the fixed-asset-based and creditor-supported economy of the 1970s. (See Yigal Rechtman, “Fair-Value Accounting: What’s So Fair?” *The CPA Journal,* July 2006.) The current economy is also financed significantly by investors, who can be divided into two classes: sophisticated informed investors and unsophisticated investors. Reporting fair value estimates and disclosing a range of possible outcomes may help the sophisticated investor but may plague the unsophisticated investor with imprecision and information overload.

Opponents of fair value imagine there will be as great or even greater imprecision in fair value accounting as in historical cost accounting. As history has shown, imprecision in measurement and accounting can lead to some very serious indirect costs. When the information in the market lacks validity, investors devalue all companies, not just the ones with validity issues. In recent years, imprecise accounting information has led to a lack of trust of auditors, financial analysts, and corporate managers. To help regain some of the lost trust, regulators have greatly increased the regulations of auditors, managers, and boards of directors. All parts of corporate governance now have additional, closely enforced, and costly regulations to satisfy, such as the Sarbanes-Oxley Act of 2002 (SOX).

In the case of corporate failure, the use of fair value could affect the existence of audit firms and appraisal companies. Today’s investors are more likely to file lawsuits when faced with losses. If those losses can be linked to less precise and less reliable fair value information, the volume of lawsuits could increase greatly. In class action lawsuits, investors and creditors tend to sue all involved parties, so it’s possible that appraisers who helped to establish the value of assets and liabilities and auditors who issued assurances related to the financial reports will be included on the list of legal defendants.

**Other Issues**

Regulators such as the Securities & Exchange Commission (SEC) and the Federal Reserve must be concerned about the use of fair value accounting. Improper fair value accounting estimates were the foundation and catalyst of the fraud committed by Enron in 2001. Other unethical managers at Qwest, Global Crossing, and Parmalat also exploited it. (See Walter Schuetze, “In Defense of Fair Value,” *The CPA Journal,* February 2006.) The use of fair value in real estate was one of the main causes of the failures in the savings and loan industry in the 1980s. On the heels of these significant economic tragedies caused in large part by the decline in ethics, can we afford to expand managerial discretion?

What will all this mean on a global scale? In his statements about fair value, Robert Herz described SFAS No. 157 as a move from a rules-based to a more principles-based set of accounting regulations (similar to International Accounting Standards), which is in alignment with the harmonization of accounting standards project (see www.fasb.org for news about the work the FASB is doing with the IASB in this regard). He also identified a few problems with a principles-based approach in the U.S., particularly with SFAS No. 157. He suggested that the U.S. legal framework (which is conducive to lawsuits), the ever-growing number of lawyers, and the tendency for markets to be driven by short-term earnings will be large hurdles for fair value accounting and principles-based standards to overcome.

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