FAIR VALUE ACCOUNTING: are you Ready?

By Jonathan Boyles

The Financial Accounting Standards Board (FASB) has long believed that fair value accounting is the most relevant basis of accounting and has had a long-stated goal of having it as the primary method of accounting. Over the past 15 years, the FASB has taken baby steps to get companies and analysts accustomed to fair value accounting and disclosures, but the move is now on to accelerate the pace of implementation. At this point, companies have to make the transition from resistance to implementation and governance, which will require considerable resource allocation, process control, and oversight. In this article I'm not going to delve into whether fair value accounting is the appropriate accounting model but instead will focus on whether companies are truly prepared for it.

In many respects, fair value accounting makes the accounting policy decisions easier for companies, but it brings along with it a tremendous amount of additional corporate governance, reporting, and investor relations issues.

THE FUNDAMENTALS OF FAIR VALUE

With fair value measurements becoming an integral part of an entity's financial statements and a significant driver of its performance during a period, it's critical that companies develop a solid governance framework over the determination of fair value. With the complexities and subjectivity in determining the fair value of many of the assets and liabilities on a company's balance sheet that may be recorded at fair value now or in the future, it's imperative that management understand what inputs are being used and how models are utilized to determine fair value. Without adequate controls, the reliability of an entity's financial statements could be questioned by auditors, regulators, investors, and analysts.

GOVERNANCE, FINANCIAL REPORTING, INVESTOR RELATIONS

Let's look at three issues regarding the reporting of fair value that companies need to know about.

Governance Over Fair Value Accounting

Once a company has decided to record more of its assets at fair value, it should adopt certain fair value governance policies to ensure accurate and reliable measurements. Previously, when fair values were primarily reported in financial statement footnotes, the values didn't always receive the rigorous internal control and detailed reviews that amounts recorded in the financial statements received. One of the primary reasons for this is that accountants aren't typically trained to evaluate the accuracy and validity of fair value amounts and have relied on quotes from pricing services or from fair value amounts calculated from internal models used by other departments within the organization. It has been difficult for a classically trained accountant (one who hasn't had much finance training) to determine if the fair value amount they were given for financial statement disclosure purposes was reasonable.

Good corporate governance over fair values should include a fair value committee that evaluates the quality of both external fair value information and internal methodologies employed to determine fair values that will be used in a company's financial statements. This committee should be responsible for setting standards for fair value models, evaluating the quality of the inputs to be used within the fair value models, ensuring model validation is performed regularly, evaluating the quality of the fair value amounts received from third parties, and certifying the amounts that are recorded in the company's financial statements. In addition, this committee should review the sources and quality of information from third parties regarding fair values that will be used for financial statement purposes. Management can't blindly rely on third parties to provide fair values without understanding the reliability of those quotes.

It's important to understand the *quality* of the fair value information received from third parties, particularly with the requirement to disclose the fair value hierarchy level under Statement of Financial Accounting Standards (SFAS) No. 157, "Fair Value Measurements." Under SFAS No. 157, it becomes management's responsibility to disclose to the public the reliability and level of subjectivity used in determining fair value amounts recorded in a company's financial statements. Because of the detailed footnote disclosures required by this Standard, management must understand the underpinnings of how the amounts are determined by their third parties who are providing them with pricing information. For example, companies must understand the source of the valuation inputs used by the third-party vendor to determine how to classify the valuation among Levels 1, 2, or 3 in accordance with the disclosure requirements of SFAS No. 157.

Companies often will hire third-party valuation experts to come into their organization and provide fair value validation services to give management comfort that, in fact, they do have adequate policies, procedures, and models in place to reliably report fair value amounts in their financial statements.

Financial Reporting of Fair Value Information

As I mentioned earlier, fair value accounting has moved from the footnotes to the face of the balance sheet, bringing with it many additional financial reporting concerns that companies need to address. Fair value accounting is

From Baby Steps to Get With It, Baby

SFAS No. 123, "Accounting for Stock-Based Compensation," was one interim step toward fair value for stock-based compensation. A primary industry argument against it was that these instruments were too difficult to value. In SFAS No. 123, the FASB relented and didn't require stock-based compensation to be recorded at fair value; it did require fair value disclosures as if the company had adopted fair value. But after several years and very few companies adopting the fair value method, the Board came out with SFAS No. 123R (revised), "Share-Based Payment," which required fair value accounting for all stock-based compensation. Suddenly the companies that had previously said they couldn't value these instruments were in a bind because they had been disclosing the information in the footnotes for several years and could no longer argue they were unable to place a value on these instruments. Accounting scandals in the early part of the millennium also added to the momentum toward full fair value accounting for these instruments. SFAS No. 123R was also an ingenious move by the FASB to get companies comfortable with calculating and reporting these amounts in their financial statements before moving forward and making it mandatory.

The same can be said for SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." When SFAS No. 133 was being developed, the FASB was under a lot of pressure not to issue the Statement because companies didn't want to have to record derivative instruments at fair value on the face of their balance sheet. When it became clear that the Standard was going to move forward, many companies argued vehemently that if the FASB were going to adopt this Standard then it should allow companies to get "special" hedge accounting. The hedge accounting rules were crafted so narrowly that companies had trouble qualifying for hedge accounting even though the hedges were accomplishing their corporate goal and reducing risk. For instance, to qualify for hedge accounting, a company must expect very high correlation between the derivative instrument and the hedged item, and failure to meet that requirement would cause hedge accounting to cease even though there were still significant offsets in value.

As a result, many companies and industries lobbied the FASB to allow them to record certain financial instruments at fair value with changes in fair value of both the hedged item and the derivative running through their income statement. This eliminates the need for companies to have to meet the strict hedge accounting rules and still allows them to offset in earnings the effective portion of the two instruments. You can see this in the FASB's issuance of SFAS No. 156, "Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140," which allowed holders of mortgage servicing rights—which have been notoriously difficult to hedge under the SFAS No. 133 guidelines—the ability to record these at fair value through earnings along with the derivative or other instruments used to economically hedge the mortgage servicing rights.

As I mentioned earlier, the FASB also issued SFAS No. 157 and SFAS No. 159, two new Standards that further the movement toward fair value accounting. In addition, there are several other projects on the FASB agenda that will continue to move financial statements toward fair value accounting.

no longer something controllers' departments do once a quarter for footnote purposes—now it's something that they must embed in the monthly close process. It isn't enough just to take information from third parties and record it in the financial statements because there's a tremendous need by senior management and the board of directors to understand what events during the period affected their financial results. Controllers and CFOs now have to determine what market events caused the changes in fair value that in turn caused volatility in earnings. Were the changes reasonable, expected, and explainable, and was the income volatility resulting from them within corporate risk tolerances? As fair value becomes the standard for financial reporting, closing the books at the end of each period won't be the responsibility of just the controller's department but will involve expertise and input from many other departments within an organization, such as the treasury, credit, and portfolio/investment departments, to help determine and/or validate valuations used in the financial statements.

Investor Relations and Education

One of the most interesting aspects of the early adoption by certain entities of SFAS No. 157 and SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115," has been analyst focus on the quality of the fair value information that companies used to produce their financial results. This has been accentuated by the recent meltdown in the credit and subprime markets, making the determination of fair values for certain asset-backed securities extremely difficult to determine because there has been a disconnect between supply and demand for subprime asset-backed securities. With supply exceeding demand, significant uncertainty regarding possible credit losses and the survival of entities that had provided recourse to these securitizations, and a lack of trading volume, it has been difficult for companies to determine with any degree of certainty what the assets they hold are worth. For instance, with the uncertainty in the credit markets, many collateralized debt obligations that traded easily just a year ago are much less liquid and often require a significant discount to their perceived economic price due to the lack of liquidity in the market.

SFAS No. 157 requires companies to disclose the kind or "level" of input they apply in determining the fair value used in financial reporting. The levels are based on the objective nature and quality of the inputs used in determining the fair value of an item. These levels are:

Level 1: Observable prices in active markets for identical assets and liabilities (e.g., NYSE or NASDAQ).

Level 2: Observable pricing inputs other than quoted prices in active markets for identical assets and liabilities (i.e., pink sheets or matrix pricing). For those not familiar with the terms, pink sheets are prices from securities sold over the counter (not on an exchange). Matrix prices are based on quoted prices for securities with similar coupons, ratings, and maturities rather than on specific bids and offers for the designated security. The name "matrix price" comes from the practice of interpolating among values for similar instruments arranged in a matrix format. These model prices must be used with care and with understanding that a specific position may be highly illiquid.

Level 3: Unobservable valuation inputs (inputs that can't be corroborated by observable market data).

Level 1 is the most objective and most reliable determination of fair value, and Level 3 is the least. Because companies are reporting a sizable portion of their earnings based on the changes in fair value of items valued using Level 3 inputs, analysts have been publicly questioning the quality of the earnings of the companies.

Fortune magazine recently published an article titled "Wall Street playing with funny money—the increase in 'level 3' assets among big Wall Street banks is an ominous trend, argues *Fortune*'s Peter Eavis." In this article, the author points out that as a result of some Wall Street companies adopting SFAS No. 157 early, investors and analysts now have a better understanding of how their earnings are significantly affected by fair value amounts developed internally (Level 3 valuations). The author points out that a "bank's exposure to illiquid, hard-to-value assets jumped sharply higher in the third quarter, a development that deepens the concerns about the transparency and strength of bank balance sheets."

If a company has a significant portion of its assets valued utilizing Level 3 inputs, it would be important for the investor relations department to understand the governance surrounding those models as well as be prepared to answer analysts' questions regarding the reliability of their periodic earnings given that the amounts essentially were determined using unobservable inputs.

Educating their analysts regarding how the company determines fair values is an important step and will take some effort by companies' investor relations departments. It isn't that Level 3 fair values are bad. But it's an admission that the assets on the company's books aren't very liquid and are difficult to value. High-quality financial disclosures describing the company's methodologies and governance for fair value accounting will help ease the transition to fair value for investors and analysts. Companies will want to avoid the bad press associated with analysts questioning the validity of their financial statements.

Companies can't rely solely on analysts and investors to understand the process and reliability of fair value amounts recorded in their financial statements. Outreach and extensive disclosures in their public filings will help alleviate many of the concerns and questions that may arise.

WHAT'S NEXT FOR FAIR VALUE ACCOUNTING?

The flaw in the current mixed-attribute accounting model is that some assets and liabilities on the balance sheet are recorded at fair value and some aren't. As a result, it's often difficult for investors and analysts to compare the financial performance of companies within the same industry based on elections each made regarding fair value accounting.

The FASB recognizes this and has been expanding its fair value projects to include a Phase 2 (Phase 1 was the issuance of SFAS No. 159 in February 2007). In this project, the Board is considering whether to permit entities a one-time election to report certain financial and nonfinancial instruments at fair value with the changes in fair value included in earnings. The FASB is currently working on Phase 2 of the Fair Value Option project. Once finalized, this new Standard will allow companies to elect a greater number of assets and liabilities, including less-liquid nonfinancial assets, to be recorded at fair value with changes in value recorded in current earnings. ■

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