Another Fair Value Controversy

Users of financial statements have become increasingly critical of the fair value option (FVO) for financial liabilities, an accounting-policy option available under both U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). In this month’s column, I’ll describe users’ main objections to the FVO and how accounting standards setters are responding to them.

Background
The FVO for financial liabilities permits a reporting entity to measure eligible liabilities at fair value. Eligibility criteria differ somewhat between U.S. GAAP and IFRS, but eligible liabilities typically include the entity’s own debt. Common examples of an entity’s debt are loans for which the entity is the borrower and bonds that the entity has issued.

Conceptually, the fair value of such debt is the price that the entity would have to pay a third party in an orderly market transaction to induce the third party to assume the debt. In practice, debt is rarely transferred between debtors as a liability, but debt often trades among creditors as an asset. Consequently, accounting standards generally allow entities to estimate the fair value of their debt as the price at which the debt trades as an asset in an active market.

In general, an entity must make an irrevocable choice to apply the FVO—or not—upon initial recognition of a financial liability. That choice may be made independently of the FVO choices the entity has made or will make for its other liabilities.

After initial recognition, financial liabilities for which the FVO has been elected must be “marked to market” at the end of each reporting period. Entities report the periodic changes in the fair value of those liabilities in “Net Income” (U.S. GAAP) or “Profit or Loss” (IFRS).

Objections to Measuring Debt at Fair Value
The application of the FVO to entities’ debt has generated significant objections from financial-statement users. Users mainly object to the accounting outcomes that arise from changes in the perceived credit risk of debt to which the debtor has elected to apply the FVO. For example, a company may experience financial difficulties that cause the credit risk of its debt, as perceived by present and potential creditors, to increase. This can be expected to depress the fair value of the debt. The debtor entity’s adjusting journal entry to record the decline in the fair value of the debt would involve a debit to the appropriate liability account and a credit for the gain that the entity experiences as a result of the decline in the fair value of its debt. Thus when an entity elects the FVO for its debt, a decline in the entity’s creditworthiness is likely to have a favorable effect on the entity’s reported income. Many financial-statement users consider this to be a perverse accounting outcome.

I don’t concur with users’ main objection to the FVO because I don’t find the accounting outcome described above to be odd at all. Quite simply, decreases in the fair value of an entity’s debt below the debt’s amortized cost create the opportunity for the entity to settle its debt at bargain prices by buying back the debt in the open market. Such opportunities generate realizable economic benefits for the entity’s shareholders.

There are four other objections to the use of the FVO for an entity’s debt, however, that I’m very
sympathetic to. First, the optional-ity of the FVO can result in vast differences in the reported financial position of entities that are actually in similar economic situations. Thus the FVO for financial liabilities undermines the comparability of financial statements among entities. It also allows an entity to account for its debts inconsistently over time.

Second, the unrealized gain that exists when the fair value of an entity’s debt is less than the debt’s amortized cost is far more likely to be realized than the unrealized loss that exists when the fair value of an entity’s debt is greater than the debt’s amortized cost. That’s because it makes economic sense for the entity to buy back its debt in the open market when it can do so more cheaply than settling the debt under its original terms, whereas it wouldn’t make sense for the entity to buy back its debt when it could settle the debt more cheaply under its original terms. Thus, it doesn’t make much sense for the accounting treatment to be symmetrical both above and below amortized cost when the likelihood of gain/loss realization is decidedly asymmetrical.

Third, any unrealized holding gain reported for a fair-valued financial liability is unlikely to be fully realizable. If a debtor entity attempts to realize the gain by buying up the debt in its entirety, the entity would create higher-than-normal demand for the debt in the market, which would in turn drive the price of the debt upward from its existing level. The more expensive the debt is to buy in the open market, the less gain the entity would actually realize.

Additionally, some creditors (such as those committed to holding the debt to its maturity) may be unwilling to sell, further limiting the debtor’s realized gain.

Fourth, using the FVO for debt potentially adds significant volatility to the balance sheet and income statement to a degree greater than gains or losses are likely to be realized. In recent years, large banks have reported billions of dollars of unrealized—and potentially unrealizable—gains and losses from changes in the fair value of their debt. This has pointlessly complicated the analysis of their financial statements. And although hedging such volatility is possible in theory, it’s difficult and uncommon in practice.

**Outlook for Change**

In May 2010, the Financial Accounting Standards Board (FASB) issued an exposure draft on financial instruments in which it proposed changes to U.S. GAAP regarding the application of the FVO to entities’ own debt. In subsequent redeliberations, the FASB tentatively decided that, for FVO-designated financial liabilities, the portion of changes in fair value that result from changes in a reporting entity’s own credit risk should be presented separately in Other Comprehensive Income (OCI) rather than as a component of Net Income. The FASB hasn’t yet formally exposed its tentative decision for public comment. In October 2010, the International Accounting Standards Board (IASB) similarly amended IFRS 9, *Financial Instruments*, which is scheduled to become effective in 2015.

Unfortunately, the Boards’ responses to financial-statement users’ objections won’t be very helpful. Entities would be forced to determine whether changes in the fair value of their debt are the result—at least in part—of changes in perceived credit risk and, if so, to what extent. And the Boards’ intended changes to their respective accounting standards would do nothing to restore comparability, consistency, or usefulness to the reporting of debt in entities’ financial statements. But given the time frame of the changes, there’s always a possibility that the Boards will reconsider whether to continue allowing entities to measure debt at fair value.  

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