Fair Value Accounting Insights

Recent Developments in Valuation Issues Related to Fair Value Accounting

Robert F. Reilly

Fair value accounting disclosures continue to become more common in the financial statements of American companies. The Financial Accounting Standards Board (FASB) continues to promulgate accounting guidance that expands the application of fair value accounting for both asset and liability accounts. Nonetheless, many valuation analysts continue to seek professional guidance regarding the application of fair value valuation procedures. This discussion summarizes some of the recent FASB pronouncements related to fair value accounting disclosures and fair value valuation issues. Valuation analysts who perform fair value valuations should be familiar with these fair value accounting issues.

Introduction

The topic of fair value accounting continues to receive a lot of press, both in the technical accounting and valuation journals and in the general business publications. Rightly or wrongly, it seems that the implementation of various fair value accounting standards has caused more controversy than just about any other recent financial accounting standards change.

Correctly or not, the financial instrument fair value disclosure requirements are blamed for both the credit crisis and the general economic downturn that occurred in Autumn 2008.

Correctly or not, the fair value accounting provisions related to financial institution investments are blamed for the financial distress at many commercial and investment banks.

Correctly or not, many corporate executives allege that the impending merger of U.S. GAAP and international GAAP (with its fair value basis of accounting) will cause both:

1. undue expense and hardship to American industries and
2. uncertainty and fluctuation in the American securities markets.

And, correctly or not, private equity fund managers (and other investment portfolio managers) assert that the advent of fair value accounting to private investments will cause:

1. a decline in portfolio performance and
2. an unhealthy fixation on short-term investment valuations.

All of these above concerns may or may not include hyperbole and scapegoatism related to the recent trends in the banking industry, the stock market, and the general economy. However, one fact is not in dispute. That fact is: the presence of fair value accounting has increased—and is expected to continue to increase—in American business financial statements.

Industrial and commercial company officers and directors, equity investors (and their financial advisers), creditors, regulators, taxing authorities, and other parties are having to adjust to the increased presence of fair value accounting disclosures.

Even outside of the immediate corporate world, lawyers, judges, retirees, reporters, union members, property tax assessors, and many other parties are affected by changes to the fair value accounting standards.

Current Issues in Fair Value Accounting

Closer to home, valuation analysts are regularly called on to prepare valuations for fair value accounting purposes.

These valuations may include fair value analyses of various types of assets, properties, and business interests. And, these fair value valuations are often commissioned by industrial or commercial company managements for use in various financial accounting purposes.

The experienced valuation analyst should understand that these fair value valuations may be subject to a rigorous contrarian review by the client company's independent auditors.

And, the experienced valuation analyst should understand that these fair value valuations may be relied upon by the client company investors, creditors, regulators, and other third parties.

This discussion will present several of the current issues related to fair value accounting valuations. This discussion is not presented in any particular order of topical importance or significance. The only criteria for inclusion in this discussion is that these fair value accounting issues are of current concern to practicing valuation analysts.

And, this discussion does not imply that these are the only topical issues. A more comprehensive discussion could easily expand the list of fair value accounting concerns to the practicing valuation analysts.

However, this discussion provides at least a basis for considering the current five fair value accounting "hot issues."

Issue #1 – The FASB Proposed that All Financial Instruments Should be Reported at Current Fair Value on Bank Balance Sheets

In August 2009, the Financial Accounting Standard Board (FASB) proposed that all financial instruments should be marked to market on banking entity financial statements. Should such a proposal become effective, that means that all bank loans will have to be reported at fair value in a bank's balance sheet.

Such a fair value disclosure would likely cause banks to recognize loan losses faster than they do currently. Not surprisingly, this proposal has met with vocal resistance from the American Bankers Association and from other banking industry representatives.

The current GAAP requires that only the debt and equity investment securities owned by a financial institution be reported at fair value. This fair value disclosure is required by FASB ASC 320 *Investments—Debt and Equity Securities*.

Under the current FASB ASC 825, *Financial Instruments*, financial institutions are permitted to elect (but are not required) to disclose "eligible items" at fair value. Accordingly, the FASB could amend ASC 825 to require that all bank loans and other receivables be reported at fair value.

The proposal currently discussed by the FASB envisions that all bank financial instruments, including loans, be presented on the bank's balance sheet at fair value. Accordingly, the bank's loan portfolios would be accounted for in a manner consistent with the bank's portfolio of actively traded debt and equity investment securities.

To date, the FASB has not issued a specific Accounting Standards Update (ASU) or other professional guidance regarding the implementation of this fair value proposal. Nonetheless, banking industry participants have expressed concern regarding the availability of FASB ASC 820 Level 1 or Level 2 inputs related to the fair value measurement of bank loans.

Accordingly, banking industry participants expect that banks may have to rely on (and to disclose) FASB ASC 820 Level 3 inputs regarding such bank loan fair value accounting valuations.

In addition, banking industry participants are concerned that such a fair value accounting requirement may turn a portion of the typical bank's loan portfolio into a "toxic asset."

Issue #2 – As Defined in SFAS No. 157, The Standard of Fair Value is Unclear to Valuation Analysts

Three years after the issuance of SFAS No. 157, *Fair Value Measurements* (now FASB ASC 820), the definition of fair value is still not unambiguous to many valuation analysts—and to many parties that rely on fair value accounting valuations.

Of course, all valuation analysts are familiar with the following definition of fair value as presented in FASB ASC 820-20:

> 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.

However, the definitional conditions of the fair value transaction are not at all as familiar to valuation analysts as the definitional conditions of the more common fair market value transaction.

In particular, many valuation analysts still seek FASB (or other) guidance with regard to the estimation of the fair value exit price, and particularly with regard to the "orderly transaction" and "market participants" fair value conditions.

With regard to the FASB ASC 350 goodwill and the FASB ASC 360 long-lived asset impairment testing, the tests are

(of course) performed on a fair value basis. Nonetheless, the intrinsic value of the subject company is often easier to estimate than the fair value of the subject company.

And, particularly in a recessionary economy, the intrinsic value of the subject company may be greater than the fair value of the subject company.

Accordingly, the use of fair value estimates may result in greater asset impairment write-offs than the use of a more determinable (and, from a long-term investment perspective, an arguably more relevant) standard of value.

In order to address the request for clarity and professional guidance from valuation analysts (and from others), the FASB continues to issue Staff Positions and proposed Staff Positions regarding FASB ASC 820. Cumulatively, the related Staff Positions are much more voluminous than the original SFAS No. 157.

This observation is only intended to indicate the complexity of the fair value accounting issue and the continued (and, some may say, frustrating) need for FASB professional guidance to valuation analysts (and others) regarding fair value implementation issues.

For example, many valuation analysts still seek professional guidance with regard to the analysis of highest and best use (HABU). The analysis of HABU in the appraisal of real estate is a common and fairly straightforward procedure. However, even with regard to the appraisal of real estate, the FASB ASC 820 definition of HABU is not entirely consistent with the Appraisal Institute definition of HABU.

In addition, many valuation analysts seek professional guidance from the FASB regarding the HABU analysis of non-realty assets, such as equity security investments and intangible assets.

Issue #3 – The FASB Continues to Provide Guidance Regarding the Use of Level 3 Valuation Inputs in Fair Value Measurements

On August 28, 2009, the FASB issued an exposure draft of a proposed Accounting Standards Update (ASU). The proposed ASU is intended to improve disclosures about fair value measurements.

The proposed ASU is titled *Fair Value Measurements and Disclosures—Overall Subtopic* ("Subtopic 820-10") of the *FASB Accounting Standards Codification*. As mentioned earlier, this GAAP codification was originally issued as SFAS No. 157, *Fair Value Measurements*.

In this exposure draft, the FASB proposes disclosure improvements about fair value measurements. The proposed ASU provides guidance about fair value measurements that use significant unobservable inputs (that is, Level 3 inputs) because of their greater degree of uncertainty and subjectivity.

Therefore, for Level 3 inputs, FASB proposed the disclosure of any significant effect(s) on fair value measurements if the reporting entity used "reasonably possible alternative inputs."

The proposed ASU addresses the disclosure of different classes of assets and liabilities that are determined based on:

1. their nature and risk characteristics and
2. their placement in the fair value hierarchy (that is, Level 1, Level 2, or Level 3).

The FASB concluded that financial statement users need more robust disclosures about:

1. the valuation techniques used and
2. the valuation inputs for both Level 2 and Level 3 measurements.

The FASB proposed this disclosure because many users consider these measurements to be less reliable than Level 1 measurements.

Proposed New Disclosures

The proposed ASU provides amendments to FASB ASC 820. The amendments would require new disclosures as follows:

1. Effect of reasonably possible alternative Level 3 valuation inputs

   For fair value measurements using significant unobservable (i.e., Level 3) inputs: if changing one or more of those inputs to reasonably possible alternative inputs would significantly increase or decrease the fair value measurement (also referred to as sensitivity disclosures), then the entity:

   a. would have to state that fact and
   b. would have to disclose the total effect of the changes on the fair value measurement.

2. Transfers in and/or out of Level 1 and Level 2

   The entity would have to disclose

   a. the amounts of significant transfers in and/or out of Level 1 and Level 2 fair value measurements and
   b. the reasons for the transfers.

3. Activity in Level 3 fair value measurements

   In the reconciliation for fair value measurements using significant unobservable (Level 3) inputs, information about purchases, sales, issuances, and settlements would have to disclose on a gross basis—rather than as

one net number.

Proposed Clarification of Existing Disclosures

The proposed ASU provides amendments to FASB ASC 820 that would clarify existing fair value measurement disclosures as follows:

1. **Level of disaggregation.**

   An entity is required to provide fair value measurement disclosures for each class of assets and liabilities. A class is often a subset of assets or liabilities within a line item in the statement of financial position. An entity would need to apply judgment in determining the appropriate classes of assets and liabilities.
2. **Disclosures about valuation inputs and valuation techniques.**

   An entity is required to provide disclosures about the valuation techniques and valuation inputs used to measure fair value for both recurring and nonrecurring fair value measurements. Those disclosures are required for fair value measurements that fall into either ASC Level 2 or Level 3.

Issue #4 – The FASB Issues Accounting Standards Update with Respect to Measuring Liabilities at Fair Value

In August 2009, the FASB issued an ASU titled *Fair Value Measurements and Disclosure—Measuring Liabilities at Fair Value* (Topic 820-10).

The FASB perceived that there may be a lack of observable market information to measure the fair value of a liability. For example, an entity may extinguish a liability by settling the obligation directly with the counterparty—rather than by paying another entity to assume the existing obligation.

The ASU addresses how to measure the fair value of a liability in a hypothetical transaction when a restriction prevents such a transfer. Unlike an asset for which observable data may simply be limited, there is no observable data available to measure a restricted liability. This is because that liability is restricted from being transferred.

However, some liabilities (for example, bonds) are traded in the marketplace as assets. The ASU addressed whether the prices of debt instruments that are traded as assets would represent the fair value of that instrument.

The amendments in this ASU apply to all entities that have to measure liabilities at fair value.

This ASU provides clarification that, in circumstances in which a quote price in an active market for the identical liability is not available, an entity is required to measure fair value using one or more of the following valuation techniques:

1. A valuation technique that uses:
   a. the quote price of the identical liability when it is traded as an asset.
   b. quoted prices for similar liabilities or for similar liabilities when they are traded as assets.
2. Another valuation technique that is consistent with the principles of Topic 820. Two examples would be:
   a. the income approach, such as a present value technique, or
   b. the market approach, such as a technique that is based on the amount at the measurement date that the entity would pay to transfer the identical liability or would receive to enter into the identical liability.

This ASU also clarified that, when estimating the fair value of a liability, an entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the liability transfer.

This ASU also clarified that both of the following are considered to be Level 1 fair value measurements:

1. a quoted price in an active market for the identical liability at the measurement date and
2. the quoted price for the identical liability when traded as an asset in an active market when no adjustments to the asset quote price are required.

Issue #5 – The FASB Issues an Accounting Standards Update Regarding Investments in Certain Entities that Calculate Net Asset Value

An investor may invest in entities (i.e., investees) that permit the investor:

1. to redeem its investments directly with the investee or
2. to receive distributions from the investee at times specified under the terms of the investee's governing documents.

Examples of such investees (also referred to as "alterative investments") include hedge funds, private equity funds, real estate funds, venture capital funds, offshore fund vehicles, and funds of funds.

Many of these investees provide their investors with a

net asset value per share (or its equivalent, for example, member units or an ownership interest in partners' capital to which a proportionate share of net assets is attributed) calculated in a manner consistent with GAAP for investment companies. These investees must measure their underlying investments at fair value.

Because of the practical difficulties in estimating the fair value of alternative investments, this ASU provides guidance on using the net asset value per share provided by the investee to estimate the fair value of an alternative investment.

This ASU applies to any entity (1) if that entity holds an investment that is required (or permitted) to be measured or disclosed at fair value, and (2) as of the entity's measurement date, if the investment meets both of the following criteria:

1. the investment does not have a readily determinable fair value.
2. the investment is in an entity that has specified attributes or is in an entity for which it is industry practice to issue financial statements using guidance that is consistent with investment company GAAP measurement principles.

Investment Company GAAP

This ASU limits such GAAP to investment companies that have the following attributes:

1. **Investment activity.**

   The entity's primary business activity involves investing its assets, usually in the securities of other entities not under common management, for current income, appreciation, or both.
2. **Unit ownership.**

   Ownership in the entity is represented by units of investments, such as shares of stock or partnership interests, to which proportionate shares of net assets can be attributed.
3. **Pooling of funds.**

   The funds of the entity's owners are pooled to avail owners of professional investment management.
4. **Reporting entity.**

   The entity is the primary reporting entity.

The Practical Expedient

This ASU permits, as a "practical expedient," an entity to measure the fair value of an investment on the basis of the net asset value per share of the investment. Such a measurement would be allowed if the net asset value of the investment is calculated in a manner consistent with the investment company GAAP.

This ASU also requires disclosures by major category of investment about:

1. the attributes of investments such as the nature of any restrictions on the investor's ability to redeem its investments at the measurement date,
2. any unfunded commitments (for example, a contractual commitment by the investor to invest a specified amount of additional capital at a future date to fund investments that will be made by the investee), and
3. the investment strategies of the investees.

The major category of investment is required to be determined on the basis of the nature and risks of the investment in a manner consistent with the guidance for major security types in GAAP.

The disclosures are required for all investments regardless of whether the fair value of the investment is measured using the "practical expedient."

Summary and Conclusion

The FASB continues to provide fair value accounting technical guidance—to valuation analysts, to independent auditors, to reporting companies, and to others.

However, the above descriptions of some topical fair value accounting issues should indicate that, currently, there are more questions than answers.

And, as the convergence of U.S. GAAP and international GAAP continues to approach, the demand for fair value accounting implementation guidance is likely to increase.

For example, the IASB is expected to issue proposed guidance regarding the fair value accounting and valuation of bank loans by late 2009. The FASB, on the other hand, is not expected to issue proposed guidance on this controversial banking industry fair value issue until 2010.

In any event, valuation analysts who practice in this area should keep current on all of the developments in the fair value accounting debate.

Industrial and commercial company clients (and their auditors, their investors their regulators, and other interested parties) will expect the valuation analyst to be knowledgeable of the most recent fair value accounting and valuation developments.

Robert Reilly is a managing director of the firm, and he is resident in our Chicago office. Robert can be reached at (773) 399-4318 or at rfreilly@willamette.com.