

# **Bowles Symposium -- 2009**

## **Fair Values**

**Is the Crowd Always Right, or  
What is the Most Useful Information Anyway?**

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# Agenda

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- Background
- What is fair value
- How to measure it
- The controversy
- Prospects

# Background

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- Long-term accounting trend is towards fair values
  - Especially for business combinations and financial instruments
- Accelerated since the '90s in the FASB and IASB
  - Recent pronouncements
  - Fair Value Measurements projects, even though they do not address when to use it
- The FASB and IASB have stated their long term goal is the measurement of all financial assets and liabilities at fair value, although they may have backed off somewhat
  - They believe it is the best method of valuing financial assets and liabilities
  - It may reduce complexity

# Background

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- U.S. GAAP
  - 1991: SFAS 107 – disclosure of fair value of certain instruments
  - 1993: SFAS 115 – trading, available for sale, held to maturity categorization of financial instruments
  - 2001: Concept No. 7 – fair value measurement guidance
  - 2006: SFAS 157, *Fair Value Measurements*
    - Exit value approach
    - Controversy arose when markets turned illiquid
- IFRS
  - 2006: exposed SFAS 157 as a discussion paper
  - Currently uses both entry and exit values
  - Conclusions now being discussed
- Both will provide measurement guidance
  - Not when to use fair values
  - More recent emphasis on additional disclosures

# What is fair value

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- US GAAP

“The price that would be received for an asset or paid to transfer a liability in a transaction between marketplace participants at the measurement date.” (SFAS 157.5)

- IFRS

“The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.” (IAS 39.11)

# How to measure

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- Key points
  - Usually an exit price
  - In the principal (or most advantageous) market
    - To maximize amount received for an asset
    - To minimize amount paid to transfer a liability
  - From the perspective of a market participant
  - Between willing parties, not in a distress situation
  - Focus on economic value
    - Not based on intent or ability to sell an asset or transfer a liability
- May be applied to insurance contracts and pensions
  - Even with no relevant and reliable exit market
- Should not use prices for distressed transactions
  - Whether the market is distressed is not relevant
- Most controversial is how to estimate in illiquid markets
  - Where limited reliable observable prices exists
- A relevant, not just any, broker quote OK to use

# Measurement inputs

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- Hierarchy levels
  - Observable based on market data
    - Level 1
      - Quoted prices for identical asset/liability
    - Level 2
      - Other market observable inputs, with an adjustment
  - Unobservable
    - Level 3
      - Based on best available information
      - Subject to cost-benefit constraint
      - Marked-to-model
- Lowest significant input
  - Determines fair value category
  - Drives level of disclosure
- Level 3 disclosures
  - Reconciliation of beginning and ending balances
  - Total gains and losses for the period
  - Changes in unrealized gains/losses for period
  - Transfers in and out
  - Description of techniques and information used

# When it applies

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- Fair value measurement standard only addresses how to measure it
- When to apply fair value is indicated in other standards
  - SFAS 157 makes many fair values more consistent
- Fair value option – on a item-by-item basis
  - Potential to avoid a mixed attribute situation
  - Until ultimate objective achieved

# The controversy

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- Challenges of using market consistency as overall accounting objective
  - Volatility
  - Markets always overshoot, as market participants often follow the herd
  - Not necessarily consistent with use
  - Inadequate disclosures
  - Complex instruments, complex models
  - Affect on market cycles and market cycles affect measurement
  - Illiquid market problems, particularly on complex instruments
- In part, issue is due to the current mixed attribute model
- Has become a political issue

# The controversy – in favor

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- Don't shoot the messenger
  - Doesn't create adverse conditions, just reports on them
- Most transparent measurement method
  - Alternatives
    - Hide information from users
    - Reduce motivation to act when needed
  - Criteria for switching judgmental
  - Better than alternatives
- Avoids smoothing
  - Volatility isn't necessarily bad
    - May provide useful information, but more difficult to interpret
- It may be more appropriate to reduce pro-cyclicality through use of required capital as a shock absorber
- Reduces room for accounting arbitrage
- Most appropriate for many users of financial statements
- There is a need for better disclosure
  - Disaggregation of changes in fair values
  - More sensitivity disclosure

# The controversy – opposed

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- Unexplainable volatility
  - Helps promote short-term thinking
- Pro-cyclical
  - Induces bank-runs or overoptimistic picture when not appropriate
  - Blindly accepts efficient market theory, which doesn't work in practice
- Unnecessarily increases systemic risks
- At worst, has contributed to financial crisis
- Doesn't work in illiquid markets
- Better to suspend in extreme situations
  - When gap with intrinsic value becomes too wide
- Overly complex when applied in a mixed attribute system
- May be incompatible with good risk management practice
- Potential for manipulation

# Some current issues

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1. Choice between
  - Mixed attribute model and single fair value system
  - Measurement reliability and volatility
2. Whether there can be a gain or loss at issue
3. Changes in nonperformance risk for liabilities
4. Can the value of a derivative (option) be negative
5. Limited current guidance for insurance contracts
  - IASB insurance contracts phase 2 challenges including
    - Possible use of a current exit value
    - Measurement/calibration of risk margins to cover risks in a reliable manner
6. More effective disclosure needed

# Prospects

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- Fair value already in effect
  - For many assets, including derivatives and in allocation of purchase price for business combinations
  - Not likely to go away
- US GAAP
  - SFAS 157 for reporting years after 15 November 2007
    - But fair values have been used for disclosure since 1991
  - FASB has indicated this not necessarily the final word
    - Refinements may follow
- IFRS
  - In various standards now, e.g., IAS 39
  - Uncertain timing of new measurement standard
- Future convergence possible
- Recent SEC report suggests tweaking but not suspending
- Will remain controversial
- Will accounting standard setters' nirvana ever be achieved?