



Fair Value Accounting

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Leslie F. Seidman

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What Is Fair Value?

Statement 157, *Fair Value Measurement*

- Issued September 2006, effective for 2008 fiscal years
- Objective:
 - Clarify a long-standing concept in GAAP
 - Not new, did not expand use of fair value
 - Expand disclosures about fair value measurements



What Is Fair Value?

Fair Value Defined:

- *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.*
- Exchange price notion that impounds current expectations about cash flows from the perspective of a willing, informed, unrelated potential counterparty



What Is Not Fair Value?

Fair Value is **NOT**:

- Mark to make-believe, mark to management, “unfair value”
- Liquidation value negotiated in a fire-sale or distressed situation



Where Is Fair Value Used in Financial Reporting?

Ongoing fair value measurements (MTM)

- To reflect the business model or activity
 - Trading, speculating
 - Broker/dealers, mutual funds (fv model for decades)
- Reflects variability in expected cash flows
 - Derivatives (cost is often \$0)
- Alternative to hedge accounting (FV Option)

Many investors would prefer fv for entire balance sheet



Where Is Fair Value Used in Financial Reporting?

Fair value used to measure impairment

- Loans held for sale (e.g., to be securitized)
 - Lower of cost or market
- Securities with “other than temporary” impairment
 - Trigger: probable that not all cash flows will be collected during expected holding period

Only losses and recoveries are recognized (until sale or other disposition)



Where is Fair Value NOT Used in Financial Reporting?

- Guarantees: Management's best estimate of probable cash outflows
 - Fair value would use market-based assumptions to lay off the exposure
- Loan impairments
 - **Pools of smaller loans:** management's best estimate of uncollectible cash flows
 - **Larger loans (incl. restructurings):** Revised expected cash flows discounted using original effective yield; sometimes collateral value

Not all losses are measured using fair value



How Is Fair Value Determined?

- Fair value hierarchy: prioritize observable market data and inputs
 - Level 1—unadjusted quoted prices in **active markets** for **identical items**
 - Level 2—observable prices for **similar** items in active markets, rates, other inputs derived from market sources
 - Not everything observable is a *price*; not every price relates to the item being measured – management must use judgment and make adjustments, if necessary
 - Significant adjustments of observable data may render the estimate a Level 3 measure; triggers more robust disclosure



How Is Fair Value Determined?

- Level 3— Unobservable inputs
 - entity's own assumptions about assumptions a market participant would use, developed based on best information available in the circumstances
 - The measurement objective remains the same: exchange price between willing buyer and seller
 - Entities are required to disclose:
 - Information about the unobservable inputs and valuation techniques used
 - Quantitative information about the effect on earnings for items remeasured on an ongoing basis using Level 3 inputs.



Valuing Subprime Positions

- Many positions *used* to be traded in active markets (L1 or L2)
- Markets are no longer as active
- FAS 157 does not require companies to doggedly mark to prices/data that may not reflect active markets, represent distressed sales, quotes that are not based on actual trades, etc.
- Can't IGNORE those data points, but judgment must be used to factor them into an estimate of fair value
- Any estimate of fair value must include a risk premium—*not* simply management's optimistic assumptions about future value if held long-term



Valuing Subprime Positions

- Fair valuation can be very judgmental in these circumstances
- Still, investors overwhelmingly support fv estimates for these positions*
- When significant assumptions are used, disclosure of the approach and key assumptions is critical
- Other information may be provided voluntarily, such as sensitivity analysis, management's intended holding period, etc.

**Based on preliminary results of recent survey by CFA Institute*



Are Losses Exaggerated?

- It all starts with impaired loans
- Complex securitizations create synthetic (magnified) exposures relating to the *same loans* (e.g., CDOs, guarantees of ABS)
- Credit default swaps written on the *same loans*



Are Losses Exaggerated?

- Tallies of losses include all of these forms of exposure to the same loans
- Probably don't include exposures held by private companies
- Guarantees and CDS have a counterparty who is presumably in a gain position; those gains may not be included in the tallies
- This is NOT about fair value accounting



Concluding Remarks

- In difficult market conditions, accounting judgments can be challenging
- But, reported results must reflect what is happening in the markets
- Robust disclosure of fair value techniques and assumptions is the best way to provide transparency to investors in these circumstances



Concluding Remarks

Fair value reflects losses
that have been incurred,
it does not cause losses.