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Research Report

The effect of additional guidance on fair value measurement and disclosure in illiquid or inactive markets

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ABSTRACT

This paper examines fair value accounting – specifically, the application of FASB FSP 157-4 in the US. Data is analyzed from financial firms before and after FSP 157-4 was implemented to examine how this standard changed fair valuations and disclosures. We consider whether managers took advantage of the flexibility in the new standard by classifying their assets at level 3. We find that there is no significant change in the amount of assets that are transferred into level 3 after FSP 157-4 as compared to before. We also find a significant increase in the extent of disclosures as measured by word count. Fair value disclosures increased by an average of 52%. After further partitioning the sample based on size, we find that both main results hold for small and big firms in our additional sample. There is no evidence managers used the flexibility of the new standard to classify more financial assets at level 3; however, managers responded to the new standard with a significantly longer disclosure.

1. Introduction

Although fair value can be defined and measured in different ways (exit price, present value, current cost), this term generally refers to the market price for an asset or liability. US generally accepted accounting principles (GAAP) define fair value as "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." (FASB ASC 820-05-1) International financial reporting standards (IFRS) offer a similar approach to fair value.

The best evidence of fair value is quoted prices in an active market. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations.... The chosen valuation technique makes maximum use of market inputs and relies as little as possible on entity-specific inputs. It incorporates all factors that market participants would consider in setting a price and is consistent with accepted economic methodologies for pricing financial instruments (IFRS 9, 5.4.2-3).

These foregoing definitions give insight into the current controversy underlying fair value measurement. While the concept of fair value is commonly accepted, various problems arise in implementation. These include how to measure fair value, how to find a fair value in a market that is not well-ordered, and how to deal with a market change that does not reflect a change in value of the asset.

The fair value controversy could be summarized as a trade-off between timeliness and pro-cyclicality (Laux & Leuz, 2009). Proponents of fair value claim that it is unbiased and timely, reflecting the change in the value of an asset in a transparent manner. Opponents of fair value claim that widespread application of fair value measures creates pro-cyclicality through contagion effects. If one market

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participant sells an asset at an exorbitant price (perhaps in a bubble market) and all other market participants write up their assets, an individual market mistake becomes the market measurement, thereby amplifying market bubbles and depressing market downturns. Both sides of the debate have been argued vigorously, especially as the current financial crisis brought these issues to the forefront.

Of all asset classes and all industries, fair value is most commonly applied to financial assets and liabilities held by financial firms (e.g., banks). As the financial crisis unfolded and banks were forced to write down their assets and incur large losses, fair value accounting came under scrutiny. Banks complained that markets were illiquid, and transaction prices were the result of fire sales as firms attempted to unload risky assets and to preserve capital. As assets were written down, debt covenant requirements and margin calls, along with the inability to secure additional credit, created a cash crisis for many financial firms, some of which folded. Other financial firms were acquired by companies with stronger capital while others were bailed out by their governments.

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) responded to public and political pressure to revisit their guidance on fair value measurement. The IASB launched a project on fair value in May 2008, providing updated guidance in 2011 (iasb.org). The FASB responded with guidance updates that included the release of FSP 157-4, allowing firms to reclassify illiquid assets, which were previously fair valued based on transaction prices (Level 1 measurement), based on an internal model (Level 3 measurement) approach to fair value measurement.

FSP 157-4 has had its share of critics. Some contended that it was inadequate to address the current accounting challenges, and would generate unrealistic write downs for holding losses on financial assets. However, the most common concern was that management would abuse this flexibility and reclassify toxic assets to avoid write downs. Auditors were aware of this possibility, seeking additional guidance to assist them in preventing litigation from misclassification.

This paper examines these concerns. We collected data from financial quarterly reports directly before and after the effective date of FSP 157-4. We analyzed the exposure of firms to fair value, the reclassification activity, and the change in disclosures. Overall, we found that financial firms had a significant percentage of assets measured at fair value. Such firms increased their disclosures, but not their reclassifications, significantly in response to FSP 157-4.

This study should be of interest to academics as it explores the implementation of fair value in a less than liquid market. It should be of interest to practitioners as it summarizes industry response to guidance provided in FSP 157-4. Furthermore, it should be of interest to policy makers as it offers empirical evidence in response to particular concerns relating to the release of FSP 157-4.

The paper is organized as follows. Section two describes the theory underlying the fair value controversy and explains the fair value standard. Section three provides a review of the literature on fair value. Section four analyzes the data to examine concerns surrounding the release of FSP 157-4. Section five summarizes the results and states a conclusion.

2. Fair valuation

2.1. The fair value controversy

The fair value accounting standard, FAS 157 (ASC 820), took effect at the end of 2007 at the time the financial crisis was developing. Many banks and other financial institutions criticized this standard due to unrealized losses stemming from their financial assets, contending that FAS 157 aggravated the financial crisis. Specifically, opponents of FAS 157 asserted that illiquid markets in bank financial assets do not provide realistic long-term asset values that reflect true cash flows (Sunshine, 2008). Applying fair values, in view of their questionable reliability in such constricted markets, has the potential to increase income volatility, reflecting a gulf between accounting income and cash flows. Marking assets to market produces a procyclical bottom line, raising income in good times and creating losses in bad times (Dumortier, 2008). Additionally, fair valuation casts a cloud over the ability of financial institutions to maintain capital in those markets, in some cases leading to asset fire sales. The viability of the entire market for securitized assets could be impaired by mark-to-market accounting due to the risk from cumulative unrealized holding losses in reporting these securities at their estimated values. Fair values can impair comparability of asset values from one firm to another, so their application in cash flow forecasting should create considerable judgment.

Fair value proponents argue that such values are useful to investors in their decision making. Such values stress current cash flow expectations for financial assets as opposed to historical cost and amortized historical cost. Historical cost figures serve to manipulate income as decisions on when to sell the assets can be timed to reflect higher gains or losses. Additionally, bank regulation capital need not coincide with financial accounting capital since bank regulatory agencies seek to ensure bank stability whereas financial reporting regulators emphasize transparency and full disclosure, primarily to protect investors. Advocates of fair value maintain that the financial crisis stems from mortgage greed, if not fraud, due to risky behavior by financial institutions. The financial crisis was caused by securitization of bad mortgages, overrating of securities by credit rating agencies, and lax oversight by government regulators – not by fair valuation of financial assets per se. While fair value accounting reflects the volatility of investments, which banks do not wish to report, banks can accommodate volatility by acquiring less risky investments, enhancing their capital reserves, and engaging in suitable hedging transactions (Curtis, 2009).

Fair valuation is inherently subjective when contrasted to historical cost, yet few financial statement items are strictly based on historical costs; even plant and equipment are subjected to depreciation and impairments. While some banks and other financial institutions have