

# **Explanation and Benefits of Fair Value Accounting**

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## Explanation and Benefits of Fair Value Accounting

### Key Points

- Many financial instruments are measured and reported at “fair value.”
- Financial firms use some form of modeling in estimating fair value for many instruments.
- Most firms have a robust internal control process for ensuring that the models used in these valuations are reasonable and reflect underlying market conditions.
- Information about how firms calculate fair value is fully disclosed in financial reports.

### Definition

Fair value is an estimate of the price an entity would realize if it were to sell an asset, or the price it would pay to relieve a liability. Many financial instruments – such as shares traded on an exchange, debt securities (U.S. Treasury bonds), and derivatives – are measured and reported at fair value.

### Use of Fair Value

Fair value is a required measure for many financial instruments. Determining whether a financial instrument should be recorded at fair value in a company’s financial statements depends in part on what type of institution owns the instrument and the intended use of that instrument. For example, in the case of a broker-dealer, a high percentage of its assets typically are traded and *must* therefore be accounted for at fair value. Other institutions record financial instruments at fair value depending on what their intent is for holding the instrument or the nature of the business activity. If an institution decided to hold a U.S. Treasury bond to maturity, for example, the bond can be shown at its original cost. If the institution purchases another identical Treasury bond that it intends to sell in the near future, that bond would be accounted for at fair value.

In addition to using fair value measures to comply with public reporting requirements, companies measure their financial instruments at fair value for a number of internal processes, including: making investing and trading decisions, managing and measuring risks, determining how much capital to devote to various lines of business, and calculating compensation. The use of fair value measurements is deemed to be relevant in these areas.

### Determining Fair Value

The process of valuing an instrument to its fair value depends on how easy it is to determine a price for that instrument. Since fair value is the price at which a willing buyer and seller agree to trade, finding the right price is the key to valuation. In the simplest case, a firm can find the price or value of an instrument in a newspaper or other **quotation system**. These prices typically reflect the last price reported to the **secondary market**. This usually works very well because listed prices are generally available for such securities.

Listed, published prices are not available, however, for all financial instruments. In those cases, some estimation is often required to determine fair value. Firms use **valuation models** that take into account a variety of relevant data, such as current economic forecasts, general market conditions, the price of similar financial instruments, etc. to measure fair value. For example, corporate bonds typically trade in a well-defined range over Treasury securities of a similar maturity. Contemporaneous transaction prices in such instruments will generally be very helpful in estimating the fair value of similar securities. In most cases, some verifiable market data exists to bolster the objective determination of fair value through modeling. Firms rely primarily on judgment only for the very complex instruments where market parameters and prices do not exist.

### **Ensuring Accuracy**

Although judgment is involved in the fair valuation process, most firms have a robust internal control process for ensuring valuations are reasonable and consistent. Management review and oversight are key to ensuring accuracy. Valuation models are subject to independent review as part of the internal control process to ensure that they reflect underlying market conditions; moreover, they cannot be changed without approvals. In addition, estimates generated by the models are compared to actual trades to determine the reasonableness of the estimates. Firms also employ other means of independent verification, such as comparing estimates to the value of the instrument at termination.

### **Benefits**

Fair value provides important information about financial assets and liabilities as compared to values based only on their historical cost (original price paid or received). Since fair value reflects current market conditions, it provides comparability of the value of financial instruments bought at different times. In addition, financial disclosures that use fair value provide investors with insight into prevailing market values, further helping to ensure the usefulness of financial reports.

### **Disclosure**

Regardless of whether financial instruments are reported at fair value on the face of a firm's balance sheet, the financial statement footnotes contain information about the fair values of all a firm's financial instruments. These footnotes provide details on how such values are determined, e.g., quoted prices, comparison to similar instruments, other valuation models, etc.

In addition, firms will begin highlighting their most critical accounting policies in the Management's Discussion and Analysis (MD&A) section of their financial statements for years ended 2001. Many view the fair valuation process as one of those critical policies.

## Glossary of Terms

**Quotation System:** A quotation system can include: newspaper quotes, broker quotes, electronic systems where prices of Treasuries and other securities can be viewed, or subscription services that provide price data for specific instruments

**Secondary Market:** When a security is initially purchased from the firm issuing it, that transaction takes place in the primary market. Subsequent transactions in that security take place in what is sometimes called the after-market or the secondary market. This is what most people mean when they refer to "the market."

**Valuation Model:** Statistical techniques that take into account various factors so as to provide an estimate of the value of a financial instrument. These are often called pricing or valuation models. These models are regularly subject to rigorous review by the firms employing them to ensure that they accurately reflect current market realities.