



Fair Value Accounting Fact Sheet

Fair value accounting provides increased transparency to financial reporting by demonstrating an asset's or a liability's current value, thereby enhancing investor confidence in the capital markets. The goal of fair value accounting is to estimate as best as possible the prices at which positions held would change hands in orderly transactions based on current information and conditions.

History of Fair Value Accounting

Fair value accounting – also referred to as “mark-to-market” accounting – has played an important role in U.S. generally accepted accounting principles (GAAP) for more than 50 years¹.

The recent standard-setting history of fair value accounting under U.S. GAAP began with guidance issued by the Financial Accounting Standards Board (FASB) in 1975 that requires that marketable securities be recorded at lower of cost or fair value.² FASB complemented that original fair value standard in 1991, when it issued guidance requiring the fair value of financial instruments be disclosed in a company's financial statements.³ In 1993, FASB expanded the fair value recognition requirements by issuing a standard that required debt and equity securities that were held for trading or held for sale to be carried at fair value in the balance sheet and required changes in fair value to be recognized in the income statement or in a category of equity referred to as other comprehensive income⁴. This was augmented in 1998, when FASB standards were adopted that required derivatives to be measured at fair value.⁵

In 2006⁶, FASB issued a new standard, FAS No. 157, *Fair Value Measurements*, which provided a single, consistent definition of fair value, established a common framework for developing fair value estimates, and required expanded disclosures about those estimates. FASB issued FAS 157 to address the complexities caused by differing definitions of fair value. Stated differently, FAS 157 itself does not prescribe any particular accounting treatment or require fair value accounting but does specify how fair value is to be determined when fair value is required by another standard.

How Fair Value Accounting Works

Assets that a company intends to trade, including derivatives, trading securities and available-for-sale securities, must be valued at the current market price. According to the Securities and Exchange Commission, these asset types represent less than half of financial institutions' assets.⁷

FAS 157 establishes a hierarchy of valuation techniques that varies based on the availability of observable market information⁸:

- Level 1 inputs are “observable market data” – such as the quoted price for an identical stock or bond in an active market;
- Level 2 inputs are “other observable market data” – such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets; interest rate, yield curve and similar data that are observable at commonly quoted intervals; and other data that may be corroborated by market data (mark-to-market measurements); and
- Level 3 inputs are “unobservable firm supplied estimates,” including the reporting entity’s own analysis of the underlying economic data that market participants would factor into the pricing of the asset or liability (mark-to-model valuations).

Fair Value Accounting in the Current Economic Climate

Suspending or eliminating FAS 157 would reduce transparency by removing the guidance for measuring fair value and the requirement for expanded disclosures. Valuing financial instruments absent a uniform methodology, particularly in illiquid markets, would result in inconsistent measurements and would not provide users with the most transparent or relevant information about the value of a company’s financial instruments.⁹

Financial institutions and other public companies have the ability to provide investors in their financial reporting and financial statements with substantial information about the judgments and assumptions underlying their fair value measurements,¹⁰ including:

- The amount of assets and liabilities measured using significant unobservable inputs (level 3) as a percentage of the total assets and liabilities measured at fair value.
- The type of assets underlying asset-backed securities and information about the credit ratings of those securities.
- Whether the entity believes, and has the basis for the belief, that the fair values being reported diverge materially from the amounts the entity currently anticipates realizing on settlement or maturity.
- A general description of the valuation techniques or models used and how the entity validates those techniques or models.
- The criteria used to determine whether the market for a financial instrument is active or inactive.

¹ “Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch.” Council of Institutional Investors. Ryan, Stephen G. July 2008. Washington, DC.

² [Statement of Financial Accounting Standards No. 12](#), “Accounting for Certain Marketable Securities,” December, 1975.

³ [Statement of Financial Accounting Standards No. 107](#), “Disclosures About Fair Value of Financial Instruments,” December 1991.

⁴ [Statement of Financial Accounting Standards No. 115](#), “Accounting for Certain Investments in Debt and Equity Securities,” May 1993.

⁵ [Statement of Financial Accounting Standards No. 133](#), “Accounting for Derivative Instruments and Hedging Activities,” June 1998.

⁶ Ibid. 1.

⁷ [Report and Recommendations](#) Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark to Market Accounting, Page 14, United States Securities and Exchange Commission, December 2008.

⁸ Ibid. 1.

⁹ Ibid. 7. Page 16.

¹⁰ Sample Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements) by the U.S. Securities and Exchange Commission, Division of Corporate Finance, [Mar. 2008](#), [Sept. 2008](#).