

Analysis & Perspective

Fair Value Financial Reporting: An Investor's Perspective

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Over the past two decades, standard setters have directed their efforts toward providing the types of information that equity and credit investors (the primary users of external financial reports) find most helpful in their decision making.

As part of this trend, financial reporting standards issued by major standard setters, including the International Accounting Standards Board (IASB) and the U.S.-based Financial Accounting Standards Board (FASB), increasingly have required that companies report either individual items, or categories of similar items, in their balance sheets and income statements using fair-value measures rather than historical cost. Indeed, some 30 international and U.S. standards now require or permit such information, and more fair value-based standards are on the drawing boards.

Consequently, it is reasonable to inquire why the principal external users of financial statements, investors, and creditors, would desire fair value measures in preference to historical cost.

Investors require answers to a variety of questions in order to analyze the potential risk-return distributions of companies and to properly price their securities, and they use a variety of methods for evaluating the investment-worthiness of securities. Financial reporting exists to serve the needs of investors who cannot otherwise command the detailed financial information they need to make investment decisions. Thus, all events that can reasonably be expected to affect the value of investors' investments, such as changes in assets, liabilities and equities, should be recognized in the primary financial statements, including much information that is currently disclosed only outside of the financial statements (e.g., off-balance-sheet financing activities).

The quality of the information available to investors, its relevance, clarity and understandability, accuracy and reliability, and the timeliness of the information will ultimately affect the cost of capital investors and creditors will require for bearing the risk of investment in the company's securities, as well as the amount of capital they will provide.

Consequently, standard-setters and regulators, preparers and auditors alike must understand investors' information needs when determining what financial state-

ment recognition of transactions and events to require, how the items should be measured and displayed, and how much footnote disclosure should be provided. Specifically, they must understand what characteristics make the information useful for financial decision-making. This article will consider three of the most important characteristics of information that make it useful for investors' decision-making: relevance, reliability, and timeliness.

Relevance. One general attribute of useful information is *relevance*. Specifically, information is relevant when it can influence an economic decision.

In too many cases, the ultimate decision regarding what information recognition and disclosure to require in the statements has come to revolve around (1) a determination of what might be easiest to measure, and (2) the certainty of the resulting measurement, rather than the ultimate usefulness of the information and its relevance for decision making. Such criteria have led to the provision of information with dubious value to the investment decision-making process and a waste of resources for those who must provide it. For example, the amount a company paid for an asset 30 years ago, or five chief executives ago, is of little or no relevance to economic decision making today.

Reliability. A second, very closely related issue is the concept of the *reliability* of information and an appropriate meaning for the term. For investors, reliable information is that which faithfully represents what it purports to represent.

Unfortunately, reliability of information commonly has come to be equated with certainty of measurement. This is a considerable shift from the original concept of reliable information as that which provides a clear and faithful representation of the underlying economic event or transaction.

Put slightly differently, the value of information to investors is diminished in direct proportion to the degree that it fails to faithfully represent the company's operations, financial position, transactions, and events.

Note that reliable and useful information may not be measurable with certainty. Indeed, very few, if any, items in the financial statements are certain. The fact that the items appear as amounts sometimes is construed as indicating a precision and certainty that is not generally in evidence. Most amounts in the financial statements are estimates, some with a reasonable degree of precision, and others that make no pretense of precision or reliability. But the ultimate issue is and must be which information is most useful for investors' decision making. Sometimes, information that is highly relevant to investors' decision making has been moved

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out of the company's financial statements because it is less certain.

Some future events, such as the amount to be settled for a contract with contingent provisions, may have a wide range of possible outcomes. In some cases, the outcomes could affect the future viability of the company. It is critical that investors be provided with full disclosure of such information in the financial statements.

Timeliness. Finally, to be useful for investment decision making, information must be current and up to date. Information declines in value in direct proportion to the age or staleness of the information. Hence, to be relevant for investment decision-making, information must also be timely.

In a hypothetical perfect world with perfectly efficient and effective markets, information useful for investors' decision making would be continuously provided to the market through a variety of information channels. Unfortunately, in today's world many obstacles exist to the continuous provision of up to date, reliable information. In any event, investors will place greater value on the most current information that can be made available to them.

Fair Value Measurement. Recently, the FASB, working on behalf of itself and the IASB, completed a major standard-setting project, Statement of Financial Accounting Standard 157, *Fair Value Measurements*. Although SFAS 157 is now part of U.S. GAAP, the IASB is currently pursuing its own due diligence requirements in preparation for adoption of the standard for international standards.

This standard does not require that all assets and liabilities be reported at fair value. Rather, it specifies how fair-value measurements should be made for those standards that currently permit or require fair value (or will in the future). SFAS 157 defines the objective of fair-value measurement, establishes a hierarchy of measures that would meet the definition, and specifies what disclosures are required in the footnotes so that users of the statements will be able to interpret the measures. The objective of fair value measurement is straightforward: to determine the price that would be received for an asset or paid to transfer a liability in a transaction between market participants at the measurement date.

Note that the objective is to determine a market price. Because not all assets and liabilities have a readily available market price, FASB has specified a hierarchy of measurements accompanied by disclosures about how the measures were determined. This hierarchy has three levels:

Level 1: Observable quoted prices for identical assets or liabilities in active markets at the measurement date.

Level 2: Observable quoted prices for similar assets or liabilities in active markets.

Level 3: Unobservable inputs, such as inputs derived through extrapolation or interpolation that cannot be corroborated by observable data, including entity information.

For example, Level 1 prices would include published closing stock prices for equity securities held by a company as investments. Level 2 prices would begin with market prices for similar assets or liabilities and then adjust them as needed using observable market inputs,

such as quoted interest rates or other observable market data. Level 3 measures would be based on methods commonly used to value such assets or liabilities and would use market inputs where available (or managers' estimates when such information is unavailable). Disclosures would be made for all three levels, but most particularly for Level 3 measures, to enable users of the statements to understand how the measures were developed and to apply their own adjustments where desired.

Note that these three levels of measures are the same as those commonly used by corporate managers when deciding, for example, whether to acquire an asset or another entity, to sell an asset, to borrow, or to retire debt early. What SFAS 157 does is to standardize market understandings of what fair-value measurement means and how such measures should be developed when reporting to outside users of the financial statements.

As with company managers' acquisition and divestiture decisions, investors' buy, sell, and hold decisions are based on fair values and changes in those values, not outdated historical costs.

Clearly, if up-to-date information that faithfully represents the underlying transactions and events of a company is more valuable for investment decision making than is other information (including stale historical cost information) then a general principle can be stated: Fair value information is the information most relevant for financial decision making. As with company managers' acquisition and divestiture decisions, investors' buy, sell, and hold decisions are based on fair values and changes in those values, not outdated historical costs. By definition, fair-value measures impound all of the most current assessments about the value of an asset or liability and any future changes in that value, including the amounts, timing, and riskiness of the future cash flows attributable to the asset or obligation. Such expectations lie at the heart of all asset exchanges. Consequently, financial statements primarily based on outdated historical costs—measures that are removed by time and constantly changing markets from current conditions—are less useful for making such assessments.

This position on fair value measurement is not a new one for investors or for CFA Institute. For example, in 1993, a position paper published by the organization (then AIMR) observed:

It is axiomatic that it is better to know what something is worth now than what it was worth at some moment in the past. . . . Historic cost itself is in reality historic market value, the amount of a past transaction engaged in by the firm. . . . Historic cost data are never comparable on a firm-to-firm basis because the costs were incurred at different dates by different firms (or even within a single firm). There is no financial analyst who would not want to know the market value of individual assets and liabilities.

(From *Financial Reporting in the 1990s and Beyond*, p. 39.)

Some have argued that the incorporation of fair value measures into the financial statements will introduce uncertainty and subjectivity to the balance sheet and income statement. In fact, most amounts currently in the largely historical cost based financial statements, including some of the largest numbers, are estimates and subject to the widely varying judgments of managers. These include such accrual and allocation amounts as depreciation, amortization, bad debt and loan loss accruals, impairment charges, and dozens of other reported items. So, uncertainty and subjectivity in financial statements is not new but has been a feature of accounting and financial reporting for centuries.

Another objection to the incorporation of fair-value information in financial statements is that the use of fair-value may cause the volatility of statement numbers to increase. We would argue to the contrary: If fair-value measures result in greater volatility than historical cost measurement, then such measures have merely unmasked the underlying economic volatility already present in the company's operations.

Sometimes it has been maintained that business managers rely solely upon historical cost measures when managing their companies. However, it is worth observing that when business managers consider an investment in a new asset, a new plant facility, or the acquisition of another company, their investment decisions are based upon their estimates of the fair values

of the assets and liabilities to be acquired, and a comparison of these to the market price of the prospective investment, rather than upon the historical cost ledgers of the acquiree. That is, when business managers act as investors, they obtain and use the same type of information that their own investors and creditors need to price the company's securities.

Since the early 1990s, financial reporting standard setters have tended to base new standards on fair-value measurement. SFAS 157 represents a major step forward for investors, but it also provides clarity for preparers and those who audit their statements. However, the majority of standards comprising the bulk of current GAAP are based not on fair-value principles but on historical cost measurement. The mixture of the two measurement bases—fair value and historical cost—in financial statements results in the so-called "mixed (measurement) attribute system."

Much work remains to be done to bring these older standards into compliance with the FASB's fair-value standard. In the interim, the CFA Institute Centre for Financial Market Integrity has proposed modifications to the current financial reporting model that will better serve the investment analysis needs of investors and will accommodate the mixed attribute system during what is expected to be a lengthy transition period to a full fair-value financial reporting model.

For more information on the CFA Institute's *Comprehensive Business Reporting Model*, go to their Web site at <http://www.cfainstitute.org/centre/cmp/BusinessReportingModel.html>.