# AICPA Media Center ? FAQs About Fair Value Accounting



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**Fair Value Basics Explained**

- **What is fair value accounting?** Fair value accounting, also called "mark-to-market," is a way to measure assets and liabilities that appear on a company's balance sheet and income statement. Measuring companies' assets and liabilities at fair value may affect their income statement. SFAS 157 was issued in 2006 by the Financial Accounting Standards Board (FASB) effective for fiscal year 2008. SFAS 157 defines in one place the meaning of "fair value."
- **Why is it important today?** Huge losses reported by financial firms on subprime assets have led to a debate over the implementation of SFAS 157 in circumstances where markets collapse and price inputs aren't readily available. In the current crisis, banks and investment banks have had to reduce the value of the mortgages and mortgage-backed securities to reflect current prices. Those prices declined severely with the collapse of credit markets as mortgage defaults escalated.
- **What is FASB?** FASB is the independent U.S. accounting standard-setting body based in Norwalk, Conn., that sets U.S. generally accepted accounting principles used by all U.S. publicly-traded companies. Bob Herz, chairman of FASB, gave a speech in New York last week discussing the performance of U.S. GAAP in this financial crisis.
- **The AICPA supports the independent role of the FASB** as the authoritative private-sector arbiter of U.S. accounting standards in the U.S.
- **How does mark-to-market work?** SFAS 157 provides a hierarchy of three levels of input data for determining the fair value of an asset or liability.
  - Level 1 is quoted prices for identical items in active, liquid and visible markets such as stock exchanges.
  - Level 2 is observable information for similar items in active or inactive markets, such as two similarly situated buildings in a downtown real estate market.
  - Level 3 are unobservable inputs to be used in situations where markets don't exist or are illiquid such as the present credit crisis. At this point fair market valuation becomes highly subjective.
- **What does SFAS 157 apply to?** The fair value accounting standard SFAS 157 applies to financial assets of all publicly-traded companies in the U.S. as of Nov. 15, 2007. It also applies to non-financial assets and liabilities that are recognized, or disclosed, at fair value on a recurring basis. Beginning in 2009, the standard will apply to other non-financial assets. SFAS 157 applies to items for which other accounting pronouncements require or permit fair value measurements except share-based payment transactions, such as stock option compensation.
- **What is the AICPA's role in this?** The AICPA's role is to make sure that our members stay informed and participate in the debate. The AICPA will seek to ensure our members are educated and have the necessary tools and knowledge to comply with current accounting standards on fair value. The AICPA has formed a Fair Value Resource Panel to identify highest-priority member needs in the area of fair value measurements and address issues in the long-run by providing detailed implementation guidance in the future. The AICPA is an observer at the FASB valuation group.
- **Has the Fair Value Standard Been Impacted by the FASB Codification?** While the standard itself has not changed, under the Codification, SFAS 157 is now referred to FASB Accounting Standards Codification 820, Fair Value Measurements and Disclosures

**Fair Value Technical Explanation**

**What are the three pricing input levels?**

- The term inputs is used in SFAS 157 and is used in applying various valuation techniques (approaches). Inputs refer broadly to the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk.
- To increase consistency and comparability in fair value measurements and related disclosures, SFAS 157 created a fair value hierarchy . The hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels.
- The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1), and the lowest priority to unobservable inputs (Level 3).

**What is the definition of Level 1 inputs?**
Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An active market for the asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available.

**What is the definition of Level 2 inputs?**
Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs would include, for example, quoted prices for similar assets or liabilities.

**What is the definition of Level 3 inputs?**
Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective should remain the same; that is, an exit price from the perspective of a market participant that holds the asset or owes the liability.

Unobservable inputs should be developed based on the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity's own data used to develop unobservable inputs should be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.

**Additional Resources:**
A list of resources available from the AICPA can be found at
http://fvs.aicpa.org/Resources/Fair+Value+for+Financial+Reporting/

FASB's explanation of SFAS 157 can be found a
http://www.fasb.org/st/summary/stsum157.shtml

Information about FASB Valuation Resource Group can be found at
http://www.fasb.org/project/valuation_resource_group.shtml

The Securities and Exchange Commission's announcement and additional guidance:
http://sec.gov/news/press/2008/2008-234.htm

http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0908.htm - Dear CFO letter from Sept. 2008

http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm - Dear CFO letter form March 2008

The text of Bob Herz's Sept. 22 speech in New York is available at: http://www.fasb.org/news/09-18-08_herz_speech.pdf

The Center for Audit Quality, an AICPA affiliate, letter to Congress and the SEC:
http://www.thecaq.org/

Views of the Council of Institutional Investors are here: http://www.cii.org/UserFiles/file/press release on bailout FINAL (2) 09-23-08.pdf

Positions of the CFA Institute can be found here
http://www.cfainstitute.org/centre/topics/reporting/official/fair_value_reporting.html

A list of resources available from the AICPA can be found at:
http://fvs.aicpa.org/Resources/Fair+Value+for+Financial+Reporting/

**Related Products:**
A list of related AICPA products available at www.cpa2biz.com including:

- Fair Value Accounting: A Critical New Skill for All CPAs (CPE Self-Study)
- Fair Value Measurements Workshop
- AICPA/ASA National Business Valuation Conference
- Current Accounting Issues and Risks 2008 — Strengthening Financial Management and Reporting (Publication)