Fair Value Financial Reporting

An investor perspective, part 2

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This article is the second in a two-part series.

Today, the majority of standards comprising the bulk of current GAAP are not based on fair value principles but on historical cost measurement, the amount initially recorded for a transaction or event. Such measures may be based on a market price, a vendor's invoice amount, managers' estimates of the cost, a discounted cash flow measure, or some other amount. In contrast, a fair value measure is defined by Financial Accounting Statement No. 157 to be (1) a market price for an identical asset, (2) a market price for a similar asset that can be suitably adjusted using market inputs such as a market rate of interest, or (3) managers' estimates, preferably prepared using methods and inputs that the markets would use to value such an asset.

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 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 accommodate the mixed attribute system during what is expected to be a lengthy transition period to a full fair value financial reporting model.

The *Comprehensive Business Reporting Model* (*CBRM*)[1] is designed to separate financial statement disclosures by the type of measurement used for an item in the statements. These measurements include historical cost, managers' estimates, fair value measures, and cash flows. From the standpoint of investors, the key question is: How can investors more efficiently and effectively use the mixed attribute information currently available to them? In regard to fair value, the *CBRM* addresses this question in two ways: (1) the statement of changes in net assets available to common shareowners and (2) the reconciliation of balance sheet, cash flows, estimates, and valuation adjustments.

The Statement of Changes in Net Assets Available to Common Shareowners

The CFA Institute Centre model includes a new display format for the income statement, the "*Statement of Changes in Net Assets Available to Common Shareowners.*" This statement would expand and transform the current income statement commonly provided in most financial reporting systems. While retaining all of the information currently available in the statement, the changes would more clearly and completely

- distinguish among items with different measurement attributes, including items measured at historical cost and fair value,
- reflect the different types of business activities (operating, investing, and financing),
- display items in the statements by the economic nature of the item rather than the function for which it is used, and
- reflect and incorporate (1) the company's obligations to the various claimants on the net assets of the company and (2) the transfer of assets to settle those claims.

As currently measured, net income is the result of the recognition of *some* revenues and gains on accounting transactions less *some* expenses and losses. In contrast, the "Statement of Changes in Net Assets Available to Common Shareowners" is designed to include timely recognition of all changes in the fair values of assets and liabilities that are currently required or permitted to be recorded at fair value, while continuing to accommodate the separate display of historical cost information, including managers' estimates. That is, the model will separate the various measures so that investors can make better use of the information. Furthermore, the statement will not require information that current standards do not require to be reported.

If investors are to be able to evaluate how the value of their investment in a company is increasing or decreasing, then they must be able to fully understand how the company's operations and activities are increasing or decreasing the values of the assets they hold and the obligations they have incurred. The clearest measures of a company's wealth-generating or -consuming patterns are changes in the fair values of these assets and obligations. This statement highlights the information investors need to make these assessments.

A schematic diagram of the "Statement of Changes in Net Assets Available to Common Shareholders" is provided in **Figure 1**. The first column of the statement indicates the general layout of the items. Separate categories are established for operating, investing, and financing items. A line is provided for the net change in net assets before transactions with owners. One particular innovation is the inclusion of information in this expanded-format statement that is currently available only in the statement of shareowners' equity: payments of assets and distributions of equity interests to the various categories of owners of the company, including minority interest and common shareowners. The final line is the net change in net assets available to common shareowners.

FIGURE 1
Statement of Changes in Net Assets Available to Common Shareowners

	Current Period Transactions	Estimates	Valuation Adjustments	Net Change In Net Assets
Operating				
Investing				
Financing				
Net Change in Net Assets before Transactions with Owners				
Net Change in Net Assets				

The second column, current-period transactions, provides for separate display of the effects of all transactions and events occurring during the period that affect the company's activities. The third column includes managers' estimates for items such as depreciation, amortization of assets, provisions for bad debts, and the like. Managers' estimates are somewhat different in nature from transactions and events, requiring a greater degree of judgement in their development. The valuation implications of such estimates may differ from those of transactions and events, so they have been separated for greater clarity and to enhance the usefulness of the information.

The fourth column displays changes in the fair values of assets and liabilities that are currently required to be reported, or those that managers have chosen to report when standards provide such elections.[2] Hence, changes in the fair values of derivative instruments, share-based compensation, portfolios of trading securities and the like would be given separate recognition. Investors will be able to make use of the information much more readily than they can in the current reporting framework where all of the information about changes in a single line item, effects of transactions, changes in estimates, and fair values, are aggregated together in a single number. This separate display for the fair value components of line items may also assuage the concerns of those who are less than comfortable with the concept of introducing periodic fair value remeasurement into the accounts.

The fifth column accumulates and summarizes the net changes in net assets. Note that this column is somewhat similar to the limited and highly aggregated display that is normally provided in the income statement today. However, the items displayed in the column have been expanded to include all changes in net assets, including items currently reported in the statement of changes in shareholders' equity.

Observe that one of the major features of the statement is that it unbundles the various items by measurement type, permitting users of the statements to directly evaluate the items. Because the current financial reporting model provides for such items to be aggregated together by line item and also by function, investors must expend considerable effort to attempt to develop the information they need to value their investments. Given that such information is readily available currently in most companies' general ledgers, the provision of the information to investors in the new model should result in little or no additional cost to companies.

The company itself will benefit from the improved disclosure, and the greater clarity and reduced uncertainty that investors will have about the company's operations should result in lower risk premiums the company must pay to obtain needed capital and greater pools of available capital. This latter outcome has been well established in academic research over the years. That is, clearer and more complete disclosures reduce the company's cost of capital.

Reconciliation of Balance Sheet, Cash Flows, Estimates, and Valuation Adjustments

Entirely new is the "Reconciliation of Balance Sheet, Cash Flows, Estimates, and Valuation Adjustments," which is provided in **Figure 2**. Indeed, this is likely to be the most useful statement of all for investors because it is based directly on the analyses that investors must undertake to value their investments and the types of information they try to generate from the limited disclosure currently available. (Notably, such reconciliations are also a common feature of the analytical work undertaken by managerial accountants as well as independent auditors when conducting their analyses of the company's accounts to ensure that the accounts are complete and accurately stated.)

In brief, the reconciliation traces individual line items from one balance sheet to the next, separating the information by measurement type, cash flows, managers' noncash estimates,

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and fair value adjustments. Note that to prepare such a reconciliation, the cash flow information must be reported using the *direct method*. This method is the cash flow cognate to the income statement currently in use in most reporting jurisdictions. The indirect method, in contrast, begins with reported net income and "patches" the net income number for two major categories of items: (1) noncash items appearing in income in the current period (such as depreciation and amortization and noncash revenues recognized) and (2) items with cash consequences that have not yet appeared in income, such as additional purchases of inventory, or payments on prior period obligations (for example, compensation accrued at the end of the prior period and paid in the current one). The direct method provides much clearer information on cash receipts and payments, information critical for evaluating the ability of the company to convert resources into cash flows, and for determining the distribution of cash flows to the various claimants on the company's resources.

Note that in the "Reconciliation," any transactions and events that have been recognized in the second column, ("Current Period Transactions, of the Statement of Changes in Net Assets Available to Common Shareowners,") but that have not either been converted into cash or consumed cash would be displayed in the "Estimates" column. That is, both noncash accruals, such as noncash revenues, and other estimates, such as depreciation, would appear in the "Estimates" column. This display highlights the fact that until items such as revenues are collected in cash, they are estimates of the cash flows that will occur in the future—and only that.

The format throws into sharp relief the nature of the company's various value-generating activities and shows how new resources are generated and claims against those resources arise, how the company converts resources into cash and distributes the cash to claimants, and how the value of the residual claimants' investments is changed as a result of these activities. Importantly, too, the statement provides clear insight into the underlying riskiness of a company's operations by displaying the information needed to evaluate both the company's short-term and long-term prospects.

FIGURE 2
Reconciliation of balance sheet, cash flows, estimates and valuation adjustments

Balance Sheet: December 31, 200X	Cash Flow Statement, Direct Method	Estimates	Valuation Adjustments	Balance Sheet: December 31, 200X + 1

One might question why the issue of cash flow reporting is given such prominence in discussions focused on fair value reporting and measurement. The answer is direct and straightforward: cash flows are the *ultimate* fair value measures. That is, by definition they are current and up-to-date at every moment and therefore are continuously measured at fair value. One way of understanding this notion is to recognize that at the last split second before an item is received or paid in cash, it is measured or remeasured at fair value. Any difference between the accrual amount recorded in the books and the amount to be received or paid in cash must be recognized as a gain or loss at the time the cash flow is recorded. To do otherwise is to misstate the accounts.

Conclusions

This brief discussion has had as its objectives to explain the importance of fair value financial reporting for investors and its role in the investment decisions they must make. It also provides discussion of a simplified model for presenting fair value information, including cash flows and information based on other measurement attributes. The CBRM does not require information that is not currently mandated by standard-setters for financial reporting or that is not already available in the company accounts for purposes of managerial decision-making and control. Hence, it should be relatively straightforward for standard-setters to move toward such a display model. The benefits to financial statement users and, ultimately, to the companies that present such information will be immediate.

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FOOTNOTES:

1. The CFA Institute Centre for Financial Market Integrity paper *A Comprehensive Business Reporting Model: Financial Reporting for Investors* provides expanded discussion of the development of the model as well as examples of how it would apply to a variety of transactions and events. The full report is available on the CFA Institute Centre section of the CFA Institute website.
2. For example, the FASB has recently issued FAS No. 159, *The Fair Value Option*, which permits managers to selectively choose to apply fair value measurement to financial instruments held by companies.