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Fair Value Measurement Disclosure Change and its Impact on Investment

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Fair Value Measurement Disclosure Change

And it's Impact on Investment Banking

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Introduction

In the fall of 2008, a financial crisis took America by storm and left millions of Americans without jobs. The reason for the financial crisis was the financial regulatory system that allowed large parts of the financial system with little to no oversight. In 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law. This Wall Street Reform contained regulation that would change certain financial reporting standards in the few years after it was signed. The purpose of this research paper is to identify the cause for change in fair value measurement disclosure of 2012 for investment banks. In this paper the 2011-04 Accounting Standards Update, the Dodd-Frank Act, and the investment bank fair value measurement disclosure will be discussed.

Part II: Accounting Standards Update 820

In April of 2011, the FASB issued an Accounting Standards Update (ASU 2011 04) Topic 820 that defines fair value measurement. This amendment was created to achieve common fair value measurement and disclosure requirements across the U.S. GAAP and the IFRS. The FASB was very specific in identifying the purpose of the update. This update explained how fair value should be measured, but does not require additional fair value measurements and are not intended to establish valuation standards or affect valuation practices outside of financial reporting.

Even though the Accounting Standards Update was issued in April of 2011, public companies were not required to provide several new disclosures related to their fair value measurements until the first quarter of 2012. The requirement of providing detailed information about the assumptions for their Level 3 measurements and the processes they have in place to determine that these measurements are consistent with the fair value framework in US GAAP was a big challenge for most public companies. Ernst & Young analyzed the quarterly financial statement disclosures of 60 companies in various industries, to help companies see how their disclosure compared to their peers. They focused primarily on the new disclosures required for Level 3 measurements (i.e., fair value measurements determined using significant unobservable inputs). They looked at how companies complied with the requirement to categorize within the fair value hierarchy items that are only disclosed at fair value. In conducting this research, they found differences in the types of quantitative information companies chose to disclose about their significant unobservable inputs (e.g., disclosing the range of inputs used or the weighted average inputs for an asset class) and the level of disaggregation at which they provided the information. The disclosures were also consistent in some areas, including how companies generally addressed pricing information from third-party vendors, such as pricing services or brokers.

The ASU 2011 04 requires companies to disclose:

- Quantitative information about the significant unobservable inputs used in determining both recurring and nonrecurring Level 3 measurements.
- A description of the valuation processes a company has in place for its recurring and nonrecurring Level 3 measurements.
    - This may include information about the group within the company that is responsible for the valuation policies and procedures, the methods and frequency of the procedures in place for validating pricing models, the processes for analyzing changes in fair value measurements from period to period and how information from brokers or pricing services is evaluated.

- A description of the sensitivity of recurring Level 3 fair value measurements to changes in the unobservable inputs, if changing those inputs would significantly affect the fair value measurement (only for public companies).
    - Public companies are also required to describe any interrelationships between the unobservable inputs and how these relationships may magnify or mitigate the effect of changes to these inputs on the fair value measurement.

ASU 2011-04 does not provide specific guidance on what quantitative information should be disclosed to meet the requirement described in the first item above. Instead, it includes an example of the type of information companies may disclose. Consistent with the existing disclosure requirements in ASC 820, the new Level 3 disclosures apply only to items measured at fair value on the statement of financial position after initial recognition and are to be presented by class of asset and liability. ASU 2011-04 also requires other new disclosures. For example, public companies are required to categorize within the fair value hierarchy fair value measurements made solely for disclosure purposes. This publication includes our observations on the hierarchy classification of these items across the companies we analyzed, as well as for certain industries.

Ernst & Young’s analysis did not focus on the following new disclosures provided by public companies because they require less judgment. For recurring fair value measurements, the amount of any transfers between Level 1 and Level 2 of the fair value hierarchy, along with the reasons for the transfer and the company’s policy for determining when transfers are deemed to have occurred. Companies previously were required to disclose this transfer only if they were deemed to be significant (Ernst & Young. Web).

In addition to this update, the FASB issued another Accounting Standards Update in July of 2012 titled Topic 926. This update focused on addressing issues in accounting for fair value information that arises after the measurement date and its inclusion in the impairment analysis of unamortized film costs. The FASB states, “The objective of this update is to align the guidance on fair value measurements in the impairment test of unamortized film costs with the guidance on fair value measurements in other instances within U.S. GAAP” (ASU 2012-7, Web.) When this update was released, questions arose about the conflict between this Topic and Topic 820. The FASB explained that Topic 820 requires a calculation of an exit price under current market conditions at the measurement date. Topic 926, on the other hand, “Requires that an entity’s fair value analysis performed as of period end date reflect those results that become known after the measurement date to the extent that an entity cannot overcome the rebuttable presumption” (ASU 2012-7, Web.).

Part III: Dodd-Frank’s Involvement in Financial Reporting Disclosure

The Dodd-Frank Wall Street Reform and Consumer Protection Act is a collection of federal regulations passed by the Obama administration in 2010. This legislation was created to prevent the recurrence of events that caused the financial crisis of 2008. These regulations reached various parts of the financial system striving to create transparency within financial institutions. In the accounting aspect this Act, “Eliminates loopholes that allow risky and abusive practices to go unnoticed and unregulated…this includes loopholes for over-the-counter derivatives, asset-backed securities, hedge funds, mortgage brokers and payday lenders” (Banking Senate, Web.).

Title VII of the Dodd-Frank Act, the Wall Street Transparency and Accountability Act of 2010 established a new framework for regulatory and supervisory oversight of the over-the-counter (OTC) derivatives market. This new framework requires the swaps that are currently conducted in the OTC market to be cleared through derivative clearing organizations. According to KPMG titled, *The Dodd-Frank Act: Could there be Accounting Consequences?*:

> One likely accounting consequence of the requirements to clear swaps pertains to measurements and disclosures of fair value under ASC Topic 820, *Fair Value Measurements and Disclosures.* Fair value measurements take into account counterparty credit risk and collateral. To the extent clearing organizations become central counterparties to swap transactions and/or collateral maintenance is required, fair value measurements of swaps will be different from what they would have been absent those characteristics. Use of clearing organizations as central counterparties may also impact a company's eligibility to offset swaps in its balance sheet (KPMG LLP, Web).

This article points out some accounting impacts that the Dodd-Frank Act had on financial reporting. It makes an important link to the effect on ASC Topic 820. As mentioned before, Topic 820 is the Accounting Standards Update that explains how fair value should be measured.

Part IV: Investment Bank Financial Reporting Disclosure

As mentioned before in the Ernst & Young article, there are similarities and differences with the way companies chose to disclosure their fair value measurement. For purposes of this research paper, the focus will be on a sample of investment banks. There are 12 banks in this sample and their disclosure decisions for their 2011 and 2012 annual reports will be discussed. These banks have similar patterns and can be categorized into 3 disclosure groups.

The first disclosure group in our sample includes Barclays PLC, Citibank, Merrill Lynch and Co. Inc, Wells Fargo, and Goldman Sachs. In these 2011 annual reports, the companies discussed their methods of fair value measurement; however they do not disclose an official schedule with the significant unobservable inputs until 2012. In the fair value footnote of the Goldman Sachs 10K for 2011, there is a schedule that presents the valuation techniques and the nature of significant inputs generally used to determine the fair values of each class of level 3 cash instrument. The schedule explains that for Goldman Sachs' cash instruments, the valuation techniques vary by instrument, but are generally based on discounted cash flow techniques. In 2012, the same schedule is presented, but this time it discloses the range of significant unobservable inputs as of December 2012 and the value of the assets in each cash instrument category. The second disclosure category in the sample includes Bank of America, Credit Suisse, USB, and Deutsche Bank. This category of banks mentions their valuation methods in the 2011and 2012 annual reports but do not include a formal schedule. The exception to this sample is that Deutsche Bank lists their financial assets and liabilities collection, but it is not the formal schedule listing the techniques and significant unobservable inputs. The third and final disclosure group in our sample consists of Morgan Stanley and JP Morgan Chase. In this category the banks do not disclose any valuation techniques in 2011. In 2012 annual report they disclose the full fair value schedule.

Valuation techniques used by the Investment Banks:

- **Comparable bond price:** a pricing input used when prices for the identical instrument are not available. In the process of determining fair value using pricing data available for comparable instruments, there is strong amount of subjectivity.
- **Discounted cash flow:** valuing a project, company, or asset using the concepts of the time value of money.

- **Correlation model:** a statistical measure that indicates the extent to which two or more variables fluctuate together; positive correlation indicates the extent to which those variable increase or decrease in parallel. A negative correlation indicates the extent to which one variable increases as the other decreases.
- **Net asset value:** the value of a mutual fund that is reached by deducting the fund's liabilities from the market value of all of its shares and then dividing by the number of issued shares.
- **Market approach:** is a business valuation method that can be used to calculate the value of property or as part of the valuation process for a closely held business.
- **Corporate loan model:** a corporate loan is a loan to a business so that it can buy buildings, equipment; rather than to a person.
- **Option model:** marketable options require different valuation methods than non-marketable ones.

These valuation technique definitions are consistent with all of the banks in the sample. The bank disclosure information depicts the statements in Part II above, because the Accounting Standards Update was issued in April of 2011, but the disclosure requirement did not become mandatory until the first quarter of 2012. Most banks started disclosing the information in 2011 in paragraph form, and then prepared an official schedule for their 2012 annual report. Ernst & Young stated above that there were differences in the way companies chose to disclose the information. This is proven when looking at banks like Bank of America, Credit Suisse, USB, and Deutsche Bank, who never prepared a formal schedule, but complied with the regulation in paragraph form.

Part V: Conclusion

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. After the financial crisis of 2008, there was a need for transparency in financial reporting, so to prevent the occurrence of another financial crisis. The Dodd-Frank Act fulfilled this need for financial reporting transparency among other regulation. Once Dodd-Frank was passed, the FASB needed to issue and Accounting Standards Update to comply with the new regulation. When this update was issued in 2011, public and private companies were forced to disclose information in their annual reports beginning in the 2012, and some chose to begin disclosing the information in 2011.

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