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# Fair Value Accounting

**Fair valuation of investment fund assets and liabilities is a critical issue for managers and investors. In this article, Andrew Clark and Jon Mills of KPMG consider the implications of fair value accounting standards in the context of current market conditions. Andrew is a Senior Manager in Investment Management technical advisory and Jon is Head of Audit for Investment Management & Funds at KPMG.**

## Fair or "unfair" value?

Fair value accounting is in the news. Politicians have suggested that fair value accounting is flawed and may have contributed to the turmoil experienced in financial markets recently. When President Nicolas Sarkozy gets involved in a debate regarding fair value accounting then we know that this issue is considered to have wide ranging impacts ("Politicians rail against fair value accounting" FT 30/9/08). An alternative view is that complaining about fair value accounting is like blaming a torch for shining a light on the mess in your cupboard. This article considers the role that fair value accounting has in respect of investment funds and the issues for investors and investment managers.

## Why is fair value accounting important to investment funds?

A wide range of investment funds apply fair valuation accounting as the basis for preparation of financial statements. For many investment funds the principles of fair value are also relevant to the striking of unit prices. Therefore, the principles of fair value accounting may have a direct affect upon investment funds that is far beyond financial reporting, including the prices for subscription and redemption of units in open ended funds, performance reporting to unit holders and, not least, the calculation of management and performance fees. However, requirements for unit pricing valuation may not always be best served by accounting standards. For example, the accounting standards definition of fair value may result in the inclusion, or exclusion, of factors that would be considered relevant to setting a price for dealing purposes.

## What is fair value accounting?

Fair value accounting entails the measurement of assets and liabilities at "fair value" and recognising changes in those fair values as movements in the Statement of Total Return (or Income Statement).

The *UK Statement of Recommended Practice for Authorised Funds*, the SORP, defines fair value as

"the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction"

This definition of fair value is drawn directly from the UK accounting standard, FRS 26, and the same concept is embodied in IFRS and in US accounting standards.

Accounting standards setters consider fair value accounting to be a straight forward and clear approach to accounting and valuation. It can be summarised as marking to market according to the price that a participant would willingly buy (or sell) and results in immediate recognition of any changes in value. However, whilst it is a straight forward concept, and one that is intuitive and highly relevant to the way in which investment funds operate, the devil is in the detail!

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## Fair value accounting in current markets

Determining whether a market is considered active or inactive is the starting point for the application of fair value accounting. An active market is one in which transactions are taking place regularly on an arm's length basis. What is "active" is a matter of judgement and depends upon the factors and circumstances of the market concerned. Characteristics of an inactive market include: a significant decline in the volume of trading activity; available prices that vary significantly over time or between participants; and prices that are stale. This issue was recently considered by an Expert Panel reporting to the International Accounting Standards Board.

Fair valuation accounting requires that when a price for an investment can be obtained from an active market then that price is its fair value (generally without adjustment). An investment manager may feel that market prices available are irrationally depressed and not reflecting fundamental value but, where the market is considered to be still active, then fair value accounting takes current transaction prices as being the best measure of fair value.

When trading volumes fall care is required in assessing whether a market should still be considered to be active or should be regarded as inactive. Once a market is determined as inactive then considerable care is required as fair value measurement becomes more subjective under inactive market conditions. In such circumstances relatively few transactions can have a disproportionate effect on market prices, and brokers quotes, valuation services or pricing data providers become less reliable as an input into the measurement of fair value. Increased bid-offer spreads under illiquid conditions can also significantly affect fair values. Although a market may be considered to be inactive the objective of fair value measurement, being the current price that other market participants would be willing to transact, remains unchanged.

In current financial market conditions managers need to consider all available information and apply a greater degree of judgement in estimating the price at which an arm's length transaction would take place at the reporting date.

## What is the fair value hierarchy and why is it important for investment funds?

Fair value accounting has specific requirements regarding the inputs to be used in a valuation model when markets are inactive (or when it is considered necessary for active market transaction prices to be subject to adjustment). Valuation inputs are to be applied according to a hierarchy. This is clearly articulated in the US accounting standard (FAS 157), and the same approach is required by UK and IFRS accounting standards.

The term "fair value hierarchy" in FAS 157 refers to the relative reliability of inputs to a valuation technique used in arriving at a fair value estimate. The highest, most reliable level is Level 1 while the lowest, least reliable level is Level 3. A fund is required to use the highest level of input that is available to measure fair value. Hence a Level 1 input (being a quoted price in an active market) must be used to measure fair value whenever available, with certain limited exceptions. Level 2 inputs to valuation models are those that can be directly drawn from market evidence (such as market interest rates or prices) but which are not quoted active market prices for that particular instrument. Level 3 inputs are those that are based upon a preparer's own judgements about the assumptions that another market participant would use.

The significance of this approach could be illustrated, for example, when a non-binding broker quote is relied upon to value a corporate bond. When an investment manager intends to rely upon a broker quote then that broker estimate should be constructed by applying the inputs in the order specified in the hierarchy. The broker should use evidence of recent transactions in the same instrument above evidence from transactions in similar instruments, and should apply both of those sources of evidence above evidence from internal estimates of, say, future cashflows or defaults. Where this hierarchy approach has not been applied then according to fair value accounting standards broker's quote may not represent fair value.

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## Disclosure of the basis for fair value estimates

Developments in accounting standards require more detailed disclosure of the basis for fair value estimates and valuation model inputs. The requirement for funds preparing financial statements according to US GAAP are to apply FAS 157, which became effective for accounting periods commencing November 2007 onwards. This standard includes a requirement to provide an analysis of the investment portfolio according to each level in the fair value hierarchy used in the portfolio valuation.

The disclosure requirements of FAS 157 go further than the current UK and IFRS standards although IFRS is expected to be brought into line from 1 July 2009. This places a significant additional disclosure requirement on funds and it may be only a matter of time before these requirements are also applied to UK Authorised Funds.

## What are the other issues facing investment funds in the application of fair value accounting?

The accounting standards specify certain requirements regarding the application of fair valuation principles. Particularly relevant to investment fund investments are: the affect of blockage, restrictions and lock ins.

- *Blockage* Accounting standards prohibit funds from applying a "blockage" factor (a volume of stock that cannot be readily transferred to other market participants) when valuing a large position in an unrestricted security that is quoted in an active market. A blockage factor would adjust the price based on the size of the position relative to the trading volume. This means that when an investment fund takes a significant position in a stock in an active market the valuation is not permitted to be discounted due to restrictions on liquidity.

- *Restrictions* Where a fund holds a stock which is subject to "restrictions" (for example the fund is subject to provisions that prohibit or restrict the sale of the instrument for a specified period) then the valuation is only permitted to incorporate those restrictions under certain circumstances. When the restriction is an attribute of the security that would transfer with the security, then a discount in the valuation to reflect the restriction is appropriate. However, a discount is not appropriate if the restriction is an attribute of the entity and would not transfer to a market participant (e.g. if securities are pledged as collateral for borrowings of the entity).

- *Lock ins* A investment fund which invests in another fund (including a fund of funds) must consider how to measure appropriately the fair value of its investment. In July the US accounting standard setter issued a statement noting that it would be inconsistent with the principles of fair valuation to presume that a fund's NAV automatically equals an investment's fair value. This is clearly relevant to funds of hedge funds when an underlying fund has invoked extended lock in periods. In these situations the view expressed in the statement may indicate that the fair value of units in those funds would need to be discounted from its NAV price to reflect the lock in as an attribute of the fund's units. The statement has caused considerable concern in the US funds industry regarding the practical implication of this approach and the industry expects that further guidance will be issued.

## Conclusion

As politicians and accounting standards setters wrestle with reconciling the objectives of financial fair value reporting and financial stability, the future of fair value accounting is in question in respect of banks. However, in respect of investment funds the principles of fair value accounting appear more relevant than ever. A move away from fair value accounting principles is not expected. The challenge for the managers of investment funds is with the practical application of fair value accounting.

In applying fair value accounting the assessment of whether a market is considered active or inactive is fundamental to the approach to valuation.

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Accounting standards have specific requirements regarding the application of fair valuation principles and the need to incorporate relevant inputs according to the fair value hierarchy in valuation models. The application of specific rules within accounting standards; such as the requirements regarding blockage, restrictions and lock ins, may need to be considered carefully for the purposes of unit pricing.

Increased disclosures, analysing the investment portfolio by type of valuation input and approach, will become required practice.