The Fair Value Carnival: Fair or Rigged?

The recent economic downturn has led many to cry fair, and others to cry foul regarding current accounting practices. **By Jarrod Willis, M.B.A. student, University of Miami; Kenneth Hiltebeitel, Ph.D, CPA, Associate Professor of Accountancy, Villanova University; and Robert Derstine, PhD, CPA, Professor of Accountancy, Kutztown University**

Bankers, politicians, financial commentators, and certain lobbying groups have clearly voiced their opinions about the supposed downside to fair value accounting.

The objective of this article is to provide a review of fair value accounting. Through the use of a "carnival game" allegory and supporting references, we review the faults and advantages of fair value accounting. Significant points from both fair value opponents and proponents are presented. Issues of consistency and transparency, and their respective roles in presenting financial statements, are examined. Finally, the authors reach their conclusion regarding the effectiveness and need for fair value accounting.

Every summer American towns are inundated by carnivals and county fairs. Sweltering, humid days are endured in hopes of enjoying a comfortable night at the fair. However, even the mildest of summer nights are exasperated by the allusive "carnival game." These carnival games never appear entirely fair or completely rigged. Childish cries of victory echo from the water gun stand, while across the midway fathers scream: "This coin toss is rigged! It's impossible!"

Similarly, the recent economic downturn has led many to cry fair, and others to cry foul regarding current accounting practices. The fairness of fair value accounting is constantly called into question. Opponents feel that fair value accounting has led to, and even caused, recent financial woes. Bankers, politicians, financial commentators, and certain lobbying groups have clearly voiced their opinions about the supposed downside to fair value accounting. On the other hand, proponents believe fair value accounting to be the solution and savior—claiming that financial statements that do not show fair values are misleading or even fraudulent. Much like carnival games, the masses remain passionately divided on the issue. To take a strong stance on the matter, a clear understanding of each respective side is necessary.

The Financial Dunk Tank

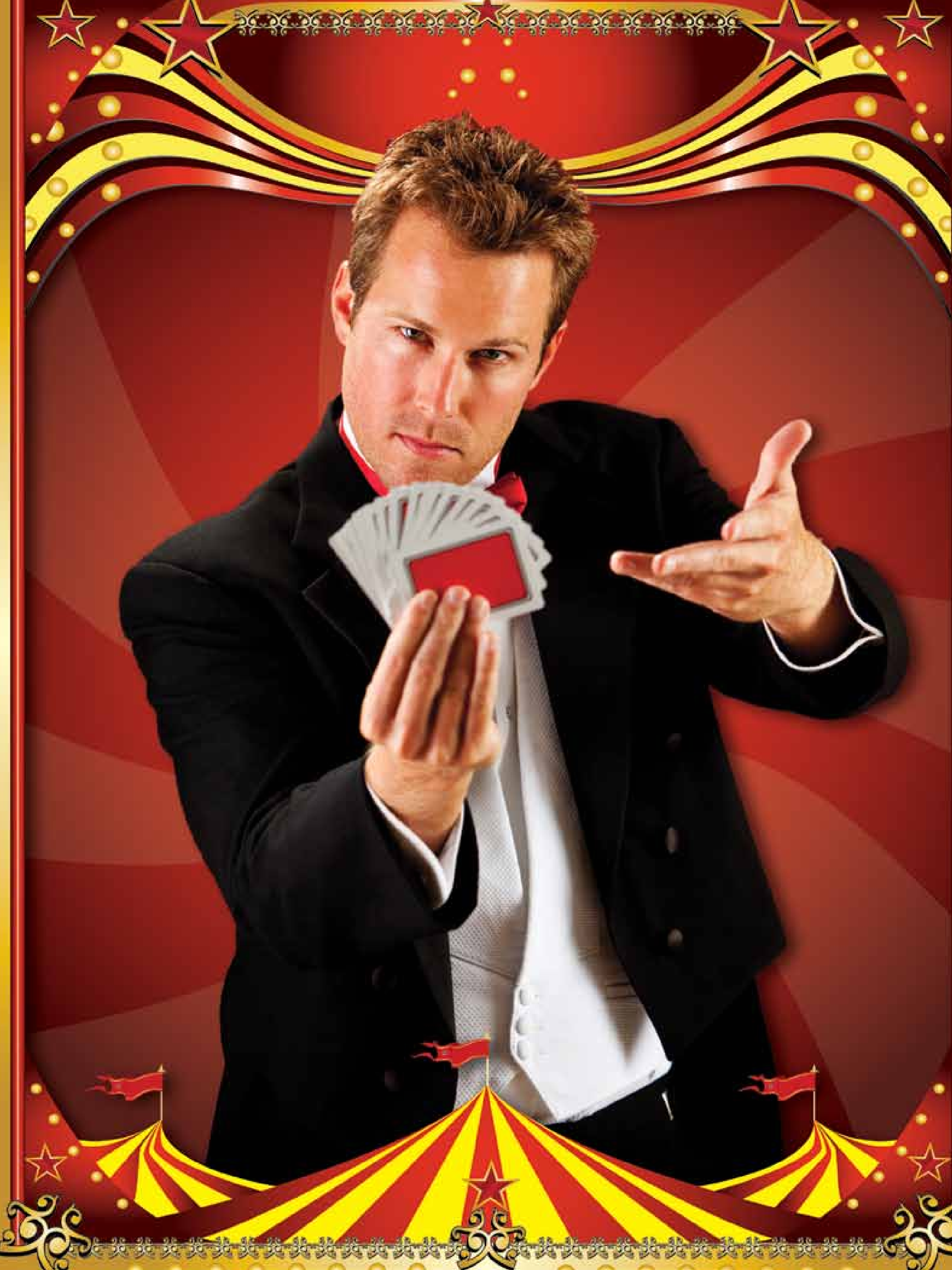
Similar to the carnival dunk tank, opponents of fair value feel drenched and drowned by the effects of 'mark-to-market accounting'. They are the poor individuals lured to participation by the promise of a "prize", but left with little more than a soaking wet wallet.

Critics take issue with the information fair value provides, especially fair values determined using "Level 3 of the Fair Value Hierarchy" [FASB Codification]. Assets and liabilities that do not have an observable market are given an estimated fair market value based on a company's 'internal pricing model'. Chasan claims: it is"…ridiculous to apply fair value accounting to assets that have no market" [Chasan, p. 1]. Other critics have characterized Level 3 estimates of fair value as "mark-to-myth" accounting.

Critics also debunk the proponents' claim that fair value more accurately represents a current transaction for the asset or liability. The critics emphasize the point that fair value often does not recognize value that actually has been 'realized', but only arbitrarily estimated. Rossi questions the reliability of fair values because of the use of estimates and measurements rather than *actual* transactions [Rossi, p. 5]. Since these estimations do not reflect actual transactions, opponents of fair value consider the use of estimates to be useful only in hypothetical financial situations.

Financial statement volatility is another issue raised by critics of fair value accounting. Colson claims that fair value measurement focuses on unrealized increases and decreases in asset and liability values that "… likely never 'will' be realized" [Colson, p. 2].

Assets and liabilities constantly valued at arbitrarily derived fair values result in financial reports that can fluctuate, making it hard to accurately capture financial position and results of operation. The result is "…rather than making things clearer, the fair value accounting rules only point to the futility of pricing assets and liabilities in highly volatile markets…" [Moyer, p. 1]. Thus, fair value does not provide the clarity that it claims. Instead, it only shows an inaccurate estimate of a volatile market, leading some investors to say that fair value is "not worth the earnings volatility it causes" [Chasan, p. 1].



Critics also point out the absurdity that, under fair value accounting, a company may revalue its liabilities to a fair value that is below book value by using a low interest rate to discount the liabilities to present value. The company would then recognize a gain and a resulting increase in shareholders' equity.

Quite a few companies are apparently using this fair value gimmick. According to a Credit Suisse report on first-quarter 2008 10Q's for the 25 companies with the largest amounts of liabilities on their balance sheets, measuring liabilities at fair value spawned first-quarter earnings gains ranging from $11 million to $3.6 billion [Katz and Reason]. James Tisch, president and chief executive officer of the Loews Corporation, argues that "the notion of a company marking its debt to market is absurd. It is going to destroy the notion of the income statement and make it unusable for investors who just want to see how a company did for a quarter." [Katz and Reason]

Estimated measurements, and increasingly volatile financial statements, also may lead managers to adjust the financial statements for favorable results. Colson addresses the role of managers in estimating fair value when he writes: "one paradox of the asset and liability recognition approach to accounting with fair value measurement is its reliance on insiders' current estimation of future events." [Colson, p. 2] Critics argue that if firm insiders of firms hold the power to estimate fair value, then the integrity of financial statements may be compromised. The result is that financial reporting is more susceptible to fraud and manipulation.

The purpose of financial statements is to provide an accurate and reliable illustration of a firm's current financial position and results of operations. If the information provided by fair value financial statements is unreliable, "… it should not be used to make financial decisions." [Shortridge, p. 3]

Winner-Winner Cotton Candy Dinner

Just as every winner of an oversized stuffed animal loves the carnival, many onlookers to the financial world adamantly support fair value accounting.

"Perhaps the strongest argument for a move to fair value accounting is that historical cost financial statements do not provide information that is relevant. The fact that the market value of publicly traded firms recently traded at five times their book asset values serves to highlight this deficiency." [Shortridge, p. 1]

Proponents of fair value accounting argue that investors and creditors extract more information from fair value information than from historical cost.

Imagine if Peter Minuit Company still owned all of Manhattan Island [which the history books state he acquired for $24 worth of beads and trinkets on May 24, 1626]. Peter, using Manhattan Island as collateral, approaches his friendly banker for a loan. Following proper procedure, the banker asks for a copy of Peter Minuit Company's audited financial statements for 2009. The only asset Peter Minuit Company would show would be Investment in Manhattan Island with the historical cost of $24. (Income statements for the last 383 years would show a grand total of $0 income from the investment.) Is this relevant information to help financial statement readers make better decisions?

Financial Accounting Standards Board Concept Statement #1 states: "Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans." Would a historical cost based set of financial statements help creditors and investors assess the amount, timing, and uncertainties of Peter Minuit Company's future cash flows? Obviously, no.

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Fornelli states: "it is intuitively obvious that what you paid for an item in the past [e.g., $24 for Manhattan Island] doesn't matter nearly so much to an investor as what you could get for it right now. Investors need to know the current value of assets so they can make fact-based decisions ….. That's what fair value is designed to provide." [Fornelli, p. 1]

In response to critics' complaints that fair value often is arbitrarily estimated, proponents suggest using a distribution of market prices with a sufficiently large sample of estimates that would be both more relevant and reliable than a single historic cost transaction. In other words, let's value Investment in Manhattan Island based on a distribution of multiple appraisers' estimates of fair value rather than a single $24 historical cost amount.

In regards to the critics' claims that fair-based reporting is creating volatility, Miller and Bahnson respond: "that indictment can be leveled if and only if one assumes that volatile results of risky investments simply don't happen if cost-based financial statements don't report them." [Miller, p. 1]

In other words, bury your head in the sand and all your troubles will no longer exist. Advocates of fair value accounting think that financial statement users "might temper their risks if they know the assets they are acquiring have to be valued at market value." [Moyer, p. 1]

Is management really making decisions based on historic cost? Proponents of fair value would state "no". So why not make that fair market value information available to the investors and creditors? Let the financial statement users make the decision of how to incorporate fair values into their evaluation models. Investors may purchase assets with greater caution leading to better allocation of scarce financial resources. In a time of financial turmoil, it is extremely important that capital is distributed in the most effective means possible. If financial statements do not provide the information needed, investors and creditors will turn to other sources of the information—resulting in increased costs and inefficiencies.

Consistency Amongst Carnivals

As a carnival attendee, above all else, one wants a certain level of consistency. Whether it is a county fair in Illinois, or Ohio, or Pennsylvania, attendees want to know that the format of the "Ring Toss" remains the same—same rules, same chances.

Although the FASB and the International Accounting Standards Board continue working on a convergence project and the SEC has exposed its timetable for a possible mandatory shift by public companies from U.S. GAAP to International Financial Reporting Standards, a number of disparities between the two sets of accounting remain—including the extent to which fair value accounting is permitted. Rossi reiterates this point when he writes that "we are heading toward global convergence in accounting standards, and fair value will play an increasingly significant role." [Rossi, p. 5]

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