



Fair Value Accounting: A Critique

By Peter J. Wallison

Fair value accounting, introduced formally in 1993 by the Financial Accounting Standards Board (FASB), was intended to make financial statements easier to compare and balance sheets more reflective of real values. Instead, as applied by accountants in the current credit crunch, it has been the principal cause of an unprecedented decline in asset values and an unprecedented rise in instability among financial institutions. The system has to be rethought, not only because of its contribution to financial instability but also because its procyclicality tends to create asset bubbles and exacerbate the effects of their collapse.

This is an essay about accounting, but that is not a good reason to stop reading. It has been more than a year since the credit crisis began, and it is now becoming clear that accounting—specifically, what is called fair value accounting—is at the core of it. If you think accounting is simply a way of recording numbers, think again. Accounting is a highly conceptual art in which many objectives compete for priority. And as in politics, appearance is often the same thing as reality. The financial condition of a company may appear strong or weak depending on the accounting theory that is used to value its assets. Trillions of dollars in worldwide investor losses—and the immense losses perhaps still to come—testify to the power of accounting concepts to shape reality.

A wide range of culprits has been implicated in the conventional analysis of today's credit crisis. Subprime mortgage brokers unconcerned about the quality of their loans, subprime borrowers taking loans they knew they could not repay, sloppy underwriting by lenders, condo-flippers hoping to sell their properties before the mortgage reset, impenetrably complex securitized instruments created by financial whiz kids, poor rating agency models, shoddy risk management at banks, laziness or inattention by investors, irresponsible sales practices

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by securities firms, and ineffective supervision by regulators are all elements that are properly cited as contributing causes. But for \$500 billion in bad subprime debt to cause a year-long crisis in a financial market with global assets of \$140 trillion, something else had to be at work.

That something else is fair value accounting—a sensible system in some respects and for some limited purposes, but not well designed for the challenges it has faced in the subprime meltdown, when it has been applied woodenly and without concern for the larger issues of systemic effect. FASB, the private group that establishes financial accounting policy, introduced the basic elements of fair value accounting in 1993 and currently has underway a long-term project, known as the “measurement framework,” to determine how the various ways to measure asset values should apply to different types of business activities. It might have been better if this study had been completed *before* fair value accounting was offered as the conventional way to value assets.

Fair value accounting rests on two underlying concepts: first, asset valuations should be consistently applied across industries so that companies can be more easily compared, and second, where there is a market price for an asset, it should under ordinary circumstances be carried on a company's balance sheet at that price. As general rules, these

are unexceptionable, but in practice they are in conflict and in some cases unworkable. Not all companies follow the same business model, even within the same industry. Some primarily hold assets to maturity, while others actively trade assets and liabilities. These different business models can result in significantly different asset valuations, and in some cases similar valuations for widely different business models. This can make companies in the same industry difficult to compare, especially because there is currently no way to make clear to investors or analysts what percentage of a company's assets are valued under each method. In addition, market-based movements in asset values can create substantial volatility in balance sheets and earnings reports—again, depending on a company's business model. Finally, where there is no observable market price, other valuation methods must be used, and these can vary from company to company—again, calling comparability into question.

The key underlying issue—which should be addressed in FASB's measurement framework—is the reason for fair valuing assets. Why, for example, is market price important? What does it tell investors or creditors if there is no intention to sell an asset at that price? It is clear that some nonmarket valuation method must be used when there are no observable market prices for an asset, but what rule applies when there is a limited market for an asset or when the market is not functioning normally? In the limited or abnormal market case, as discussed below, a strong argument can be made that the market price is misleading rather than informative. It is true that valuations based on the initial cost of an asset—although simple to apply—can be misleading as conditions change over time, but it appears that the mark-to-market approach favored by fair value accounting can be equally misleading in some circumstances and, in the market conditions today, affirmatively harmful to a full understanding of a company's financial condition.

The Basics of Fair Value Accounting

The foundational ideas associated with fair value accounting were adopted by FASB in Statement of Financial Accounting Standards (FAS) 115.¹ The rule divided financial assets into three categories—those held “to maturity,” those held “for trading purposes,” and those “available

for sale.” Each of these categories is treated slightly differently. Assets held to maturity are valued at amortized cost; assets held for trading are marked to market, with unrealized gains or losses included in earnings; and assets deemed available for sale are marked to market, with unrealized gains or losses excluded from earnings but included in shareholders' equity.

Obviously, these three categories provide many opportunities for the manipulation of earnings. For example, a management that wanted to increase earnings during a reporting period could transfer appreciated assets from the available-for-sale category to the trading category, where the appreciation would add to the bottom line; in the same way, moving a depreciated asset from the trading category to the available-for-sale group would reduce reported losses. To prevent this kind of manipulation, FAS 115 contains a number of rules about how assets are to be valued when moved from one category to another. The held-to-maturity category is particularly difficult for accountants and auditors to police because its key element is an assessment of management's intent, which is always difficult to determine.

For that reason, FAS 115 contains a number of stringent rules about when an asset may *not* be treated as held-to-maturity; these prohibit held-to-maturity treatment, for example, if the asset might be sold to meet the company's need for liquidity or if there were changes in funding terms or currency risk. If an asset is excluded from the held-to-maturity category, it is automatically carried in the available-for-sale group—and in that case it is supposed to be marked to market.

Because of the restrictive rules on when an asset could be considered held to maturity, it is likely that many commercial banks carried large portfolios of asset-backed securities as available for sale, even though the purpose of these assets was to produce cash flows. Investment banks, on the other hand, because their business model involved trading, probably carried proportionately more assets in their trading accounts, where the rise or fall in market value directly affected their earnings. In both cases, how to mark these assets to market became a highly complex and controversial matter, especially when increases or decreases in value on a mark-to-market basis could directly affect earnings. Accordingly, in 2006, FASB adopted FAS 157 in order to provide accountants and preparers with

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more guidance on how marking to market was supposed to be done.

FAS 157 formally defines “fair value” as “the price that would be received to sell an asset² . . . in an orderly transaction between market participants at the measurement date.”³ In other words, fair value is, theoretically, a quoted price for an asset in a properly functioning market. To implement the mark-to-market valuation regime, the rule established three categories or levels of certainty, a structure known as the “fair value hierarchy.” Level 1 covers those assets for which there is an observable—that is, quoted—price in the market. This is not as easy as it sounds, since for many debt and asset-backed securities there may not be a liquid and functioning market in identical assets. Where there is no market for identical assets, Level 2 in the hierarchy applies. This category describes how to use quoted prices for similar assets in active markets or other observable prices such as yield curves for the same or similar assets.

Finally, there are Level 3 assets. In the words of FAS 157, Level 3 covers assets for which there is “little, if any, market activity.” There is much confusion about Level 3 assets, primarily because this level can only be understood by deciphering the obscure language that FASB used to describe this category. Level 3 makes extensive use of the terms “observable inputs” and “unobservable inputs” in describing the valuation process. Observable inputs appear to be market prices, although why FAS 157 did not simply call them so is unclear. Unobservable inputs are “the reporting entity’s own assumptions about the assumptions market participants would use in pricing the asset.” Unobservable inputs are disfavored: “Unobservable inputs shall be used to measure fair value to the extent that observable inputs are *not available*.”⁴ It appears that, with this language, FASB was attempting to create a kind of sliding scale on which greater weight in valuation would be placed on market prices when these are available. Confirming this interpretation, FAS 157 states: “Valuation techniques used to measure fair value shall maximize the use of observable inputs”—that is, market prices—“and minimize the use of unobservable inputs.” In other words, FAS 157 requires reporting companies and their auditors to give greater weight to market prices, where they are available, than to any other method of valuing assets. Nevertheless, there are many cases in which

observable inputs are not available in any sense; in these cases, it appears, companies use cash flow estimates and expectations to value their asset-back portfolios and other assets.

The failure of the SEC, FASB, and the accounting profession to accept responsibility for adjusting the rule to take account of a truly unprecedented and still-dangerous situation for the financial markets is difficult to understand.

With this background, it becomes clear why and how fair value accounting has had such a profound effect on the financial reports of banks and securities firms. The stringent rules on when assets can be considered held to maturity forced most debt and asset-backed securities into the two accounts that are required to be marked to market under FAS 115. Then, although FAS 157 allows the use of a model of some kind under Level 3, it disfavors this method if market prices are available. FAS 157’s bias toward the use of market prices—which continued, as described below, even where the market was not functioning normally—had a predictable effect on how auditors inter-

acted with reporting companies; in general, it appears that auditors have given substantial weight to market prices in valuing assets, despite the condition of the market, and this in turn has had a highly adverse effect on the apparent financial condition of companies.

The Effect of Mark-to-Market Accounting on Asset Values

As losses mounted in subprime mortgage portfolios in mid-2007, lenders demanded more collateral. If the companies holding the assets did not have additional collateral to supply, they were compelled to sell the assets. These sales depressed the market for mortgage-backed securities (MBS) and also raised questions about the quality of the ratings these securities had previously received. Doubts about the quality of ratings for MBS raised questions about the quality of ratings for other asset-backed securities (ABS). Because of the complexity of many of the instruments out in the market, it also became difficult to determine where the real losses on MBS and ABS actually resided. As a result, trading in MBS and ABS came virtually to a halt and has remained at a standstill for almost a year. Meanwhile, continued withdrawal of financing sources has compelled the holders of ABS to sell them at distressed or liquidation prices, even though the underlying cash flows of these portfolios have not necessarily been seriously diminished. As more and more distress or

liquidation sales occurred, asset prices declined further, and these declines created more lender demands for additional collateral, resulting in more distress or liquidation sales and more declines in asset values as measured on a mark-to-market basis. A downward spiral developed and is still operating.

The Institute of International Finance (IIF) concisely described this process in a report issued in April 2008:

[O]ften-dramatic write-downs of *sound* assets required under the current implementation of fair-value accounting adversely affect market sentiment, in turn leading to further write-downs, margin calls and capital impacts in a downward spiral that may lead to large-scale fire-sales of assets, and destabilizing, pro-cyclical feedback effects. These damaging feedback effects worsen liquidity problems and contribute to the conversion of liquidity problems into solvency problems.⁵

The unending writedowns have produced a number of similar statements by analysts to the effect that things have gone too far—that assets have been written down well below their real value. Statements of this kind have been made by S&P analysts,⁶ the Bank of England,⁷ the Financial Stability Forum,⁸ and, most recently, the Bank for International Settlements.⁹

It is through this mechanism that the decline in market values—and its recognition in the mark-to-market valuation required by fair value accounting—has had its most significant effect on the balance sheets of financial intermediaries such as commercial and investment banks. These entities were likely holding large amounts of MBS and ABS, many of them rated AAA and thus initially thought to be of high quality. Because of the difficulty in meeting the standards for assets held to maturity (carried at amortized cost) under FAS 115, most of these assets were probably carried on balance sheets either as trading assets or assets available for sale—both of which are subject to mark-to-market rules under fair value accounting principles. By many accounts, the cash flows associated with these assets have generally continued to meet expectations, but the market values of the assets themselves have continued to fall. Under fair value accounting principles, then, these commercial and investment banks have been required to continue to write down the value of the asset-backed securities on their books, producing large and continuing operating and capital losses and making them appear weaker than they

would if their assets were valued on the basis of the cash flows these assets produce.

In an effort to shore up their balance sheets, these organizations were compelled to sell shares at much reduced values, causing substantial losses to their shareholders. Bear Stearns, the first victim of this process because it had been unable or unwilling to raise sufficient new equity in time, had to be rescued by the Federal Reserve. Its failure would likely have created panic among the millions of investors around the world who—in mid-March—had doubts about the financial stability of most of the world’s major financial institutions. Without this rescue, these investors and creditors might have rushed for the doors in all the great commercial and investment banks, producing a worldwide financial collapse. It seems an unavoidable conclusion, however, that the doubts about the financial stability of these institutions were sown by the drastic cuts in asset prices required by the mark-to-market valuations of fair value accounting, instead of a fair appraisal of the value of the cash flows their assets were producing.

This was not a necessary outcome. FAS 157 contains language that—if properly and reasonably applied—might have prevented this outcome. It should be recalled that FAS 157 requires market prices to be used for the valuation of assets when they are sold in an “orderly transaction” and that Level 3 valuations (unobservable inputs, like models) may be used when there is “little, if any, market activity.” In discussing the meaning of “orderly transaction,” the rule’s language is important:

A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset . . . at the measurement date. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; *it is not a forced transaction* (for example, a forced liquidation or distress sale).¹⁰

This language would have made it possible for FASB or accountants themselves to adjust their implementation of FAS 157 so that preparers could take account of the fact that the market prices they were seeing were the result of “a forced liquidation or distress sale.” It was also possible that the Securities and Exchange Commission (SEC)—which has delegated financial rulemaking authority to

FASB—would step in and clarify FAS 157 so that the market prices of distressed and liquidation assets did not become the basis for the values that accountants would require that their clients use. But that is not what happened. In early March 2008, the SEC sent a letter to the chief financial officers of public companies, commenting on FAS 157 and its applicability in current market conditions:

Fair value assumes the exchange of assets or liabilities in orderly transactions. Under SFAS 157, it is appropriate for you to consider actual market prices, or observable inputs, even when the market is less liquid than historical market volumes, *unless prices are the result of a forced liquidation or distress sale*. Only when actual market prices, or relevant observable inputs, are not available is it appropriate for you to use unobservable inputs which reflect your assumptions of what market participants would use in pricing the asset or liability.¹¹

The letter gave no useful guidance whatsoever to companies or accountants about the effect of market conditions on asset values. It avoided completely the central question—whether market values were the result of distress sales and liquidations—and probably made things worse by saying that “actual market prices” had to be used as long as they are available, unless of course these “actual market prices” are the result of a forced liquidation or distress sale. Moreover, the last sentence of the quoted paragraph also discouraged the use of Level 3 valuation methods under FAS 157—which applies when there is “little, if any market activity”—by stating that this was possible “only when actual market prices, or relevant observable inputs, are not available.” If Level 3 valuations had been permitted, companies might have been able to use discounted cash flow for valuing their assets, thus avoiding the writedowns associated with marking their assets to distressed market prices. All the SEC had to do in this connection was note that, even though some prices were available in the market, there was actually “little . . . market activity”—a fact everyone in the market was pointing out at the time.

As for FASB and the accounting profession, they resisted any change in the wooden application of mark-to-market accounting to asset values. Their representatives

continued to insist that if a market price was available, no matter what the condition of the market, it was to be preferred to any other way of establishing asset values. Thus, at an AEI conference on fair value accounting in April 2008, an FASB representative responded as follows to a question about whether companies are being compelled to use distressed or liquidation prices to value their assets:

Are there many willing buyers of those assets? That might suggest that it is not a distressed sale even though the seller is in distress. So it’s a very judgmental question, and just to sort of complete the loop, even in those rare circumstances where we would say, that’s a distressed sale, it does not mean that you ignore it.¹²

A representative of an accounting firm expressed the same view:

Fewer or even a lack of any transactions in a debt security or similar debt security makes it much more challenging to determine fair value. But, again, even with fewer transactions, less liquidity in the marketplace, I don’t think that would lead you down the path that fair value is still not the most relevant measurement to users of the financial statements.¹³

These responses simply read out of FAS 157 the language that creates an exception for markets that reflect distress or liquidation sales. If this language was intended to have any meaning, it would certainly apply in the financial market we have been experiencing since the summer of 2007. The failure of the SEC, FASB, and the accounting profession to accept responsibility for adjusting the rule to take account of a truly unprecedented and still-dangerous situation for the financial markets is difficult to understand. All that can be said with certainty is that this failure occurred and is continuing, with huge resulting losses to investors and unnecessary jeopardy to the stability of financial institutions.

Fair Value Accounting and Asset Bubbles

Fair value accounting must be fixed, and quickly—not just because of its strongly adverse impact on financial

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institutions in today's market, but also because it is highly procyclical. In other words, it tends to exacerbate current financial trends, whatever they are. It may well be, for example, that fair value accounting was in substantial part responsible for the residential real estate bubble that collapsed—with devastating consequences—over a year ago.

We can now see how the mark-to-market effect of fair value accounting has caused a downward slide in asset values and how this decline has evolved into a dangerous downward spiral. But it is important to note that rising asset prices have the opposite—and equally procyclical—effect. As market values rise for homes, stocks, commodities, or any item that has a readily available price, more and more credit becomes available to carry these assets. As more credit is available, more money is chasing fewer assets and prices rise. From the standpoint of institutions, a rise in the value of assets is recognized in earnings under fair value principles if the assets were held for trading and recognized in the institution's capital or equity position if the assets were treated as available for sale. In both cases, the growing earnings and strengthening capital induces more borrowing and the acquisition of more assets, so the upward spiral—also known as a bubble—continues.

It is no answer to say that bubbles and collapses of all kinds are ultimately the result of the human tendency to think that trends at any given moment will continue. Of course this is true, but the object of policy design is to adopt those policies that will counteract and ameliorate what we know to be the normal failures in human activities and perceptions.

Procyclicality is obviously an unintended consequence of fair value accounting, but nonetheless an issue for policymakers. The central purposes of fair value accounting were good—to make financial statements easier to compare and to bring asset values more in line with reality—but these goals, even if they had been achieved, are not as important as avoiding or reducing asset bubbles, producing steady growth in the economy, and encouraging stability in our financial institutions. That is why, to paraphrase Georges Clemenceau on war and generals, accounting is too important to be left to accountants. Someone with a broader perspective than the accuracy of financial statements has to take control of the process of reforming fair value accounting. This would normally be a task for the SEC, but the agency, with its March 2008

letter to chief financial officers, indicated that it is not prepared to take on this task.

If some policymaker takes charge, reform will mean curbing its effect in causing bubbles when assets are rising in value and the instability of financial institutions when asset values are falling. It will also mean giving the term “forced liquidation or distress sale” its obviously intended meaning as a protection against requiring financial institutions and others to use market prices that are not a true reflection of asset values. In a properly functioning market, asset values reflect the discounted value of cash flows. In a market that is not functioning normally, as is true today, market prices—affected by liquidity considerations and distress sales—can diverge from the values derived from cash flows. This point was made well in the discussion memorandum published by IIF in April 2008:

There is of course no question that actual or reasonably likely losses or deterioration of underlying cash flows on assets should be reflected in valuations. However, under conditions since July 2007, lack of market activity, expectations of continued downward pressures, extremely high risk premia, uncertainty, and sometimes irrational results . . . have created a situation where it has become obvious that the market has failed to produce pricing inputs that reflect actual default probabilities of sound assets.¹⁴

It is also no answer to say that assets are worth “whatever someone else will pay for them.” In one sense that is a truism, but in a deeper sense it only reflects reality at one moment in time and only if the assets are in fact for sale at that time. As accountants look at the issue, the value of something is its value in the market on the “measurement date.” That is perhaps true in the artificial world created by having to complete and publish a financial statement as of a particular date. But, with the exception of assets actually held for trading purposes, the true value of an asset such as an asset-backed security is far more likely to be the cash flow it produces than its price in the market on an arbitrary measurement date.

Any reform of fair value accounting must also recognize that there is more at stake in accounting than financial reports. Companies exist to create value, not financial reports. The true value of a going concern is not what the

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market would pay for its assets, one by one, on a particular day, but—as IIF correctly noted—the cash flows that it can generate. Similarly, especially in the case of financial institutions—the assets of which are particularly subject to market volatility—the importance of stability must be taken into account. All this appears to have been abandoned in the interest of creating a reference number for accountants on a particular “measurement date.”

What Now?

Assets held for trading should be valued at the market, even if the market is weak, illiquid, or not functioning normally. That is one of the risks a company takes in holding assets for trading purposes. But assets held for sale—that is, not held to maturity—are a different matter. There is no good reason to mark these assets to market, even if there is a market. A better means of valuation—one more in line with what investors want to know about companies—is to value these assets for balance sheet purposes based on the discounted value of their cash flows. To be sure, there are opportunities here for manipulation by managements. The choice of a discount rate can have important effects, as well as other factors, but every system—including the system set up by FAS 115—presents opportunities for management manipulation. Indeed, each major element of an income statement—as most accountants will admit—is nothing more than an estimate by management about the future.¹⁵

What we should be looking for in an accounting system is a regime that represents reality, not one that is easy for accountants to administer. If asset-backed securities and loans, even those held for sale, were valued on the basis of their cash flows, there would be elements of contention between auditors and managements, but there would also be far less procyclicality in the result. Cash flows do not change as rapidly as market values, and asset valuations based on cash flows would not foster bubbles as rapidly as a valuation system based on marking to market. Gains and losses in this category would, as today, be reflected in the equity account and not in earnings, as is currently the rule under FAS 115. This would also have a salutary effect in reducing the procyclicality of fair value accounting.

Finally, the standards for counting assets as held to maturity should be eased so that financial institutions could hold more assets in this category. This would also significantly reduce the procyclicality problem associated with fair value accounting. It will be objected that this opens a large loophole for management manipulation,

because assets that are falling in value have less of an impact on a company’s financial position if they are deemed to be held to maturity and thus not marked to market. Our first objective here, however, should not be preventing manipulation but instead making sure that our accounting system does not foster destructive financial bubbles. If manipulation is occurring—and even if it is not—it would be good policy for financial disclosure to include a footnote in which management records the transfers of assets among the various FAS 115 categories—trading, held-for-sale, and held-to-maturity—and the effect these have had on the financial statements.

Research assistant Karen Dubas worked with Mr. Wallison to produce this Financial Services Outlook.

Notes

1. Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities*, May 1993.

2. FAS 157 applies also to the fair valuing of liabilities, which is beyond the scope of this essay. However, many critics of the fair value system have noted the bizarre fact that a company’s earnings may be increased under fair value principles when the rating on its liabilities is reduced.

3. Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 157, Fair Value Measurements*, September 2006.

4. *Ibid.*, paragraph 21a and b. Emphasis added.

5. Institute of International Finance, “IIF Board of Directors: Discussion Memorandum on Valuation in Illiquid Markets,” April 7, 2008, 1. Emphasis in original.

6. Standard & Poors, “More Subprime Write-Downs to Come, but the End Is Now in Sight for Large Financial Institutions,” March 13, 2008, available at www2.standardandpoors.com/portal/site/sp/en/us/page.article/4,5,5,1,1204834028416.html (accessed July 17, 2008).

7. Sean O’Grady, “Banks Are Overstating Losses, Says King,” *Independent*, May 1, 2008.

8. Financial Stability Forum, “Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience,” April 7, 2008, 31, available at www.fsforum.org/publications/r_0804.pdf?noframes=1 (accessed July 17, 2008).

9. Richard Barley, “ABX May Overstate Likely Subprime Bond Losses—BIS,” Reuters, June 8, 2008.

10. FAS 157, 3, paragraph 7. Emphasis added.

11. Securities and Exchange Commission, “Sample Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements),” March

2008, available at www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm (accessed July 17, 2008). Emphasis added.

12. Leslie Seidman, "What Is Fair Value Accounting and Why Are People Concerned about It?" (presentation, American Enterprise Institute, Washington, DC, April 8, 2008), available through www.aei.org/event1704/.

13. Mark Scoles, "What Is Fair Value Accounting and Why Are People Concerned about It?" (presentation, American

Enterprise Institute, Washington, DC, April 8, 2008), available through www.aei.org/event1704/.

14. Institute of International Finance, "IIF Board of Directors: Discussion Memorandum on Valuation in Illiquid Markets," 1.

15. See Peter J. Wallison, "Hostages to Fortune: A Change in the Audit Certification Can Reduce Auditors' Risks," *Financial Services Outlook* (April 2007), available at www.aei.org/publication25915.