

**Vincent C. Ross Institute of Accounting Research
New York University Stern School of Business**

Ross Roundtable

Are Investors and Investment Entities

Well- Served by Fair-Value Accounting?

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Seymour Jones welcomed the participants to the Roundtable on what he believes is “the most exciting aspect of GAAP that we have run into for a long time”. The Ross Roundtable provides the perfect venue for a panel of experts to discuss their views on fair-value accounting. The sequencing of speakers followed by commentators provided the audience with an in-depth presentation of the pros and cons of adopting fair values, and set the stage for lively discussion thereof.

Eli Bartov (NYU) set forth some of the fair-value issues for discussion from both the practical and conceptual points of view.

- Do the subjective, inconsistent, and perhaps unreliable metrics of fair values meet the objectives of fair-value reporting?
- Will inaccuracies be exploited for earnings manipulation?
- Will a mixed model provide a better measure of assets, liabilities, and earnings?
- When and where do we report unrealized gains and losses?
- Should reporting be consistent across firms?

Some studies provide evidence that fair-value based balance sheets of banks were important to investors. However, the unrealized gains and losses recognized were not relevant.

Bob Herz (Former Chair, FASB) stated that the debate over “fair-value accounting” often tends to be couched in over simplistic and extreme terms of “mark-to-market” accounting vs. historical cost accounting. A deeper analysis of the topic should address issues related to the diversity of the investors, the nature of the assets and liabilities, types of financial instruments, investment strategies, and industries. If fair-value accounting is extended, should the adjustments be recognized in earnings, OCI, footnotes, or as supplementary items?

The FASB exposure draft on financial instruments that is out for public comment recognizes financial instruments held for long term at both amortized costs and fair value on the balance sheet. Reconciliation of amortized-cost earnings would be reported in OCI. The FASB has been meeting extensively with a variety of stakeholders, including many investors, to obtain their views on the proposal. There seems to be a diversity of views amongst different types of

investors about the relative merits of reporting fair values directly on the balance sheet. For example, investors that take both long and short positions and those that mainly take short positions seem to be more supportive of reporting both fair values and amortized costs as providing useful information on risk and improving management thereof. On the other hand, most long-term investors that take long-only positions generally seem to oppose fair-value balance sheets.

The reporting by failing banks of positive equity using both GAAP and regulatory accounting measures would seem to indicate a “product defect” in the accounting standards that use historical cost accounting for many financial instruments. On the other hand, criticisms of fair value include:

- How do you interpret “fair value” gains recognized by a firm on their debt because their credit rating declines?
- Fair values for non-traded instruments are not only subjective and costly to develop, they can exacerbate *irrational exuberance* in up markets and the *falling knife* problem in down markets.

The use of fair values adds “irrelevant noise” to the financial statements. But historical cost accounting is also seen as having some issues, including not reporting on a timely basis the effect of changing economic and market conditions on an entity’s financial instruments and financial condition.

Alfred King (Marshall & Stevens), an appraiser with over four decades of experience, is strongly opposed to the proposal¹. Fair-value estimates of hard assets and intangibles, at best, fall within a range of 10%. Fair-value financial reports provide a false sense of precision. Valuations are based on judgments about a host of economic variables. How do you audit judgments? Appraisal reports are based on financial projections over a five-year time frame and disclose the effect of change. He believes that fair-value accounting will increase the cost and decrease the usefulness of financial reports.

Roy Smith (NYU), a professor of finance, became a proponent of fair-value accounting after the S & L debacle because banks were able to disguise the value of their investments. Had the FDIC known the real value of Continental Illinois’ assets, their stated objective of the bailout, “helping the taxpayer” may actually have been realized.

Incorporating sustained illiquidity into fair-value measurements presents a new challenge. However, he believes that risk managers of financial institutions are better off with “the nasty type of accounting you get from fair values” than being self delusional. Banks that are financing 40% of their assets with their deposits are no longer protected from volatility. “The rest is out there being hocked to the market on a margin basis so a lot of that is being measured at fair value.”

Mark Lilling (Lilling & Co) commented that both the dollar amount and the complexity of today’s financial instruments have made auditing increasingly difficult. His previous convictions about the certainty of market values have recently been challenged. When markets

¹ FASB Exposure Draft on Fair Value Measurements and Disclosures

lose their infrastructure, they contaminate the entire system. During the crisis, when bonds were devalued and spreads were huge, market values² may not have been indicative of fair values. If market values cannot be relied upon, how reliable are managerial estimates based on “assumptions that market participants would use”³ ? Mr. Lilling completed his presentation with a “ ?..... “Auditor conundrum 2010”.

Miklos Vasarhelyi (Rutgers) said we have the technology to provide us with multiples bases, but are still using old standards that try to establish dynamic markets with fixed measures. “We must use technology that reports on a real-time basis to provide the basis for steady-state valuation.”

Roman Weil (NYU) believes that investors would be well served by *some* fair-value accounting. Any asset that can be owned by a mutual fund should be on the balance sheet at fair value. Mutual funds need net asset values every day. For assets that do not meet mutual fund requirements, impairment should be recognized when market value drops below cost.⁴ Another issue of concern is “handcuffing or distorting GAAP to fit the needs of regulators is inconsistent with the different purposes of financial reporting and regulators”. He agrees that it is “Better to be vaguely right than precisely wrong” (John Maynard Keynes), but cautions that moving to fair values requires relief from litigation.

Joshua Ronen (NYU) stated that changes in cash flow, discounted by the internal rate of return, provide a measure of the expected rate of return. Changes in exit values provide a measure of downside risk. The juxtaposition of the two would provide investors with measures of value and risk. He suggests reporting exit values, discounted cash flows, and cost—where cost is realized cash flows.

Stanley Siegel (NYU Law) said that the argument that in the future fair values may be wrong will be true of anything. Outcome is not the way to test a valuation technique. There is a consensus that book values cannot be used as a basis for decision making. Information about fair values is useful for investors, and has both stewardship and behavioral effects. He disagreed with commentary that it should be the analyst’s job to produce fair values. The bank crisis consists both of the valuation techniques applied and the failure to collect from inside the company the information on valuation and risk and make it publicly available. Professor Siegel believes that lawsuits are the primary reason that we have a woefully inadequate disclosure system.

Neri Bukspan (Standard & Poors) said it was of interest to note that the current discussion is almost identical to a speech made by the SEC Commissioner in 1939. The economic environments of 1939 and 2010, although not identical, share many hallmarks. He proposed two scenarios as *food for thought*:

1. The balance sheet reports precise fair values in period “t”, resulting in irrelevant income statements in “t + 1”. Next year’s income statements become

² Level One.

³ Level 3

⁴ IFRS

irrelevant because they report the [rate of interest x equity + corrections in estimates].

2. Liquidity suddenly shuts down. Change my business model? Change my accounting measures? Create another hypothesis?

He firmly believes that accountants should disclose risk in the footnotes, and interpretation thereof is the role of the analyst. Furthermore, “GAAP is not a one size fits all, and in certain industries fair value is not applicable.”

Stephen Ryan (NYU) concurs with the suggestions⁵ of a dual presentation that gives equal salience to fair value and cost. Research on investment securities finds that in addition to the relevance of fair values, cost-basis realized gains and losses maintain their value relevance. “I don’t think anyone can say anything convincing one way or the other about pro cyclicity”. The lack of decision-useful information of historical cost may cause investors to freeze. The problems related to incorporating fair value and illiquidity measures into financial reporting is a topic worthy of research. Professor Ryan strongly favors fair-value accounting for financial institutions.

The participants, in general, agreed that the historical costs of e.g. property, plant, and equipment may be *reliable*, but totally *irrelevant* for decision making. However, adopting fair value reporting would provide “open season” for litigators. In 1965 the Nobel Prize was awarded⁶ for the Efficient Market Hypothesis. In 2010, EMH has been called, among other things, a “myth”. Extant research provides evidence that footnote disclosures⁷ of information relevant for decision making, e.g. fair values, are not being incorporated efficiently by investors. Have markets ceased to be efficient? What has been the impact of real-time traders, flash trading, and similar trades?

1978: Financial information should provide information that is useful to present and potential investors and creditors.... The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence. (SFAC 1, Objectives of Financial Reporting)

2010: Accounting should not be designed for the attention and deficit impaired. (Stephen Ryan)

The market collapse has produced a long list of suspects and casualties. The culprits include the accounting profession, regulators and political intervention. The investors and taxpayers are listed among the casualties. Perhaps it’s time for the investors to do some due diligence.

“...financial statement footnotes are “the decoder key to unlocking a company’s true value.” (David Trainer, Forbes 2006)

⁵ FASB Exposure Draft on Fair Value Measurements and Disclosures

⁶ Eugene Fama

⁷ The term “Buried in the footnotes” is a ubiquitous media criticism of accounting disclosures.