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Ross Roundtable

On Fair Value Accounting

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The objective of the Ross Roundtable on Fair Value Accounting was to discuss the FASB Exposure Draft, *Fair Value Measurements,* and to explore the practicality and implementation issues of expanding fair value measurement. The Draft provides a definition of fair value, and presents a hierarchy for selecting inputs, valuation techniques, and additional measurement guidance for assets and liabilities currently measured using fair value under existing GAAP. Although the Draft does not expand the use of fair-value measurements, the participants of the Roundtable explored and debated the cost-benefit relationship of applying fair-value measurements to all elements of the Statement of Financial Position.

There was a consensus of opinion among participants that fair-value measurements were *relevant,* and thus useful for decision making. But, were they *reliable?* A time-honored question. A summary of empirical research on the topic was presented. The results provided evidence that market participants were using fair-value information, thus it was *relevant* for making decisions. The discussion of *reliability* focused on Level 3 Estimates. A three-tier Hierarchy was set forth in the Draft. Levels 1 and 2 include active markets for identical or similar assets or liabilities. Level 3 estimates include entity inputs derived from internal estimates and assumptions.

The discussion surrounding *reliability,* the verifiability of the measurements, and auditable and associated attestations, raised many concerns. These concerns created a "Brainstorming" environment wherein new ideas where presented, challenges to both existing and new theories explored, and resulted in ideas worth pursuing.

The way the vocal market participants think, has slowly but surely had its impact on , if not the thought processes, but certainly the actions taken by the Profession. *Generally* ***Accepted*** *Accounting Standards,* must be accepted by members of the Profession. The Board cannot, nor does not, promulgate Standards in isolation. There is an extensive due-process period, wherein the need to be responsive to the viewpoints of the entire economic community is recognized. The Standard setting process, currently the function of the FASB, can neither escape nor disregard political pressures. Non the less, have the recent political pressures put on the FASB, receiving momentum and fueled by the recent scandals, been misdirected?

The Roundtable participants were clearly divided on the benefits of adopting fair value measurements. The lines of division were also clearly drawn between the auditors, and other participants representing the Board, academic scholars, valuation experts, and other distinguished members of the world of finance and business. The reason? The "house" was not divided based upon *principles,* but rather fear of litigation. How can one attest to a Level 3 estimate without fear of litigation? The Board is obligated to consider the viewpoints of the entire economic community. Should the Board consider protecting auditors against litigation in setting Standards, if in so doing reduces the effectiveness of "telling the story"? All participants agreed, financial reports should "tell the story". A "story", not necessarily based on *verifiable* historical cost. A story that is *representationally faithful.* However, auditors are not in favor of "stories" that are not *verifiable.* Respondents to the Draft asked for strict guidelines on how to manage the tradeoff between *relevance* and *reliability.* Can *qualitative* tradeoffs requiring judgment be standardized and prescribed? Should they be?

Fair-value measurements highlight the tradeoff difficulties between relevance and reliability, and were presented at the Roundtable in theoretical terms with limitless boundaries. Can we find a solution to this time-honored problem whose piecemeal non-resolution has ended up in the courts? Frauds, scandals, greed-- have been with us since the beginning of time-- increasing in their levels of sophistication. Verifiable, historical-cost accounting cannot, nor did not, prevent the presentation of fraudulent financial reports.

The ingredients of *Relevance* are: *predictive value, feedback value, and timeliness.* The ingredients of *Reliability* are: *verifiability, representational faithfulness, and neutrality.* The controversy surrounding adopting fair-value measurements centers on decreased *reliability.* In fact, it is only one component of reliability that is of concern--verifiability. How can we address the concerns of the auditor on the lack of *verifiability* of Level 3 estimates, while maintaining *representational faithfulness*? Although constraining litigation may sound appealing, it would be naïve to assume that the litigious nature of our society will change any time soon.

The objectives of financial reporting, and the qualitative characteristics that make financial reports useful, are eloquently presented in the Conceptual Framework. One of the basic *assumptions* underlying financial reporting, the *stable monetary unit*, was challenged in the 70's, and a Standard[1] requiring reporting price-level changes was promulgated. It was unsuccessful and amended. Currently the basic *principle* of *historical cost* is being criticized . It is of interest to note that Level 3 in the structure of the Conceptual Framework--assumptions, principles, and constraints, is correlated with the Level 3 hierarchy for fair-value measurements in the Draft, involving the *historical cost principle.*

Price-level changes were presented supplementary to historical costs, but as part of the financial reports. Participants of the Roundtable suggested that fair-value measurements be presented in a similar fashion, or as disclosures in the footnotes.

[1] SFAS No. 33, Financial Reporting and Changing Prices.

Furthermore, the attestation could be confined to the historical cost data, accompanied by comments related to the fair-value measurements. The additional commentary should not assume a liability similar to attestation. A suggestion was made to consider a supplementary Statement, (proposed by Professor George Sorter, 1976); " A Statement of Uncertainties".

The Roundtable Discussion crystallized the controversy surrounding fair-value measurements, and consequentially principles versus rule-based accounting, reducing it to one ingredient of *Reliability, --- verifiability.* The issue of *verifiability* is not only associated with auditors seeking protection against litigation, *verifiability* is a critical need of our capital markets.. The trade-off between *Relevance and Reliability,* between *historical cost and fair-value measurements,* the move towards financial reports that are *representationally faithful,* can perhaps be resolved with a simple change in the format of the reports and/or scope of the auditor's attestation.

There was one other major issue that was brought to light during the discussion; an education in finance that is fundamental to understanding and applying fair-value measurements. New York City, the financial capital of the world, is one of the last states to adopt the 150-hour requirement for CPA licensure.[2] Additionally, the 150-hour requirements have not mandated additional credit hours in finance. It would be necessary to revisit the educational requirements for certification, and require a minimum level of efficiency in understanding and using financial and econometric models.

[2] Effective 2009.