

The Fair Value Compromise — a Proposed Solution

by Steve Rabin, MBA, CPA, CVA, CITP

Under the “matching” principle of accounting, expenses match related income, and the balance sheet is a plug, reflecting this recognized net income. In this perspective, the balance sheet is intended to reflect neither current market value nor liquidation value. Rather, it is a plug.

If a company nears insolvency, auditors currently add additional language similar to this: “The accompanying financial statements have been prepared assuming that [XYZ] Company will continue as a going concern....” The financial statements do not include any adjustments that might result from the outcome of this uncertainty.”¹ This language is consistent with this revenue-and expense-perspective, and informs financial statement users that the balance sheet has *not* been adjusted to reflect the current liquidation value of the entity.

Over 80 percent of public company audit reports are unqualified, without any explanatory language whatsoever, let alone doubt as to going concern.² For this majority of companies, investors and creditors desire a useful and fairly presented income statement.

Mark-to-market fair value turns this upside down. Portions of the balance sheet are carried at “fair value” and adjusted “mark to market” for each reporting period. This

newer asset-and-liability perspective has auditors carefully auditing the fair value of the balance sheet each period, and the change in value flows to the income statement, *which becomes the plug*.³ Principles of matching, historical cost, consistency, and comparability are abandoned in this method of accounting! The purpose of the income statement in this model is no longer to predict future operating results in a manner useful to investors. The income statement becomes merely a plug.

This asset-and-liability view is strongly supported by the FASB Conceptual Framework⁴ and by other recent FASB standards, such as FAS157. The framework concedes, however:

Although some continue to believe that the asset and liability view emphasizes the balance sheet and de-emphasizes the income statement, that is not the issue. Instead, the issue is how income is manifested.⁵

A historic cost value is supported by objective records from an arms-length transaction. But determining fair value requires experts to subjectively determine the value of an asset or liability in a hypothetical transaction. For tax purposes, IRS Revenue Ruling 59-60 says, “Earnings may be the most important criterion of value in some cases, whereas asset value will receive primary consideration in others.”⁶

¹ *Auditing and Assurance Services*, 12th ed., by Alvin Arens et al, Prentice-Hall, 2007, pg. 53.

² Personal communication: Mike Klein. 1/30/2009. “There are a total of 34,888 companies reported with auditor opinion codes in the Compustat database.” Of these:

28,167 (80.7%) have unqualified opinions.
5,783 (16.6%) have unqualified opinions with additional language.
697 (2.0%) are unaudited.
66 (0.2%) have a qualified opinion.
48 (0.2%) have no opinion.
1 (0%) has an adverse opinion.

³ The term “plug” in this article denotes the dependent variable when solving a system of equations. In the current FASB asset and liability perspective, income results entirely as a mathematical consequence from changes in audited asset and liability values, and is therefore a plug.

⁴ www.fasb.org/fasac/conceptual_framework.pdf; February 14, 2009.

⁵ *Ibid*, pg. 6.

⁶ Rev. Rul. 59-60, 1959-1 CB 237.

The FASB, however, has chosen to always favor the most conservative approach, the asset value (market) approach, as being the strongest evidence of fair value. According to FASB, “A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available....”⁷ FASB thereby requires accountants to present a significant portion of business assets and liabilities (but not all) at near liquidation value. The portion presented at fair value depends on many company-specific factors.

Two questions emerge, then, regarding the fair value compromise:

- At a time when investor psychology is very negative, does it make economic sense to be reporting companies at near liquidation value?
- At a time when governments are struggling to budget funds to stimulate the economy and increase money supply, does it make sense to contract the money supply by using an unproven and highly conservative regulatory perspective?

Defending Mark-to-market Fair Value

According to Dane Mott and Sarah Deans at JPMorgan Chase, “Blaming fair value accounting for the credit crises is a lot like going to the doctor for a diagnosis and then blaming him for telling you that you are sick.”⁸ Furthermore, “Historical cost is obviously not acceptable as the securities of particular interest in this crisis are substantially impaired. This leaves us with some form of mark-to-model valuation.”⁹

I am aware of the following substantial arguments in support of fair value:

- Investors and creditors want to know the liquidation value of a business that has a significant possibility of failure.
- Fair value prevents managers from managing income through trading timing, since gains and losses are recognized when they occur rather than when realized.¹⁰

Arguments Against Mark-to-market Fair Value

Federal Reserve Chairman Ben Bernanke remarked, “Nobody knows what true mark-to-market is.”¹¹ According to Rep. Todd Tiahrt (R-KS) the \$700 billion bailout would have passed easily if fair value rules had been suspended.¹²

To my knowledge, the following substantial objections have been raised against mark-to-market fair value:

- Performing valuation each period is highly subjective, particularly when markets are thinly traded or illiquid.
- FASB preference for the market approach over the income approach often understates value.
- Removing value from balance sheets is counter-productive at a time when the government is trying to stimulate the economy.
- For over 80 percent of public companies whose continued operation is reasonably likely, investors do not care about liquidation valuation.
- Mark-to-market gains and losses obscure the use of the income statement to predict future revenue.
- Mark-to-market gains and losses interfere with the use of the income statement to evaluate management performance.
- Accounting information drives markets; allowing markets to also drive mark-to-market accounting information can create a feedback loop, a “vicious negative-feedback cycle.”¹³
- Mixing standards favoring the balance sheet with those favoring the income statements adds complexity and cost to financial reporting and increases the possibility of unintentional errors.
- Reduced transparency resulting from mark to market can contribute to frauds like Enron.¹⁴
- The fair value of contingent liabilities is fraught with problems and is particularly likely to result in overly conservative valuations and subsequent reversals.¹⁵
- Fair value of intangibles (both internal and acquired) is particularly subjective.¹⁶
- The use of blockage and other discounts and premiums or transaction costs in determining fair value remains controversial.
- Mark-to-market fair value results in an overstated income statement when temporary valuation assumptions of a conservative nature are subsequently reversed.
- Mark-to-market adds volatility to the income statement.
- For those companies where there is doubt of continued operation, mark-to-market fair value does not go far enough. Only selected portions of the balance sheet are marked to market value. Liquidation value of the entity is not disclosed.

⁷ www.fasb.org/pdf/aop_FAS157.pdf paragraph 24; March 11, 2009.

⁸ <http://schulzkelaw.com/wp-content/uploads/2008/09/fv-jpmorgan092908.pdf>; February 22, 2009.

⁹ Ibid.

¹⁰ Adapted from Fair Value Accounting course notes, by Ron Quintero, The Center for Professional Education, from a July 2008 presentation by Stephen G. Ryan.

¹¹ www.bloomberg.com/apps/news?pid=20601087&sid=agj5r6nhOtpM, January 7, 2009.

¹² Ibid.

¹³ www.berkshirehathaway.com/letters/2008ltr.pdf, March 11, 2009.

¹⁴ *Forensic and Investigative Accounting*, 2nd edition, by D. Larry Crumbley et al., CCH, 2005, pp. 3-5.

¹⁵ *Fair Value for Financial Reporting*, by Alfred M. King, Wiley, 2006, pp. 111-113. Also see the recent 4/1/09 dissenting opinion of FASB member Linsmeier at www.fasb.org/pdf/fsp_fas141r-1.pdf, pp. 5-6. In his dissent, Linsmeier expresses concerns regarding consistency and comparability and does “not believe this FSP will be operational.”

¹⁶ “Kick the Habit: The Excess Earnings Method Must Go!” by Michael A. Paschall, ASA, CFA, JD, *Business Valuation Review*, September 2001, pp. 1-5.

The IFRS Direction

International Financial Reporting Standards appears headed in the direction of putting all fair value adjustments into other comprehensive income.¹⁷ This helps answer concerns regarding the continued usefulness of the income statement, but does not address:

- Excess conservatism, volatility, and additional financial reporting costs, for over 80 percent of companies whose investors do not care about liquidation value
- The contention that mark-to-market fair value does not go far enough; liquidation value of the entity is not disclosed.

Current Proposals

Some say that despite its weaknesses, mark-to-market fair value is the best approach so far, and with sufficient adjustments it can somehow be made to work. Approaches to resolve the problems with fair value include the following:

- FASB FSP FAS157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active"¹⁸ potentially gives more leeway to management to make subjective assumptions to obtain a higher value in some situations, assuming that auditors, who are very conservative by nature, are willing to accept such higher values.
- A recent 211-page congressionally mandated SEC study of fair value concluded, "Improve, do not suspend, fair value accounting standards."¹⁹
- PricewaterhouseCoopers has recently proposed modifications to fair value that involve reporting incurred credit losses in net income and all other impairment losses in other comprehensive income. The PWC proposal "is not intended to be a panacea that addresses all fair value concerns."²⁰
- A proposal by McKinsey staff called "A Better Way to Fix the Banks" recognizes some of the problems with mark-to-market fair value, and proposes that the government create a market to assist in valuing illiquid financial assets.²¹

In my opinion, all these proposals are minor improvements to an unsatisfactory compromise. Operating value remains understated. True liquidation value of an entity is still not disclosed. Most of the other complaints listed above remain unresolved.²²

My Proposed Solution

Based on discussions I've had about fair value with CPA auditors and corporate controllers, mark-to-market fair value does not reflect the views of a majority in the accounting profession. Mark-to-market fair value has a long list of problems which are not resolved by current proposals.

Instead of using the balance sheet to disclose a current market value, let's keep the balance sheet a plug, at historic cost, and report all contingent liabilities under FAS-5.²³ These methods are somewhat arbitrary but have the virtues of simplicity and over 30 years of reasonably successful operation.

Let's include an additional, separate Statement of Liquidation Value, unrelated to the income statement and balance sheet, *but only for large companies whose auditors are noting a reasonable level of doubt of continued operation.*

For a company that is a going concern, investors and creditors do not care about the balance sheet. We want to know the future income and cash flows. For a company that is near insolvency, we want a complete Statement of Liquidation Value, not the weak compromise currently represented by fair value.

My proposed solution still allows management to possibly time the realization of gains and losses. However, it addresses the long list of problems created by mark-to-market fair value, and it provides additional disclosure of asset market values, but only when they are relevant, when there is doubt as to continued operation. **VE**



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¹⁷ Steve Rabin, Wiley IFRS Faculty Bootcamp notes, February 2009.

¹⁸ www.fasb.org/pdf/fsp_fas157-3.pdf, March 11, 2009.

¹⁹ www.sec.gov/news/press/2008/2008-307.htm, Feb. 22, 2009.

²⁰ www.pwc.com/images/us/eng/about/pov/PwC_PointofView_FairValue_012009.pdf, Feb. 22, 2009.

²¹ www.mckinseyquarterly.com/Financial_Services/Banking/A_better_way_to_help_banks_2314, March 11, 2009.

²² Final staff positions, issued by FASB on April 9, 2009, reaffirm the need for subjective judgment in inactive markets, without resolving the fundamental dilemma between operating value and liquidation value. Instead, these new staff positions represent a mushy compromise between these two values. See "FASB Issues Final Staff Positions to Improve Guidance and Disclosures on Fair Value Measurements and Impairments," at www.fasb.org/news/nr040909.shtml.

²³ www.fasb.org/pdf/fas5.pdf, March 11, 2009.