Fair Prices in Accounting

Valuing in illiquid times prompts criticism (and praise)

BY ROMANA KING

All is not fair in love, war and finance, according to financial pundits during a Standard & Poor sponsored panel in mid-June on fair value accounting (FVA).

Critics of FVA believe the accounting method does not provide a realistic view of assets/liabilities and gains/losses, particularly when there is no market for an asset or investment vehicle.

Their main concern is that under FVA the lack of market valuation prompts accountants and corporations to rely upon complex mathematical models to determine asset values, which dilutes transparency and accessibility, particularly since such complex formulas can be confusing to investors, as well as to financial professionals.

Proponents of FVA, however, believe that this method of accounting is more transparent since it does not rely on historical cost. As such, proponents of FVA believe that any sacrifice in the reliability of financial statements is more than offset by the relevancy FVA provides in evaluating the current worth of assets and liabilities.

What stirs this debate is the growing use of FVA – used to price current and future assets and liabilities – particularly with the adoption of International Financial Reporting Standards (IFRS) slated for 2011.

In a panel discussion in June sponsored by Standard & Poor's, bank officials, accountants, analysts, regulators and ratings specialists squared off on whether or not the increased relevance offered by fair value accounting obfuscates the accuracy of financial statements.

Under generally accepted accounting principles (GAAP), the fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties (other than in a liquidation). On the other side of the balance sheet, the fair value of a liability is the amount at which that liability could be settled in a current transaction between willing parties. But this valuation relies upon an active market that offers the fair market price of an asset/liability.

Unfortunately an active market is not always present, as was the case in the fall of 2007, when the subprime mess prompted a credit crunch and global illiquidity in some financial instruments,. Quoted market prices for some investment vehicles – such as asset-backed commercial paper – were unavailable. Under FVA, however, these assets/liabilities were shown on the balance sheet as an estimate of worth. To critics of FVA, this decision created and maintained the volatility already seen in a shaky market.

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"What accounting throws up is extremely relevant to business decisions, so we have to make decisions that minimize volatility," explains Bob Brooks, vice-chairman of ScotiaBank. "Fair value accounting, as is currently applied, has produced far more harm than good – for all participants, except for accountants [due to] the income statement volatility [it produces]."

Brooks's arguments were supported by other industry representatives, including Donald Chu, director, financial institutions ratings, S&P Toronto; Diane Hinton, director, financial institution ratings, S&P New York; Karen Stothers, managing director, accounting policy division, Office of the Superintendent of Financial Institutions; and Robert Wessel, managing director, proprietary equity, National Bank Financial – all end-users of FVA financial statements.

"As an accountant and as a regulator, I know the banking business," said Stothers. "And the standard setters within this industry are trying to make [the accounting] simple, because they are trying to sell a message. The problem is that fair value accounting is extremely complicated and the market it exists in is extremely complicated. [The reality] is that we are not dealing with just accounting, we are talking about economics for everyone."

Brooks adds that while FVA attempts to value investment vehicles by interpreting today's market value, proponents of this accounting standard fail to appreciate how the market works.

"Fair value accounting will show a TSX sticker price for 3,000 shares the same as 300,000 shares – but the market shows us differently," explains Brooks.

He believes that the problem is in the approach. "We tend to opt for disclosure as a way to mitigate underlying problems – and it sounds good – but [fair value accounting and other industry initiatives] are just BandAid solutions."

For advisors and their clients this debate has a far-reaching impact. Chu sums up the impact by saying, "there is no consistency in the marketplace." This lack of consistency – and the need to rebuild financial statements – creates uncertainty and diminishes a professional's ability to evaluate a company. "It means [we'll] never be able to assess a business properly."

As an end-user, Chu's statement is poignant, particularly since evaluating assets/liabilities properly was the main intent of FVA.

Yet, accountants and a few other financial professionals believe that forward – with FVA – is the best way to go, rather than reverting to GAAP or historical cost standards.

Philip Arthur, senior partner at Ernst & Young, cited a recent article in *The Economist* that defended FVA and explained that "4,000 pieces that make up a Porsche are a lot more difficult to value than the Porsche itself."

It's this inability to measure value that creates volatility, not the method of accounting, he explains.

Yet, despite the difficulties of valuing using estimates (rather than active market valuations), Arthur and other accountants "do want to try," and assess and value businesses properly.

As a fan of FVA, Arthur has worked with banks and life insurance companies that have "over the last 15 years, been using a fair value accounting-like system." As such, Arthur and colleague Gord Cetkovski, partner at PricewaterhouseCoopers LLP, believe that out of the three accounting alternatives – amortized costs, fair value and a mix of the two – fair value is the best option.

The evolution of FVA is due, in part, to the volatile and dynamic nature of today's economy. In the 1970s, when the financial accounting principles were introduced by various North American accounting standard bodies, the economic environment was fairly static. Today rapid price changes, shorter technology cycles, and increased developing world presence has prompted more volatility in the global economic system. FVA, then, was a result of trying to provide more transparency in financial reports than historical cost-based measurements.

Historical costs were never comparable, explains Arthur. For example, if an investor were to examine two mining companies, each with a closed-pit in northern Alberta, with one company having bought the mining pit years ago and the other having just completed construction of its pit, the prices on the balance sheet for each company cannot be compared. As a result, financial ratios, other investment metrics and inputs for valuation models are confounded. Yet, by moving to FVA, the valuation of these companies will significantly increase comparability.

"Cost is a static measurement," explained Arthur. "Fair value is more dynamic and it forces better development of terms, economics, risks and values."

While critical of FVA, Stothers is also not convinced that this accounting standard needs to be replaced, but she does question whether FVA is providing the better disclosure it intended.

"[Financial statements] should provide more clarity in how models are working and provide a better understanding of the business. I haven't heard if fair value accounting is the way to get that."

These and other questions come on the heels of a report released by the Basel Committee on Banking Supervision. This report, concluded that the evaporation of liquidity made primary and secondary transaction prices unavailable for many complex structured products. This prompted some banks to respond by switching from valuation methods based on observable prices to methods that relied more on modelled valuations.

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"During the turmoil banks had difficulties in selecting appropriate valuation inputs," the report explained. "In particular, it was necessary to assess whether observable inputs were reliable and did not represent distressed sales."

This dilemma, in fact, epitomizes the difficulty many industry professionals have with fair value accounting.

Prior to and during the crisis, banks assumed that market-quoted prices could be relied upon to ascertain fair value. Yet, these quotes failed to hold up under subsequent stressed conditions, with "many products that proved difficult to value during the market turmoil," explained the report. The authors argue: "The overreliance by many banks and other market participants on a single information source to determine value was a fundamental weakness in risk management."

While credit rating agencies have received the brunt of the criticism, many financial service professionals, including Brooks, believe accountants are just as responsible.

"There is no question, and this has really been shown in the last 12 months, that accounting drives business decisions," explains Brooks.

"The problem with incorporating assumptions about the future into accounting records is that you are bringing today's present value into financial statements and those definitions and values are wrong and will change. Inherently this is a process that will create a lot of volatility."

And the debate is not over.

The Securities and Exchange Commission has announced it will host a roundtable to "facilitate an open discussion of the benefits and potential challenges associated with existing fair value accounting and auditing standards."

The panel will focus on:

- the usefulness of fair value accounting to investors
- potential market behaviour effects from fair value accounting
- practical experience and potential challenges in applying fair value accounting standards
- aspects of the current standards, if any, that can be improved
- experience with auditors providing assurance regarding fair value accounting.

In Toronto, however, Neri Bukspan, managing director, credit market services, S&P, sums up the debate, noting, "the challenges associated with fair value can only be overcome by recognizing that it is impossible to translate the complexity of an economic event into a single number – whether presented using historical or amortized cost, fair value or any other agreed-upon measurement basis – and consequently, providing additional instructive disclosures and greater transparency around fair value measures is essential." AER