The “Real” Problems with Fair Value Accounting

Global accounting standard-setters have been working toward requiring fair value accounting for more than a decade. Conceptually, the arguments favoring fair value accounting are sound and quite appealing. Unquestionably, financial statement users will benefit from data about how a company’s assets and liabilities change in value during a reporting period. However, there are two major issues associated with fair value reporting that accountants, investors, legislators, and regulators need to address in the wake of our most recent financial crisis.

The major problem with fair value accounting is not the complexity associated with computing fair values, but rather that management will have too much flexibility in how these amounts are computed. The potential “problem values” are those associated with assets for which quoted market prices do not exist. For these assets, management can “create” values based on their own assumptions. Consequently, fair value accounting provides managers with yet another tool to manipulate balance sheets and reported earnings. Additionally, fair values add a complexity to the reporting process beyond the scope of most corporate accounting departments. This creates significant non-audit consulting opportunities for the largest global accounting firms. The reality is that many companies now outsource their valuation tasks to consultants who likely do not fully understand their client’s business model and the related valuation implications.

A second significant problem with fair value accounting is the lack of independent oversight over management’s valuation assumptions. While regulators and the investing public undoubtedly will look to a company’s independent auditor to verify reported fair values, the recent financial crisis once again raises questions about the
ability of the largest global accounting firms to provide effective oversight of reported fair
values. Moreover, it is no coincidence that the move to fair value accounting has
occurred simultaneously with attempts by these same big accounting firms to reduce
their legal liabilities for poor quality audits. Unable to secure legislative relief in the
United States through tort reform, these “Big Four” firms have used their significant
influence to make generally accepted accounting principles more subjective and
judgmental. By doing so, they reduce their exposure to future lawsuits since their audits
devolve into reviews of management valuation assumptions rather than the actual
transaction verification that the public expects. Clearly, the effectiveness of the
independent auditor’s report has been diminished by the move to fair value reporting.
The result is a very dangerous situation in which the incentives of both a reporting
company and its auditor are now aligned in favor of fair value reporting. Companies
favor it because they can create their own values and manage earnings, and their
auditors appreciate it because it is much more difficult to assess audit quality where
judgments are involved.

One possible antidote for this perverse incentive alignment is to supplement fair
value accounting and reporting with historical cost data. Standard-setters have
attempted to compensate for the lack of measurement objectivity of fair values by
requiring extensive disclosures of how such amounts are derived. However, they have
omitted any requirement that historical costs for these fair value assets also be
reported. This supplementary disclosure could potentially highlight major disparities
between cost and fair value, thus potentially mitigating management incentives to
overstate fair values, or auditor overreliance on management or consultant valuation
assumptions. The strength of this proposal is its simplicity. Moreover, it is easy to adopt and relatively costless to the investing public and the existing regulatory structure. Finally, its adoption will make a meaningful and lasting contribution to improving financial reporting transparency and ethical business decision-making.

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