

What Is Fair Value Accounting and Why Are People Concerned about It?

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Introduction
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A few weeks ago, the SEC's Division of Corporation Finance sent an unusual letter to public companies about the applicability and interpretation of Statement of Financial Accounting Standards 157—the FASB statement that is at the heart of the fair value accounting controversy. “Fair value accounting,” the Division wrote, “assumes the exchange of assets or liabilities in orderly transactions. Under SFAS 157, it is appropriate for you to consider actual market prices, or observable inputs, even when the market is less liquid than historical market volumes, unless those prices are the result of a forced liquidation or distress sale. Only when actual market prices, or relevant observable inputs, are not available is it appropriate for you to use unobservable inputs which reflect your assumptions of what market participants would use in pricing the asset or liability.”

This is a nice straddle, which must have left recipients with as many questions as they had before. Preparers of financial statements, said the Division, are supposed to use market prices, even if the market is “less liquid” than normal, *unless*—and this is a big unless—“those prices are the result of a forced liquidation or distress sale.” The SEC has, thus, left companies with the key decision: whether to use the prices the market is generating.

There is no question that markets for asset-backed securities, and even interbank and secured lending, are not functioning normally. This is because of uncertainty about losses—where they are and their ultimate size. According to some participants, the credit markets are virtually shut down. Bid-asked spreads are wider than most market veterans can remember. But some sales are going on anyway because some companies *must* sell in order to raise cash. Are these sales at what the SEC or the auditors would define as “distress prices” or is this just a market with lower volumes than usual? There are also derivative markets of various kinds that provide some information about how the underlying securities might be priced if sold. Are these “observable market inputs” as described in SFAS 157?

Despite all the heat that has been generated about fair value accounting, there has been little light shed on what companies are actually doing. Yet, this is the key question. Under SFAS 157, they must use market prices, unless these are the result of a distress sale. If they conclude, somehow, that what they are seeing in the market is the result of distress sales, they may use other “unobservable” valuation methods that are more obscure—models, estimates of cash flows, and other internal means.

How are they deciding whether the prices in the market are the result of distress sales? And if they so decide, what methods are they using to calculate the value of their assets? What

role do their independent auditors play in this process, and how do they interpret SFAS 157 and the SEC's message?

A few weeks ago, S&P analysts wrote, "When we dissect the percentage of writedowns taken against various types of exposures, the magnitude . . . is greater than any reasonable estimate of ultimate losses." This is a very serious charge. If asset values have been written down excessively, financial intermediaries like banks and securities firms are financially stronger than they look. Consequently, the credit crunch—in which the financial markets have been virtually shut down for months—is worse than it needed to be, investors have taken unnecessary losses, and the U.S. economy may slide into a recession that may be more serious than it would otherwise be.

On the other hand, what is the alternative? If asset values are falling, is it realistic to treat companies that are holding these assets as though there has been no change in their financial condition? Investors and lenders clearly don't think so. They have been calling on companies to back their borrowings with more collateral, or withdrawing their financing entirely. In part, this is responsible for the distress sales, since companies have been compelled to liquidate assets that are no longer acceptable collateral. In addition, if market prices do not reflect reality, what does? If companies are permitted to use unobservable methods to value their assets, how are we sure that they are not overstating these values? Could things be *worse* than they look? Again, what role are auditors playing in this decision?

Josh Rosner, a shrewd observer the markets, observed in Friday's Wall Street Journal, "A failure of institutions to rectify opacity will propel us further down the road toward a Japanese-style 'lost decade.'" This is the other side of the problem. If assets are not written down *enough*—or at least to a level that reflects a rough reality—banks and other lenders will be slow to lend. This is true because their capital condition is weak and they must allocate capital to new loans. This reduced level of credit will restrain growth and recovery from any recession we might experience. This is exactly what happened in Japan. The Japanese banks refused either to recapitalize or to recognize immediately losses that had already been incurred. As a result, they recognized their losses slowly, writing them off against profits. It took more than a decade to get the Japanese economy back on track.

So there are two sides to the fair value accounting story, and both reflect the seriousness of the issue we will be discussing today. If assets are being written down too deeply, it could be producing and reinforcing an unnecessary downturn, but if companies are not recognizing the full extent of their losses, it could produce a long period of recession or slow growth.

There are not likely to be clear answers here. It is surely correct that assets in the normal case should be valued at what they are worth in the market. The market is the only valid standard of value. On the other hand, we don't know quite what to do when the market isn't functioning normally. What standard is applicable then?

What we will try to learn at this conference is what the FASB had in mind when it wrote SFAS 157, how the FASB thinks the rule should function in the current market, how the audit profession is enforcing the rule at the level of companies, and what companies, analysts, and people with regulatory experience, think about all this.