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How Far Can Fair Value Go?

An SEC committee hopes standard-setters will hold off on extending mark-to-market accounting to the assets and liabilities that rules don't yet cover.

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Members of a Securities and Exchange Commission advisory committee doubt that the U.S. financial reporting system will ever make a wholesale jump to fair-value accounting. They want the SEC and the Financial Accounting Standards Board to work out some practical issues first — something that could take years.

As it is, the ability to verify a company's fair-value assessment can be harder to do, compared to historic cost, because of a lack of consistent valuation standards, questionable valuation models, and uncertainty about the veracity of valuation specialists. For those reasons, some members of the SEC's Committee on Improvements to Financial Reporting (CIFR) "assume that a complete move to fair value is most unlikely," according to one of their reports.

The momentum toward enveloping more measurements of assets and liabilities under the fair-value rule has accelerated in the past year, since FASB passed two major fair-value standards. One of them, FAS 159, gives companies the irrevocable option to use the fair value for most financial instruments. But the reliability of using fair value over the traditional use of historic cost to measure a financial instrument's worth has come under harsh criticism by financial service firms burned by today's illiquid markets and write-downs blamed on the other fairly new standard, FAS 157, FASB's guidelines on how to measure fair value.

They are hoping for a so-called mixed attribute model that would allow them to use both fair value and historic cost calculations — the latter of which is being phased out by accounting standard-setters in their push for the widespread use of fair value. (They do not yet require nonfinancial assets to be measured that way.)

The volatility issues at the banks raise the question of whether FAS 157 should be revised, suggested CIFR member Joseph Grundfest, a professor at Stanford Law School, during a meeting last week. "Not only do we have problems with phantom capital in situations where mark-to-market allowed you to create capital that never really existed, we can also by the same logic have phantom losses, where mark to market creates situations where you have to go out and raise physical capital in order to cover losses that as a practical matter were never really there."

Susan Bies, a CIFR member and former member of the Federal Reserve System's board of governors, is wary of full fair-value. At the CIFR meeting, she disputed the notion that fair value offers more transparency. "Moving to fair value acts very much to create more of these asset bubble kind of panics in the market," she said. "I question investors who say we want everything fair value. OK, but why?"

Still, fair value does have supporters. Some investors and analysts have disputed bankers' complaints about mark-to-market accounting and consider it more relevant than historic cost accounting. In their view, fair value helps them better understand the latest and truest worth of a firm's assets and liabilities.

At this point, the time for pitting fair value against historic cost accounting has passed, according to FASB Chairman Robert Herz. The matter is no longer an either/or proposition, he said at the CIFR meeting, where he participates as an observer. "I feel fairly strongly that after many of years of looking at this, it's unproductive to have this fair value versus cost type of [discussion]," he said. "Let's get back to fundamental economics, to the way investors look at the information and use it."

CIFR itself acknowledges that the fair-value debate is far from offering clear-cut solutions — particularly as it concerns its mission of simplifying financial reporting. On one hand, the partial use of fair value and organizations' demands for exceptions have led to a pile-up of accounting literature. On the other, CIFR admits, the expanded use of fair value can lead to more consistency — a constant demand from investors — and provide investors with a better idea of management's perspectives.

In a preliminary list of suggestions that could be submitted to the SEC later this year, CIFR plans to recommend that the standard-setters slow down and concentrate on their conceptual framework before allowing more items to be brought into the fair value fray. FASB's and the International Accounting Standards Board's joint project is a major undertaking to redefine major concepts, such as revenue and full fair value. However, Jeff Mahoney, general counsel at the Council of Institutional Investors, tried to discourage CIFR from making this recommendation, saying he believes the conceptual framework and further deliberations on fair value could continue simultaneously.

CIFR may also propose that FASB design a disclosure framework to make all disclosures more consistent and less redundant — and offer a way to record the varying judgment calls companies have to make under fair value. "A disclosure framework should more effectively signal to investors the imprecision associated with significant estimates and assumptions, particularly some fair value measurements," one of CIFR's subcommittees wrote.