

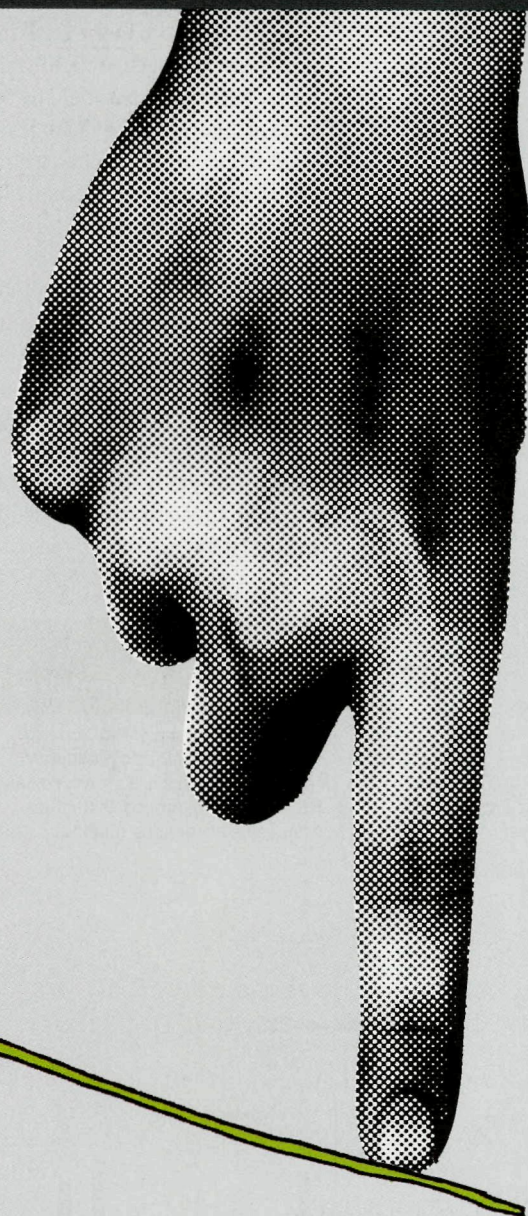
Why “Fair Value” Is the Rule

How a controversial accounting approach gained support *by Karthik Ramanna*

For the past two decades, fair value accounting—the practice of measuring assets and liabilities at estimates of their current value—has been on the ascent.

This marks a major departure from the centuries-old tradition of keeping books at historical cost. It also has implications across the world of business, because the accounting basis—whether fair value or historical cost—affects investment choices and management decisions, with consequences for aggregate economic activity.

The argument for fair value accounting is that it makes accounting information more relevant. However, historical cost accounting is considered more



conservative and reliable. Fair value accounting was blamed for some dubious practices in the period leading up to the Wall Street crash of 1929, and was virtually banned by the U.S. Securities and Exchange Commission from the 1930s through the 1970s. The 2008 financial crisis brought it under fire again. Some scholars and practitioners have connected its proliferation in accounting-based performance metrics to the actions of bankers and other managers during the run-up to the crisis. Specifically, as asset prices rose through 2008, the fair value gains on certain securitized assets held by financial institutions were recognized as net income, and thus sometimes used to calculate executive bonuses. And after asset prices began falling, many financial executives blamed fair value markdowns for accelerating the decline.

Yet both Generally Accepted Accounting Principles in the United States and International Financial Reporting Standards, adopted by nearly 100 countries worldwide, continue to use fair value extensively—for example, in accounts concerning derivatives and hedges, employee stock options, financial assets, and goodwill impairment testing.

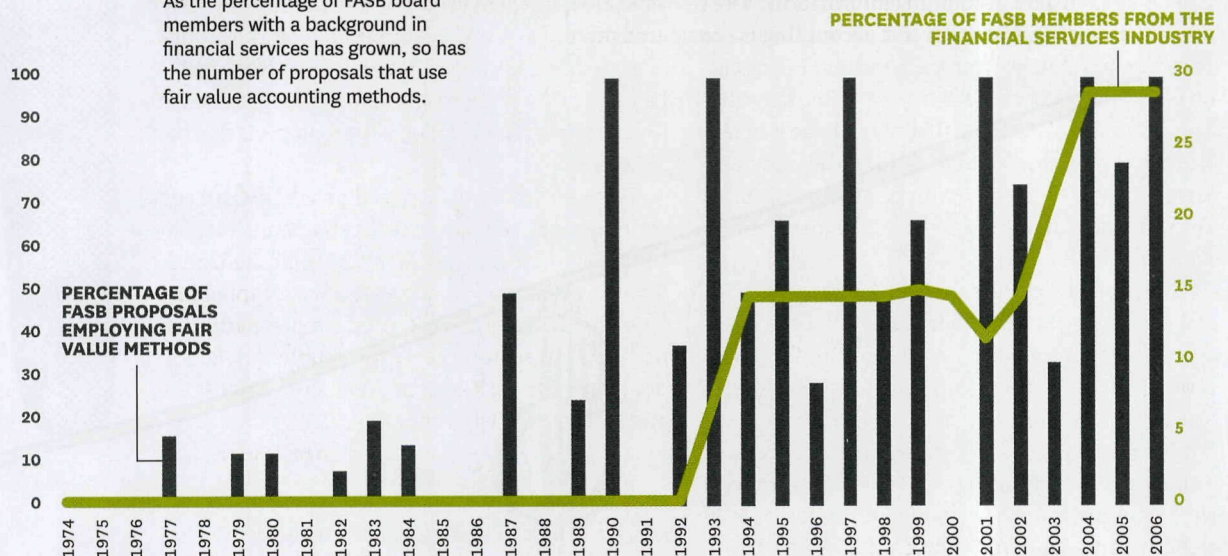
One explanation for the rise of fair value accounting is that finance theory—in particular, the idea that

financial markets are efficient and their prevailing prices are reliable measures of value—permeated academic accounting research in the 1980s and 1990s, thus changing opinions on the relative merits of historical cost and fair value.

A study that the Harvard Business School doctoral student Abigail Allen and I published in the May 2012 issue of the *Journal of Accounting and Economics*, "Towards an Understanding of the Role of Standard Setters in Standard Setting," points to another explanation. The study covers all the members of the Financial Accounting Standards Board, which sets standards for GAAP, from its inception, in 1973, through 2006. We investigated their backgrounds and the nature of the standards they proposed. To control for both hindsight and potential researcher bias, we relied on the contemporaneous assessments of the largest audit firms as expressed in 908 separate comment letters filed at the FASB archives in Norwalk, Connecticut. Specifically, we examined how the auditors evaluated the proposed standards on the dimensions of accounting "relevance" and "reliability." The FASB recognizes a trade-off between those two goals and has justified the increased use of fair value accounting by arguing that it increases accounting's relevance. Several academics, myself

The Shift to Fair Value

As the percentage of FASB board members with a background in financial services has grown, so has the number of proposals that use fair value accounting methods.



SOURCE "TOWARDS AN UNDERSTANDING OF THE ROLE OF STANDARD SETTERS IN STANDARD SETTING," *JOURNAL OF ACCOUNTING AND ECONOMICS*, MAY 2012

Fair value accounting was blamed for some dubious practices leading up to the Wall Street crash of 1929. The 2008 financial crisis brought it under fire again.

included, have argued that it decreases financial reporting's reliability.

We found that the backgrounds of the individual standard setters on the FASB predict which standards they have proposed. Notably, those with a background in the financial services industry—defined for our purposes as investment banking or investment management—are more likely to propose the use of fair value methods. Before 1993 the FASB included no financial services veterans; now such members make up more than a quarter of the board (see the exhibit “The Shift to Fair Value”). The link between fair value proposals and a background in financial services is robust to numerous substantive controls, including other background factors such as members' tenure on the board, their political affiliation, the backgrounds of contemporaneous members of the SEC, broader market and macroeconomic conditions, and biases, if any, among the large audit firms.

This empirical link can be augmented with anecdotal evidence. For example, the Investment Company Institute, a U.S. industry association of asset management firms, strongly supported the use of fair value accounting when lobbying the SEC in 2008 on FASB Statement 157, which helps define fair value. And in 2000 and 2001 the then three largest investment banks—Goldman Sachs, Morgan Stanley, and Merrill Lynch—were all enthusiastic supporters of fair value rules for mergers and acquisitions during FASB deliberations on the subject.

The possible motives for individuals from financial services to support fair value accounting are complex and numerous; here I outline a few likely ones. First, investment banks and asset managers are accustomed to using fair value in their day-to-day business to prepare in-house balance sheets for risk-management purposes. This familiarity with the method may have shaped their preferences in public financial reporting standards. Second, GAAP profits defined on a fair value basis rather than a his-

torical cost basis accelerate the recognition of gains, particularly in periods of rising asset prices. To the extent that managerial bonuses are based on GAAP profit numbers, financial services executives reap richer rewards in a fair value regime. Third, the use of fair value to determine impairment of goodwill from M&A activity (in lieu of the historical cost approach of amortizing goodwill) imposes, on average, less drag on earnings, thus potentially boosting M&A activity—a major revenue source for investment banks.

Does this mean that the selection process for FASB members has been captured by special interests from finance? It's hard to say for certain. Members are chosen by the trustees of the private Financial Accounting Foundation in a poorly understood process that is often influenced by the Securities and Exchange Commission. The growth in the proportion of FASB members who have backgrounds in financial services may represent the growth in that industry—and the growth in its political clout. Also, the SEC and the FASB have generally viewed the asset-management sector of the financial services industry not as a special interest but as a consumer of accounting information whose interests need to be protected. In any case, more research is needed to explain why financial services representation has increased.

What is clear is that it *has* increased, with a concomitant impact on accounting standards. Perhaps tellingly, privately held companies in the United States—which are less oriented toward capital markets than their publicly traded counterparts are—have recently set up their own accounting standards board, the Private Company Council, in part to get away from fair value accounting. ▀

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