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Financial reporting quality: is fair value a plus or a minus?

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Recent deliberations by both the International Accounting Standards Board (IASB) and the Financial Accounting Standard Board (FASB) in the United States have focused on how fair values of assets and liabilities should be measured. The issue of *when*, rather than *how*, fair value measurement should be applied is still far from resolved, however. Fair values have been mandated for some assets and liabilities under both IASB and FASB standards, but it is fair to say that principles governing the applicability of fair values have yet to be articulated: when is fair value accounting appropriate and when is it not? Or, in terms of my charge for this paper, under what circumstances is fair value a plus or a minus?

To prepare for my task, I made a survey of public statements made for and against fair value accounting by a variety of standard setters, regulators, analysts, and preparers. The stated 'minuses' typically point to the dangers of fair value estimates from marking to model rather than marking to market, concerns about introducing 'excess volatility' into earnings, and feedback effects (on banks' lending practices, for example) that could damage a business and, indeed, heighten systematic risk. A few antagonists question whether fair values (for bank assets and liabilities, for example) really capture the economics of a business (in fostering core deposits and making loans). In counterpoint, the proponents of fair value argue that fair value is a superior economic measure to historical cost. Consider the following arguments, often advanced as 'pluses':

- Investors are concerned with value, not costs, so report fair values.
- With the passage of time, historical prices become irrelevant in assessing an entity's current financial position. Prices provide up-to-date information about the value of assets.
- Fair value accounting reports assets and liabilities in the way that an economist would look at them; fair values reflect true economic substance.
- Fair value accounting reports economic income: in accordance with the widely accepted Hicksian definition of income as a change in wealth, the change in fair value of net assets on the balance sheet yields income. Fair value accounting is a solution to the accountant's problem of income measurement, and is to be preferred to the hundreds of rules underlying historical cost income.
- Fair value is a market-based measure that is not affected by factors specific to a particular entity; accordingly it represents an unbiased measurement that is consistent from period to period and across entities.

So self-evident do these points seem to be that fair value accounting is often just presumed to be 'more relevant'. The words, 'fair value' sound good (who could be against ice-cream and fair value?!) while 'historical cost' sounds, well, passé. As it turns, out, however, each of these statements becomes qualified under scrutiny. Can economic argument lead to constructive arguments for implementing fair value accounting?

1. Some preliminaries

Pluses and minuses can only be evaluated against an alternative, so I will take the approach of asking if (or under what conditions) fair value accounting is an improvement over historical cost accounting. In discussions about fair value, people often proceed at cross-purposes, so a few points need to be clear before we proceed.

1.1. What is fair value?

Three notions of fair value accounting enter the discussion, and one must be clear which is being entertained.

*The author is at the Graduate School of Business, Columbia University, shp38@columbia.edu This paper draws on some of the themes in a White Paper prepared for the Center for Excellence in Accounting and Security Analysis (CEASA) at Columbia Business School. See D. Nissim and S. Penman, *The Boundaries of Fair Value Accounting*, White Paper No. 2 (Center for Excellence in Accounting and Security Analysis, Columbia University, 2007). Comments received at the *Information for Better Markets Conference* have been helpful as has a close reading of the manuscript by Martin Walker and Pauline Weetman.