

The mad affair with fair value

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The accounting standard setters' obsession with accounting for financial instruments, and the underlying fair value accounting rule, is almost reaching the limits of craziness. Work on new rules for accounting for financial instruments started in early 1980s as it was realized that valuations based on historical cost may not be very interesting to the reader, who was looking for current valuation of the firm. However, in their bid to translate more and more financial instruments to fair values, the standard setters classic accounting rule – accounts are statements of fact and not opinions. The moment we move away from facts and get into opinions or estimates, we lose objectivity, which is, unarguably, one of the key accounting premises.

Market valuations are understandable for those instruments which have market value. But requiring instruments which either do not have any markets at all, or have opaque markets, to be valued at fair values, is to allow the complexities and vagaries of valuations to enter financial statements.

As fair values of instruments which do not have active markets are obviously highly subjective, the amount of standard writing that has been done over it in the recent past is mind-boggling. **

FAS 157 – a US standard that is currently mired in controversy – sought to classify fair valuations into 3 levels. ** Level 3, in plain English, meant that the valuation was highly subjective, based almost entirely on internal estimates. Level 3 valuation is applicable where the market for the financial instrument in question is inactive. In the current credit crisis, markets for several structured financial products have become dead. In response, there was a strong demand from the banking fraternity that the application of FAS 157 be suspended. Complexity apart, there are strong contentions that the accounting standard is pro-cyclical, as it exacerbates the pains of a crisis by requiring notional losses to be converted into actual losses. In response, the FASB came up with a staff position FSP 3 on FAS 157, which has laid down a detailed present valuation rule for instruments whose markets have become illiquid.

One of the contentions on the part of the bankers was that the current market situation is that of acute turmoil. At this stage, fair values are hardly fair – as they represent distress sale values. The market itself is in state of distress – hence, the prices that the market is quoting, for several instruments, are not the values that would exist in normal market situations. If these distressed values are reported, the resulting earnings would not give a true picture of the health of the entity. On the contrary, it would foster more dislocation, as readers of financial statements would get wrong negative signals about the reporting entity. The borrowing power of entities, their leverage ratios, cost of borrowings, ability to stay in certain lines of business etc are dependent on reported earnings and net worth. If reported earnings are depleted, albeit on account of a notional loss due to fair value based reporting, the resulting adversities for the reporting entity are numerous.

Instead of seeing sense in a crisis-time suspension of fair value reporting, both FASB and IASB have reiterated their love with fair values. Both have issued statements that there is nothing wrong with fair value based reporting.

IASB is going ahead with several projects directly or indirectly related to fair values. It is running a project on replacing the accounting standard for financial instruments (IAS 39). IAS 39 was revised in 2000, once again substantially revised in 2003, and is now sought to be replaced. It is also running a project on fair value measurement.

The standard setters need to realize that except in case of trading assets, fair values should be relevant only for information purposes and not to affect the earnings statement. The current approach that regards all derivatives as trading instruments also needs a relook. The final answers to the complex issue that opens up age-old accounting convention may not be easy to come by – in the interim, balance of convenience clearly lies in suspension of fair value accounting rule.