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### *Fair Value and the Search for Truth in Accounting*

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#### CONTEXT: ACCOUNTING'S GLOBAL CRISIS

It's no news that we live in a world of unprecedented global interaction—the age of globalization. This is, by and large, extremely beneficial and liberating, but globalization can also be a blunt force and a source of homogenization, attracting much criticism for this reason. Although much of the criticism of globalization is directed at its most localized effects, the consequences of consolidating international political power and corporate governance responsibilities deserves equally critical examination. While this paper deals in part with theoretical issues in accounting, there is also a broader institutional point: *globalization need not lead to convergence*. Importantly, diversity across public and private institutions of governance can shield against systemic global failures when inevitable mistakes are made. This paper emphasizes the role of accounting in the United States, the dominance of which has proved to repercuss throughout the world in what some consider resounding failure, magnifying the effects of poor general economic conditions.

Perhaps the greatest impetus for convergence is the basic desire to have simple guidelines to navigate an ever-complex world. But if the guidelines are wrong, so, too, is the navigation. Sometimes, however, there simply is no objectively right answer in representing financial data, yet accountants must still present transactions, making important choices about how to do so *fairly*. Critically, the emphasis on “scientific” questions in accounting (e.g. how to account for certain instruments and transactions) has obscured the political and institutional aspects of accounting policies. Failing organization is overlooked in false hopes of perfecting the rules.

This increasingly political context has risen simultaneously with a shift in rhetoric from “accounting as art” to “accounting as science,” resulting in less attention to accounting's oversight and a dangerous mix of public and private interests in promulgating accounting standards. This scientific idealization also disregards the deeply political and decidedly non-scientific nature of many aspects of accounting and stands at odds with the emphasis on experience, judgment, and artistry used to justify CPAs' role in financial regulation, as formalized in the U.S. in the 1930s amidst another financial crisis. Contemporary accounting should return to incorporating elements of judgment and subjectivity by requiring increased disclosure and transparency, not by prescribing elaborate fixed rules.

Financial accounting exists primarily to convey historical financial information to interested parties both inside and outside the reporting entity. The U.S. Securities and Exchange Commission (SEC) itself recently affirmed that the investor (potential or existing) is the primary user of financial statements. Accountants select the data and its presentation, which investors then use to make decisions. Contingencies must be disclosed *today* but are, by definition, imprecise and uncertain in nature.

Accounting is governed by a complex and expanding set of governmental, quasi-governmental, and non-governmental organizations which work to further the special interests of accountants and also struggle amongst themselves for greater control. Accounting is also necessarily subjective and non-scientific at times, and the rhetoric of ‘accounting as art’ has long played an important role in the profession's self image and marketing to the public. Fair value accounting is imperfect, but it is not evil. The history of fair value is extensive, and it is also a story of responding to fair value's alternatives and their problems, both theoretical dilemmas and implementation obstacles.

#### THE “REGULATION” OF ACCOUNTING AND ITS EFFECTS

Accounting's regulatory framework has long been criticized for its ineffectiveness and complexity. Too many organizations with overlapping jurisdictions, missions, and authority have their

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hands in accounting, yet avoid taking any responsibility for accounting's problems. This environment makes the profession especially prone to egregious rent-seeking and further entrenchment of the interests of those with the most power already.

Accounting's relationship to other financial institutions and professions is critical to understanding the effects and importance of its internal structure. Recently, U.S. accounting policies have been portrayed as adversely affecting the rest of the financial world because of accounting's control over the content of financial reporting and the supposed repercussions of changes in financial statement representations, an effect called "procyclicality." The actual extent of procyclicality from fair value accounting is unknown, but its potential effects cannot be dismissed.

Even by late 2007, securitized loans started becoming "toxic assets" nobody was willing to touch, in part because there was an expectation of the U.S. government stepping in, as has since happened. Investors were reluctant to trade without knowing what the government was going to do, and because everybody was unwilling to buy, the markets for those assets in effect shut down. In the meantime, procyclicality almost certainly did contribute to the drying up of credit markets, making asset-trading increasingly difficult as loans were called after taking accounting write-downs.

If the trading price of an asset is zero, many U.S. companies interpreted Financial Accounting Standard (FAS) 157 to mean that they must also adjust their books to zero for such assets. But are such assets truly worthless? Of course not – and today's financial conditions actually make them potentially attractive investments. No doubt these assets were overvalued in the past, but even risky assets like mortgage-backed securities still have *some* underlying value, often called fundamental or intrinsic value. After all, they still represent valid claims against debtors, even if some debtors are considerably riskier than others. Taking write-downs to the book value of such assets made some firms (e.g. Lehman) unable to get or maintain the credit they needed to operate, but the assets said to be responsible for the "meltdown" are not actually worthless, they merely are not worth as much as people were once saying.

The weaknesses of fair value accounting were well-known as accounting *slowly* transitioned to more of a fair value paradigm. Fair value's rise came about because, in different circumstances, it has the potential to counteract the problems of alternative accounting methods—problems that have had very real effects in recent history, as in the 1980s Savings & Loan Crisis. Moreover, FAS 157 did not make fair value accounting mandatory, it merely clarified existing use. Rolling back FAS 157 does not repeal fair value accounting, it simply makes its contours more confusing and ambiguous.

The Financial Accounting Standards Board (FASB) issues all Statements of Financial Accounting Standards (SFAS or FAS), including the infamous FAS 157, yet FASB is a private association with no inherent legal authority of any kind. Accounting, as a profession in the U.S., does not have an actual "self-regulating organization" (SRO). Who "governs" American accounting is really quite ambiguous and, as a result, no organization is willing to take responsibility when things go awry. The SEC and other regulators rarely issue their own rules about accounting, although the SEC is the only body with explicit Congressional authority to do so. FASB likewise assures the public it is *not* a regulator, thus cannot be held accountable for oversight failures. The Public Company Accounting Oversight Board (PCAOB) further confuses matters, as it is a private organization, created by Congress, privately funded by publicly-collected funds, and also has enforcement authority. Accounting's "governance" is more like a web of private and public institutions which influence accounting in different ways and at different times and with different degrees of overlap. And all of them point at each other whenever anything goes wrong.

The Certified Public Accountant (CPA) is generally considered the most rigorous and prestigious of accounting credentials available in the U.S. Additionally, only CPAs may perform financial statement audits for SEC-registered corporations. Internationally, virtually every country has a similar structure, where CPAs or Chartered Accountants, licensed by the state, have exclusive (i.e. monopolistic) privileges. Again, though, international convergence threatens whatever substantive and regulatory differences currently remain between national accounting regimes.

Relying on "independent" bodies to set accounting standards is controversial, but has been the U.S. rule ever since the SEC's Accounting Series Release (ASR) No. 4 (1938) and No. 150 (1973), which established, then confirmed, the use of outside standard-setters. And even the SEC has recently acknowledged the need to clarify the ongoing relationship and roles of FASB and the SEC. Within five years of its creation, the SEC had formally delegated its accounting standard setting

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authority primarily to two private organizations: the Committee on Accounting Procedure (CAP) and the Accounting Principles Board (APB). Inflation before, during, and following World War II increased the demand for fair value presentation, yet the CAP and the SEC continued to insist upon historical cost accounting. This dogmatism was not without a high political price, however, as both the CAP and APB would soon be replaced as the SEC's source of accounting standards.

The FASB is part of the Financial Accounting Foundation (FAF), a private association created in 1972 to be the independent standard setter for accounting in the U.S. Over the years, FASB's role has evolved into a quasi-regulatory body, creating standards adopted used not only by the SEC but also influential internationally. Although a private organization, FAF has both private and public arms: FASB and the Governmental Accounting Standards Board (GASB). Thus, a private body not only sets the accounting standards for business, often eventually adopted by a government regulator, but also formulates the standards applicable to accounting by governmental bodies. In a federalist system, intergovernmental competition in financial and corporate matters may be an important and valuable feature. On the other hand, accountants today are a powerful special interest lobby in their own right. Additionally, by virtue of its privileged status by the SEC, FASB has no real competitor, nor do states or other organizations promulgate comprehensive standards sufficient to offer an alternative to FASB-centered standards, even for use by companies that are not SEC-regulated. This lack of alternative standards is also of increasing importance internationally.

There is a growing call for global convergence of accounting standards, yet it remains a complicated debate. The Norwalk Agreement was the product of a meeting between FASB and IASB in September 2002, in which:

...each acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. At that meeting, both the FASB and IASB pledged to use their best efforts to (a) make their existing financial reporting standards fully compatible as soon as is practicable and (b) to coordinate their future work programs to ensure that once achieved, compatibility is maintained.

Further, the SEC has announced formal plans to cooperate with the IASB and, in December 2007, also issued Final Rule 33-8879, allowing financial statements of U.S.-traded foreign firms to be filed in compliance with IASB's IFRS standards without reconciliation to U.S. GAAP. More generally, IASB has come under intense pressure to reform its structure from countless groups, including the AICPA and G-20 national leaders. The IASB has responded to this criticism by announcing its plans to increase membership and geographic diversity, as well as establishing a new Monitoring Board.

I agree with the many critics that accounting is in desperate need of a fix, but recent "reforms" have been only further duplicative of accounting's already redundant and ineffective oversight mechanisms. Instead of competitive jurisdictional and substantive overlap, which might result in better governance, accounting's oversight bodies have delegated their functions amongst each other, creating a lucrative niche for oversight professionals. If accountants are gatekeepers, their own gate is in desperate need of mending.

**UNCERTAINTY AND FAIRNESS**

The underlying transactions of accounting are sometimes simply impossible to represent objectively; we can only choose from among equally imperfect methods and then demand detailed disclosures. We can demand responsible accounting, but not perfect accounting. Reformers should be careful to make sure that any accounting reforms recognize and retain accounting's inherent flexibility and role for discretion. Accounting rule changes do not merely influence financial statement presentation, but may also change underlying incentives and behavior, in ways both foreseen and unforeseen. This is equally true of fair value and historical cost accounting. Importantly, fair value accounting worked in the past to keep assets on the balance sheet valued realistically, particularly in light of asset devaluation; historical cost accounting and created a different set of incentives.

Fair value and its procyclicality might have created a type of market hysteria, but the traditional alternative of historical cost makes credit harder to obtain for a lot of firms taking entrepreneurial risks, because it is difficult for them to leverage on the value of appreciating assets. This, in turn, creates more incentives to hide details in the financial statements, or try to get around

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reporting values altogether. Financial accounting rules, “in addition to having a goal of presenting a fair and accurate picture of a company’s finances and operations... may be used legitimately in such a way as to obscure underlying economic reality,” as in so-called “off balance sheet financing.”

Neither is accounting insulated from political realities and influences. While fair value is being attacked in today’s political discourse, its specific forms may themselves be political creations. One important argument for fair value accounting is to combat the effects of inflation. In the U.K., however, the government made “not an accounting choice but a political one” to “solve” this problem, choosing to insist upon current cost instead of current purchasing power. Politicians often end up complaining about problems, such as overstated earnings, that are themselves a product of political decisions, as with the choice of current purchasing power in the U.K.

Criticisms of accounting generally overlook the ultimate problem: *all accounting rules are inherently flawed and bring with them incentives which may create additional problems.* Any systematized method of representing financial data is going to have these types of problems with overbreadth and imperfection. “Principles-based” accounting advocates, who want financial statements to “present fairly” using an appropriate method, but *not* have fixed rules, do not often take into account that relying on judgment is at least as flawed as fixed rules. Law professor Lawrence Cunningham concludes that *any* system of accounting is somewhere along a continuum which *necessarily includes both rules and principles.* And, as he puts it: “*If it is infeasible to establish a principles-based system of corporate law, securities regulation, or accounting, then it is misleading to promote the possibility.*” Accounting is constantly changing, and managers will always seek to bend, stretch, or work outside the framework, in “creative compliance” with the rules. Perfection is impossible not only because accounting is always aimed at a moving target, but also because management takes advantage of that.

At its core, the problem of valuing contingencies is one of knowledge and uncertainty. Imagine that Startup Company gives me, an employee, a promise of a \$100 bonus if the company is profitable for each of the next five years, but nothing otherwise. The odds of this happening, let’s say, are 50/50. Startup Company will either owe me \$100 or \$0 in five years. One way to model this cost today is to expense the discounted present value of \$50, the probabilistic cost of the bonus promise in five years. The problem is obvious, though: under no circumstance will that be the actual cost to Startup Company of the bonus promise, which will owe me *either* \$0 or \$100, but *not \$50 under any circumstance.* If these bonus promises are tradable (like some stock options), then someone might develop a portfolio of bonus promises from many firms, in which case the probabilistic cost is a critical number: buy at any price under the present value of \$50 in five years. For Startup Company to expense *either* \$0, \$50, or \$100 (or any other amount) when the promises are made is an imperfect representation of this contingent liability, but *to say that \$50 is the mandatory treatment implies an element of precision that simply does not exist.*

Accounting offers a perspective quite different from and more subjective than that of economics or finance. One person’s debit is another person’s credit—literally. A *credit* to a consumer’s cash account is a *debit* to the bank’s cash account. Similarly, investors have a different perspective from those running a corporation, and customers a still different perspective, etc. To expect that accounting data has (or should, or even *could* have) the same ‘outsider’ perspective as finance or economics is misguided.

The “entity theory” of the early twentieth-century emphasized accounting’s unique, internal perspective, and focused on issues such as whether goodwill is an asset, or whether to measure balances at cost or value—issues still of tremendous importance today, but often neglected. Entity theory’s principal advocate, William Paton, was always conscious of the importance of perspective, and sought to reform accounting with that in mind:

*The accountant naturally looks upon the business world through the eyes of the individual enterprise; the economist views the situation primarily from the standpoint of an entire industrial community, a whole market situation.* Consequently concepts and terms extremely valid in one field cannot be transferred to the other without, at any rate, very careful qualification. Yet... *the accountant has often made unwarranted use of certain concepts of the economist.* Similarly some economists have attempted to make dubious applications of the *point of view of the business enterprise* to the problems of economic theory.

It seems strange to expect that a company can and will make ‘objective’ valuations about their own financial condition instead of making representations in light of subjective factors, including their hopes and expectations. This is information which the company has a bias in representing, but also information that they are in the best position to know, or at least to give evidence of. And “independent” audits do not necessarily foster an environment where auditors are necessarily privy to this information, nor are they in such a position as to demand such knowledge from their clients.

## ACCOUNTING AND EPISTEMOLOGY: INDETERMINACY, PRAGMATISM, AND ARTISTRY

How do you represent “facts” or “truth” about financial conditions if every conceivable way to observe and present those facts is inherently flawed? If accounting does have its own, internal perspective (as the entity theory asserts), a perspective different from economics’ or finance’s systemic perspective, then accounting need also have its own theoretical framework. Is accounting an art or a (social) science? Many would argue it is something of both.

A strong formulation of “impossibility” rejects the very existence of truth or objectivity, of right and wrong. U.S. debates over accounting during the early twentieth century seem to have been grappling with a rather strong formulation of impossibility, especially in the wake of the 1929 stock market crash, where many doubted that any presentation could ever be fair. Accounting, though, is best said to be *underdeterminate*—its rules or principles narrow the range of presentation to a subset of possible answers, but will often not lead to a single conclusion. If accounting is underdeterminate, then it will never be free of uncertainty, either in theory or in practice. Statistical representations are one way to present uncertainty and, increasingly, accounting relies on such methods, as in the case of stock options. Traditionally, however, accounting’s answer to uncertainty was the experience and judgment—the artistry—of the accountant. The language of both experience and artistry led accountants to pragmatism.

Accounting, however, was not the only place of pragmatism’s influence, as pragmatism also promised justification for much of the era’s Progressive activism, in which accountants and other professionals would be given the important role of “disinterested expert.” Part of the reason accountants were attracted to pragmatism is simply that the leaders of the profession realized they were in desperate need of a theoretical grounding for their profession, especially as they sought to formalize accounting’s educational requirements. Even as accounting struggled to theorize itself, it also found political means through which accountants could secure the success and distinction they had been seeking. Most accountants of the time were opposed to government intervention in financial matters, some very outspokenly so. Apparently seeing no irony, however, these same accountants had long sought exclusive privileges from the government for their profession.

Just like today, various financial crises spurred criticism of accountants even as they were emerging as a profession. Failures of large “trusts” (holding companies) provoked calls for increased regulation, but proposed legislation to pass a federal corporate law, and a right to inspect books, was repeatedly defeated in numerous congressional sessions between 1903 and 1930. The panic of 1907, when New York banks lost over \$12 million in just three days, presented itself as an opportunity for accountants to seize upon “a political environment favorable to further regulation,” and a *Journal of Accountancy* editorial declared: “Publicity [of financial statements] is a safe and conservative remedy for most corporate abuses. The certified public accountant is the authorized agent of publicity.” Thus for all of accounting’s anti-government rhetoric, accountants were not so principled as to not join in criticism, or seek to secure their own interests, following crisis.

Even today’s accountants face difficult decisions in which judgment, not economic or financial modeling, guides them to recognize events in particular periods, and to decide where and how to classify events in the financial statements, and under what type of valuation method. David Myddelton has put it exceptionally well: “Accounting is an art not a science, and *trying to outlaw thinking and imagination would cripple the profession*. Restricting company accountants and auditors to checking compliance with rules is *like requiring real artists, childlike, to paint by numbers.*”

We certainly may be right to expect the accountant to present blemishes, but is “touched up” financial data any less a true representation of a corporation than a portrait is of its subject, where the portrait made the person look slightly better than they actually did at the time? At what point do superficial changes distort the truth of the representation? But, importantly, “while ‘smoothing’ is now

out of fashion it does allow managements to give some emphasis to longer-term trends.” Thus, while earnings management may be a deliberate manipulation, it is not *necessarily* nefarious and *may* reflect a better long-term picture.

Just like a photograph, we may let accounting’s seeming accuracy and precision also allure us into believing in its absolute truth. Paton’s entity theory of accounting was built around the idea that accounting and accountants have a definite point of view: “The *accountant looks* upon business operations essentially *through the eyes of the particular group of managers and owners*.” How much of a practical difference does perspective make in reporting on business operation? A lot, at least according to Paton: “It is a point of view in marked contrast to that of the economist... and in this contrast lies the chief explanation of the difference between accounting and economic categories.” And perhaps Susan Sontag’s description of photographs’ point of view applies, in the spirit of Paton, equally to financial statements:

Photographs had the advantage of uniting two contradictory features. Their credentials of objectivity were in-built. Yet they always had, necessarily, a point of view. They were a record of the real—incontrovertible... since a machine was doing the recording... The truth is they are not “simply” anything, and certainly not regarded just as facts.”

Financial statements are no more factual than a photograph is. Accountants, in trying to appear reputable and unbiased, have placed too much emphasis on creating and maintaining a façade of objectivity, effectively eschewing the inescapable influence of perspective. Accountants used to emphasize the need for judgment, along with their expertise in providing it. Today, though, both accountants and photographers purport to be mere reporters, conveying a simple truth. Like photographers, who often purport to “take” (passively, instead of “make”) photographs, too many accountants today wish to be—or at least claim to be—engaged in a similarly passive enterprise. Yet snapshots can be misleading precisely because their accuracy, however great it may be, is fleeting.

Perspective (or subjectivity) in accounting was not always considered a bad thing. Allowing for multiple, competing visions actually makes accounting more vibrant. Plurality leads to evolution that facilitates accounting keeping up with an ever-changing business environment. Experience and judgment can properly lead accountants to new and different presentation of information, and “deviation from conformity with existing norms sometimes reflects useful innovation rather than harmful obfuscation.”

Notes to the financial statements should remind us of the statements’ own, sometimes steep, limitations. The notes remind us that we are seeing one version of the story, but that certain facts may be omitted, disputed, glossed over, or subject to different interpretation than what we are presented with. Legal scholar Olufunmilayo Arewa has previously advocated increased disclosure standards, writing about accounting for intangibles, arguing that increased disclosure not only improves accuracy but also increases information, which makes financial statements both more reliable and more transparent.

The SEC, too, has recognized that the notes to the financial statements can offer increased understanding and transparency of the underlying data. In its 2008 report on fair value accounting, the Chief Accountant’s Office recommended the introduction of a new schedule reconciling cash flows to comprehensive income, for inclusion in the notes, to increase investors’ understanding of cash flows and sources of future income. More generally, the SEC has also noted that financial statement users and producers have each highlighted the value of increasing disclosures, including sensitivity analyses, projections of future values, and detailed discussion of both the inputs and valuation techniques employed in the financial statements. Regardless of the specificity of standards, increased disclosures allow users to select and analyze the data they believe to be valuable.

Perfect *valuation* may be impossible, but disclosure goes a long way to ameliorate the problems of choosing among competing valuations. By disclosing alternatives and the facts underlying circumstances, users may (and are exhorted to) use the conditions *they deem relevant* in assessing the company’s overall financial condition.

## HISTORY OF ACCOUNTING IN FINANCIAL CRISES AND ALTERNATIVES TO FAIR VALUE

Double entry bookkeeping dates to at least 1299 AD, and must surely have included questions of valuation among its earliest users. In terms of valuation leading to financial crises and eventual government response, an early and well-documented case is the South Sea Bubble of 1720. Corporate form had become popular to spread risk during periods of extensive colonization, beginning with corporate charters for English trade companies dating back to failed Roanoke in 1585 and the profitable East India Company in 1600. These early capital markets fueled many successful ventures, but the South Sea Bubble renewed desire for conservatism, skepticism of capital asset valuations, and also spurred the creation of the public accounting profession.

Throughout the creation and expansion of capital markets and businesses in the U.S., accounting also struggled to evolve, sometimes in competing directions. It was observed during this time, for instance, that Americans defined personal wealth as capital accumulation (i.e. net worth), while the English defined wealth in terms of income. Whether American accountants caused, contributed to, or simply responded to this phenomenon is debatable, but accountants certainly faced the problems of asset valuation, regardless of the cause of its growing emphasis in America. After over 100 years of rapid growth, there was widespread and growing concern by 1900 about misleading, inflated capital asset valuation by the promoters of securities. Even while questions of valuation grew more important, accountants struggled not only over how to value assets, but what assets were in the first place. This formative period was also when accountants began to move towards some consensus on moving away from pure historical cost accounting.

Panics in 1837, 1842, 1857, 1874, and 1893 no doubt further shook confidence in valuation. However, it was the panic of 1907 that served most conveniently for the emerging public accounting profession to argue for reform, as well as their own expertise in financial reporting. Although CPAs had limited success in these efforts, the wake of 1929's monumental crash opened wide the regulatory door through which the profession would transform itself. Throughout these formative years of the modern U.S. economy and financial system, a variety of valuation techniques were in active use, including historical cost, replacement cost, and "price-level" (a form of fair value) accounting. Although historical cost would come to experience somewhat greater prominence, but never exclusivity, its problems became more apparent after it contributed to significant economic problems, eventually leading to the renewed use of fair value in the 1970s and 1980s.

Current accounting standards compel both fair value and historical cost accounting, in different circumstances, under the "mixed-attribute model." Some assets, for instance, are commonly valued at the lower of cost or fair (i.e. market) value, thus both valuations are maintained by the reporting entity, yet potentially reported differently in different periods, making the asset valuation incomparable across periods.

Like fair value, historical cost accounting is not a single method, but a range of possible methods, all of which are anchored in, but also depart from, simply recording historical prices. Further, historical cost is susceptible to general price fluctuations between or even within periods. We generally think of this as inflation, but it may also work in the opposite direction. Neither is it obvious that historical cost reflects actual economic conditions. Depreciation is applicable only to historical cost accounting, yet depreciation, too, is only a fair estimate and cannot predict the actual timing of the need to replace equipment. In a period of expansion and increased usage, replacement could be necessary long before full depreciation or, under other circumstances, long after.

Neither "historical cost" nor "fair value" accounting is absolutely better than the other, or free of subjectivity. The upward valuation of assets had been quite common during the 1920s, but was "virtually extinct" by 1940 on the basis that such write-ups were "arbitrary," especially in the typical cases of using *appraised* values for fixed assets and intangibles. The valuation of securities, however, had by the 1970s proved to be sometimes drastically unrealistic where trading values were far below original cost. Unclear guidance, specifically as to whether firms that had written down securities which had now recovered their value could now write them back up, prompted the FASB to issue SFAS No. 12, *Accounting for Certain Marketable Securities*, in December 1975. This statement clarified that all marketable securities were to be valued at the *lower of cost or market* values. Reaction to the savings and loan crisis, interest rate deregulation in the 1980s, increased used of

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derivative financial instruments in the 1990s, and numerous other factors led to a hodge-podge of additional statements allowing or even mandating fair value accounting.

By September 2006, when FAS 157 was issued, there was a desperate need for clarification of the numerous standards calling for or otherwise affecting the practice of fair value accounting. All told, *FAS 157 amended or superseded four APB opinions, thirty-seven FAS Statements, and numerous other formal Interpretations and other documents.* FAS 157, instead of mandating a major change, clarified 35 years of prior, confusing, and sometimes conflicting statements about fair value accounting, which has been used in various ways throughout that period of time. FAS 157 only clarifies *methods* of estimating fair value, it is *not* a statement that implements it. To repeal FAS 157 would not roll back the requirement of fair value accounting, but merely remove the guidance on how to go about determining it.

The SEC explicitly chastised misinterpretations of FAS 157 to require mark-to-market accounting, especially in distressed markets, as financial institutions have faced since late 2007:

From the various recent public dialogues over fair value accounting, one area of concern appears to be a possible lack of understanding surrounding the concept of “fair value” and its application in the accounting literature. For example, in addition to a misconception among some that SFAS No. 157 itself requires fair value accounting, *other misconceptions are that the requirements in SFAS No. 157 apply only to instances where a market price cannot be determined, or that SFAS No. 157 requires preparers to use observable prices in inactive or disorderly markets, neither of which is accurate.*

No markets could better be described as “inactive or disorderly” than the markets for securitized mortgages in 2008, yet many continued to interpret FAS 157 to require market valuations. It is also important to remember the extent to which fair value is used—which is far less than many reports would lead us to believe. Even in financial institutions (which have more items subject to fair value accounting than most entities do) “less than a majority of assets and liabilities” are subject to fair value, and “a significantly smaller population of instruments” are valued with mark-to-market methods.

The most obvious candidate for valuing assets if we were to retreat from fair value accounting is historical cost accounting. Historical cost, then, is simple and objective to compute, right? Well, first we must consider what *basis* we should use. FASB and IASB have been working together to discuss measurement alternatives, but they do not even use the terms “historical cost” and “fair value” because, according to the SEC, “there is little common understanding of these terms.” It is far more precise to talk of a “time frame” in which to orient measurement: past, present, or future value. Even within a particular time frame, however, we face the question of what *basis* to use, i.e. whether to use entry prices, exit prices, or some sort of modified figure. And even within these choices there may be finer choices to be made, such as whether present entry prices should be based on replacement of identical assets, equivalent assets, assets capable of the same output or capacity, etc.

Another problem with discussing historical cost and fair value as different paradigms for financial reporting is that financial reporting in the U.S. simultaneously uses *both* historical cost and fair value. Modern financial accounting is structured to produce an integrated *set* of financial statements, including (1) a balance sheet, (2) income statement, (3) cash flows statement, and (4) changes in equity. A shift to “pure” historical cost or fair value paradigms would undermine this framework of an integrated set of financial statements. A pure historical cost model would give primacy to the income statement, which would convey the value added by the financial statement issuer, while the balance sheet would merely represent the matching of income to its historical costs. On the other hand, a shift to pure fair value reporting would make the balance sheet the most important indicator of value, while the income statement merely captured the changes in balance sheet accounts from year to year. Although it is not simple, the primary virtue of a mixed framework is that it offers four related, yet different, depictions of the issuer’s underlying economic activity during the period.

## CONCLUSION: ACCOUNTING IN CRISIS AND “REFORM”

Mark-to-market accounting may be partially responsible for recent fluctuations in asset values but, even if true, these accounting changes came about precisely because historical cost was causing firms to hide bad loans at other times, under different circumstances. What are we to make, then, of the current financial crisis and accounting’s alleged role in it?

One current problem is that when companies do make write-downs under fair value accounting, the write-down itself triggers further devaluation, like a run on banks, to a point probably much lower than the assets are actually worth. Reactionary legal changes to accounting, however, overlook the underlying problems. Accounting remains mired in an ever-deepening cycle of scandal-“reform”-scandal. The attack on fair value accounting is but the most recent chapter of this story, even while it relies an idealized view of accounting’s precision and objectivity.

A lot of people say fair value accounting (and especially mark-to-market valuation) is terrible, but it is hardly obvious that it is worse than its alternatives. Even if fair value accounting did contribute to financial crisis, we have no idea in what ways other accounting methods would have restructured or exploited incentives and their effects given the same underlying economic conditions. We do, however, know that other accounting methods have contributed to prior financial crises. Yes, fair value accounting brings with it certain problems, but so does historical cost accounting... which is why we have moved towards fair value accounting in the first place.

No method of accounting is a perfect representation of anything. Accounting is biased and individualistic, not systemic, in its perspective. Acknowledging accounting’s limitations takes it off the pedestal of science, but it also points to the need for transparency (through disclosure) more than trumped up rhetoric of precision and objectivity. Transparency should be the primary goal of financial accounting. However, the primary mechanism of transparency in financial reporting is not uniform reporting, but robust disclosure requirements. In the absence of rigorous disclosure, even the strictest standards serve only as a shroud, especially as incentives adapt and compliance becomes, inevitably, “creative.”

Accounting, as both a profession and a tool of corporate governance, suffers from both poor incentives and bad publicity, largely a function of the profession’s own rhetoric of science and objectivity, eschewing its prior (and more accurate) emphasis on judgment and artistry. The result has been an increasingly unrealistic expectation of accounting’s “truth,” leading to inevitable disappointment and blame in the wake of problems. On top of this, the conflicted regulatory interests affecting accounting’s professional organization lead to a lack of accountability and a glut of blame-shifting when the public cries out against the profession.

Accounting should focus less on uniformity and more on judgment. Emphasizing accounting’s reliance on judgment need not soften public expectations of accountants, and may also reintroduce genuine accountability among accountants themselves. In our interconnected modern world, we should remember that cooperation doesn’t necessarily require conformity; we can embrace differences. Indeed, different accounting treatments not only help highlight the weaknesses of other methods, they also serve as a reminder of the imperfection of all financial reporting.

Fellow, Liberty Fund, Inc. This paper summarizes some of the arguments made in Daniel Austin Green, *Accounting’s Nadir: Failures of Form or Substance?*, 12 U. PA. J. BUS. L. \_\_\_\_ (forthcoming 2010).

*Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting* 9 (Office of the Chief Accountant, Division of Corporation Finance, U.S. Securities and Exchange Commission 2008) [*hereinafter* 2008 SEC Report].

See JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 163-64 (2008).

“Overall, suspending SFAS No. 157 would not eliminate fair value accounting. Instead, it would return practice to a state in which fair value accounting exists, but without a consistent framework for determining those measurements.” SEC Report, *supra* note NOTEREF\_Ref222682185 \h \\* MERGEFORMAT 2, at 169.

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SEC Report, *supra* note 2, at 167.

ASR No. 4 (1938); PREVITS GARY JOHN PREVITS AND BARBARA DUBIS MERINO, A HISTORY OF ACCOUNTANCY IN THE UNITED STATES: THE CULTURAL SIGNIFICANCE OF ACCOUNTING 276 (1998).

FASB's "Conceptual Framework," developed in the 1970s and 80s, had a profound influence on UK and IASC regulators, too, both of which "more or less followed its conclusions" in 1999 and 1989, respectively. D. R. MYDDELTON, UNSHACKLING ACCOUNTANTS 37, available at <http://www.iea.org.uk/files/upld-book241pdf>.

*See generally* ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES (2002).

Memorandum of Understanding, AICPA and IASB, available at <http://www.fasb.org/news/memorandum.pdf>.

*See IASB Oversight Body Responds to Call for Accountability*, J. ACCOUNTANCY, Feb. 3, 2009, <http://www.journalofaccountancy.com/Web/IASBRespondstoCallforAccountability.htm>; *G-20 Addresses Accounting Issues at Financial Summit*, J. ACCOUNTANCY, Nov. 17, 2008, <http://www.journalofaccountancy.com/Web/G20AddressesAccountingIssues.htm>.

Olufunmilayo B. Arewa, *Measuring and Representing the Knowledge Economy: Accounting for Economic Reality Under the Intangibles Paradigm*, 54 BUFF. L. REV. 28 (2006).

MYDDELTON, *supra* note 7, at 135.

Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation, and Accounting*, 60 VAND. L. REV. 1413 (2007), available at <http://law.vanderbilt.edu/publications/vanderbilt-law-review/archive/volume-60-number-5-october-2007/download.aspx?id=2501>.

*Id.* at 1492 (emphasis added).

*Id.* at 1478-79.

WILLIAM ANDREW PATON, ACCOUNTING THEORY: WITH SPECIAL REFERENCE TO THE CORPORATE ENTERPRISE v-vi (1922) (emphasis added).

*See* Daniel Austin Green, *Whither and Whether Auditor Independence*, 44 GONZAGA L. REV. 365 (2009), at 379 (discussing clients' incentives to hide information from auditors).

PREVITS AND MERINO, *supra* note 6, at 186.

JOHN L. CAREY, THE RISE OF THE ACCOUNTING PROFESSION: FROM TECHNICIAN TO PROFESSIONAL (VOL. 1) 54-55.

MYDDELTON, *supra* note 7, at 99.

*Id.* at 117.

PATON, *supra* note 16, at 17.

*Id.*

SUSAN SONTAG, REGARDING THE PAIN OF OTHERS 26 (2003).

*Id.* at 46.

MACEY, *supra* note 3, at 156.

Arewa, *supra* note 11, at 95.

SEC Report, *supra* note 2, at 198.

*Id.* at 151.

PREVITS AND MERINO, *supra* note 6, at 215.

SEC Report, *supra* note 2, at 27.

*Id.* at 34-35.

*Id.* at 35.

*Id.* *See also* SFAS 12 (now fully superseded by SFAS No. 115, ¶124).

*Id.* ¶ 1.

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See FAS 157 87-145 (detailing the documents it affects). See also *Status of Statement No. 157* at <http://www.fasb.org/st/status/statpg157.shtml> .

SEC Report, *supra* note 2, at 172 (emphasis added).

*Id.* at 43.

*Id.* at 174.