SEARCHING FOR THE FAIR STORY BEHIND FAIR VALUE FOR FINANCIAL INSTRUMENTS

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Our paper aims at telling the whole story where fair value accounting is concerned. Harsh criticism has been brought to this concept under current circumstances that motivated out research. Without arguing for fair value as something it is not, we briefly try to point some relevant aspect on the situation. The paper starts on a conceptual level, looking at fair value through regulator's perspective, and further more analyzes some aspects of the current financial crisis. Finding make us think about the past and maybe thinking twice before shooting the messenger, since fair value reflects losses, but it can not generate them.

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1. Introduction

Our paper intends to create a short overview on fair value as a standard of value in financial reporting. We can argue our choice starting with the ongoing shift of financial reporting standards for listed companies towards fair-valued-based reporting, notably the increasing importance of fair value as an accounting measurement attribute. Nevertheless, current events brought serious critics and opponents fighting to restrict the use of fair value within financial reporting.

We should mention the critical event triggering the shift towards the fair value paradigm was the Savings-and-Loans (S&L) Crisis in the USA during the 1980's, which laid open the deficiencies of the prevalent reporting system based on the historical cost. It resulted in regulatory action by SEC, which among other thing advised the FASB to develop a standard on accounting for certain debt securities at their market value instead of amortized cost. Despite its limited scope, this initiative represented a major evolution in accounting though on the regulatory level (Arthur Wyatt refers to it as "possibly the most significant initiative in accounting principles developed in over 50 years" (Wyatt, 1991), a notion emphasized by the testimony of SEC General Counsel James Doty to the US Senate, who made it clear that 'the time has run out on "once-upon-a-time accounting"'.

Ever since the mid-1980's, the US Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have systematically substituted market-based measures for cost-based measures. Starting out as a specific remedy for the inequities of the reporting model for certain financial instruments, fair value has manifested itself as the dominant measurement paradigm for financial instruments and, more recently, has increasingly been implemented for measurement of non-financial items. The cost and transaction-based reporting model is in decline, a new market value and event-based model is rising, with dramatic implications for the role and properties of balance sheet measurement and accounting income. Starting out as a special regulation for certain securities, fair value measurement was soon identified as the most relevant attribute for financial instruments.

The Financial Accounting Standards Board (FASB) made a fundamental decision that fair value is the most relevant attribute for financial instruments (FASB, 2004, p. 8). Although the quoted market value is the prescribed measure of fair value, the FASB adopted the term ''fair value'' instead of market value to encompass estimated values for financial instruments that are not traded in active markets. The decision to mandate fair value disclosures was made amidst a long-standing debate between the advocates of fair value accounting and advocates of historical cost accounting. The basic premise underlying the FASB's decision is that fair value of financial assets and liabilities better enables investors, creditors and other users of financial statements to assess the consequences of an entity's investment and financing strategies. Advocates of historical cost, on the other hand, point to the reduced reliability of fair value estimates relative to historical cost. Their arguments suggest that investors would be reluctant to base valuation decisions on the more subjective fair value estimates (Barth, 1994, p. 3). Given the FASB's stated long-term goal of having all financial assets and liabilities recognized in statements of financial position at fair value rather than at amounts based on historical cost, the purpose of this study is to test claims that fair value is more informative relative to historical cost.

The Financial Accounting Standards Board and the International Accounting Standards Board (hereafter FASB and IASB) are jointly working on projects examining the feasibility of mandating recognition of essentially all financial assets and liabilities at fair value in the financial statements. In the United States, fair value recognition of financial assets and liabilities appears to enjoy the support the Securities and Exchange Commission (hereafter SEC). In a report prepared for a Congressional committee (SEC, 2005), the Office of the Chief Accountant of the SEC states two primary benefits of requiring fair value accounting for financial instruments.

First, it would mitigate the use of accounting-motivated transaction structures designed to exploit opportunities for earnings management created by the current "mixed-attribute" – part historical cost, part fair values – accounting model. For example, it would eliminate the incentive to use asset securitization as a means to recognize gains on sale of receivables or loans. Second, fair value accounting for all financial instruments would reduce the complexity of financial reporting arising from the mixed attributed model. For example, with all financial instruments measured at fair value, the hedge accounting model employed by the FASB's derivatives standard would all but be eliminated, making it unnecessary for investors to study the choices made by management to determine what basis of accounting is used for particular instruments, as well as the need for management to keep extensive records of hedging relationships. Nevertheless, as noted in the SEC report, there are costs as well associated with the application of fair value accounting. One key issue is whether fair values of financial statement items can be measured reliably, especially for those financial instruments for which active markets do not readily exist (erg specialized receivables or privately placed loans). Both the FASB and IASB state in their Concepts statements that they consider the cost/benefit trade-off between relevance and reliability when assessing how best to measure specific accounting amounts, and whether measurement is sufficiently reliable for financial statement recognition. A cost to investors of fair value measurement is that some or even many recognized financial instruments might not be measured with sufficient precision to help them assess adequately the firm's financial position and earnings potential. This reliability cost is compounded by the problem that in the absence of active markets for a particular financial instrument, management must estimate its fair value, which can be subject to discretion or manipulation. Assessing the costs and benefits of fair value accounting for financial reporting to investors and other financial statement users in particular reporting regimes is difficult.

Opponents of fair value measurement, on the other hand, criticize the questionable reliability of fair value measures, especially for model-based estimates relying on management's expectations and projections. In particular, the implementation of fair value as a balance sheet measure is the subject of intense discussion and debate. The controversy regarding fair value accounting for financial instruments as recently highlighted by the rejection of IAS 39 (revised 2003) for full EU endorsement, illustrates both conceptual and technical issues involved. Apparently, the debate is far from resolved.

2. A standard setting body's perspective

Both FASB and IASB stress the capacity of market values to incorporate, in an efficient and virtually unbiased manner, market consensus expectation about future cash flows. Our analysis on fair value starts with the FASB because of its initiative in the field. The set of accounting standards available within the American referential around 2004 did not include a unique source of general guidance, valid in the attempt of defining and estimating fair value. The guidance that concerned fair value could be found mainly in a series of intersected and "patched" accountancy standards, which referred to financial instruments. On the other side, the exiting accountancy standards showed an increasing level of the acceptance of fair value as attribute of evaluation (in comparison with the depreciation cost). Assuming that there is a high probability that future standards will include evaluation at fair value, the definition of this concept (fair value) as attribute of evaluation – accompanied by procedural guidance at the highest level, and concerning a consistent estimation of the concept – became a priority in the goal of the efficient application of already existing or new standards.

The goal of this new standard was to assist the users of information provided through financial reports, so that they could evaluate more appropriately the relevance and credibility of the estimations of fair value. The financial reports should also contain information about the data and models used to provide fair value estimations. The standard created by FASB in the autumn of 2006, SFAS 157 - *Fair Value Measurement* seems, on one side, to judder the foundation of historic cost based evaluation, but, on the other side, appears harmless because it does not impose the use of fair value on a wide scale (Miller and Bahnson, 2007). In fact, the truth lies, as usual, somewhere in the middle, in the way that the standard acts both ways.

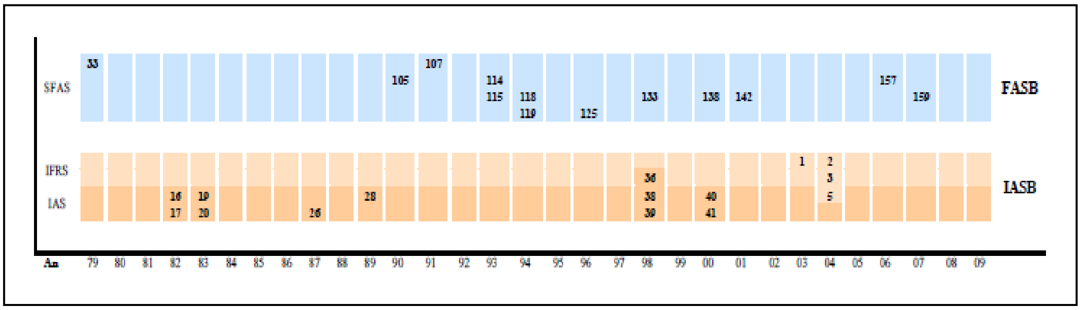
Indeed, the new standard does not impose the use of fair value in situations other than the ones already mentioned by previous standards. However, SFAS 157 modifies the 'status quo' in three essential ways. We refer here to the fact that the level concerning practical aspects is being raised, a new series of factors that must be considered is emerging. These factors must be taken in consideration when those fair values already mentioned in existing GAAPs are evaluated, so that the evaluation process can disclose information that is more important. Another effect was that the introduction of SFAS 157 cleared the way for SFAS 159 - *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 159 created the possibility for fair value to be introduced and used in new ways. Another merit of this standard was that it prepared the field of financial reporting for the new Conceptual Framework developed by FASB. We rely on these affirmations and on the preliminary aspects contained in the (PV) *Objective of Financial Reporting and Qualitative Characteristics of Decision - Useful Financial Reporting Information*, introduced in 2006 by the same FASB These stated that the fair value will be ultimately preferred as an evaluation attribute in financial reports (FASB, 2006). In this context, the introduction of SFAS 157, was meant to clarify and put things in order, is fully justified.

It is thus clear that the objective of the issuing of SFAS 157 is to bring uniformity and consistency to the professional literature, and to accountancy practice. One of its great contributions resides in the fact that it offered a real catalogue of situations in which fair value is used, and a standard annex presenting more than 60 cases in which fair value is valued and reported.

The core component of SFAS 157 is the description of Fair Value Hierarchy (paragraphs 22-31), that identifies the priorities that management should respect when estimating fair value of assets and liabilities. This hierarchy describes the input data of evaluation methods, without specifying what models should be used. In fact, these inputs represent the assumptions that market agents would use when evaluating the value of an asset or a liability. They can be represented by "visible inputs" and by invisible ones (invisible inputs). Visible inputs are based on the information provided on the market – thus belonging to independent sources – while invisible

inputs represent the assumptions generated by the reporting entity, assumptions which would be used by the participants on the market to evaluate the respective asset.
The estimation of fair value follows, in principle, a three-tier hierarchy. The preferred level (1) fair value estimates are those based on quoted prices for identical assets and liabilities, and are most applicable to those assets or liabilities that are actively traded (e.g. trading investment securities). Level 2 estimates are those based on quoted market prices of similar or related assets and liabilities. Level 3 estimates, the least preferred, are those based on company estimates, and should only be used if level 1 or 2 estimates are not available. With the emphasis on market prices, the FASB emphasizes that firms should base their estimates on market prices as model inputs wherever possible (e.g. use of equity market volatility estimates when employing the Black-Scholes valuation model to estimate the fair value of employee stock options). If other models employing market inputs are not available fair value estimates can be constructed using entity-supplied inputs (e.g. discounted cash flow estimates). The governing principle is primacy of market-based measures – the refutable notion that market prices or market data are more informative and reliable than internal estimates. Not to forget that market prices represent the best estimate for fair value, if market conditions satisfy the fair value definition. The relevant "quality" of market prices is assessed because of the active market criterion, that is, regular trading of the item on a liquid market is required for the market price to qualify as an estimate of fair value. The second level of estimation hierarchy requires considering (modified) market prices of comparable items, where comparability naturally refers to the cash flow profile. Only when such prices cannot be used either, marking-to-market fails and fair value is mandated to be estimated using internal estimates and calculations. This marking-to-model, the use of accepted, theoretically sound pricing methods, represents a technique of last resort. Ample guidance exists on valuation models for financial instruments, and accepted methods can be found in the marketplace.
After only 6 months from the appearance of SFAS 157, through the emission made by FSAB in February 2007 of SFAS 159 *The Fair Value Option for Financial Assets and Financial Liabilities*, whose elaboration, adoption and implementation surely would have been harder to realize if the basis would not have been put through its predecessor. The good part of SFAS 159 regards those innovative managers that will profit on the permissively of the standard like an occasion to increase voluntarily the quantity of information useful on the capital markets, through the intermediation of the offered financial information. We are not to forget though the possibility of exploration of its flexibility in offering a false image over some of the financial assets and debts of the entity, as a negative effect of the managers' innovative capacities, stimulated through the standard. The theory offers us though an answer when facing this danger, considering these efforts negatively oriented, with a great lack of ethics, and un-useful, due to the fact that, earlier or later, capital markets will impose the well deserved punishment through the diminution of the quoted prices and the increase in capital costs. It is not to neglect the necessity of developing some mechanisms of corporative governance meant to encourage honest financial reports and objective ones (Ronen, 2008).
The IASB also develops an International Financial Reporting Standard on fair value measurement, which is based on SFAS 157. The sharp distinction of fair value and value in use clarifies that fair value measurement is not to include entity-specific competitive advantages, that is, no private skills and no private information. Given the gradual evolution of the fair value paradigm, its impact on current standards shall be summarized briefly. Currently, both US GAAP and IFRS require the disclosure of fair values for virtually all financial instruments (IFRS 7, SFAS 107). Guidance on fair value accounting for financial instruments is also identical in principle. IAS 39 and SFAS 115, 133 require trading securities and derivatives held for trading or as part of a fair value hedge to be measured at fair value with revaluation gains and losses taken directly to income. Available-for-sale securities are also carried at fair value, but gains beyond

the historical cost ceiling are recognized as other comprehensive income until realization. This recycling approach is also applied in accounting for derivatives that are part of a cash flow hedge. In both regimes, securities classified as held-to-maturity, non-securitized financial assets and obligations, except derivatives, are in principle accounted for at cost. This mixed model approach reflects standard setters' reluctance and affected parties' resistance to implementation of full fair value accounting, despite the tentative consensus on its conceptual merits especially on the relevance dimension. The IASB has taken a big step in this direction with the 2003 revision of IAS 39, which has introduced the "fair value option" to designate any financial instrument as "measured at fair value through profit and loss" at inception. Objections especially from bank regulators, notably the European Central Bank, resulted in a partial endorsement by the EU only ("carve out") and prompted the IASB to restrict the fair value option to areas where an accounting mismatch is eliminated. With the recent publication of SFAS 159 in February 2007, the FASB follows suit and implements a similar, yet less restrictive fair value option. The following figure shows a parallel of the main standards regarding[473] fair value, developed on time[474] by the two major accounting regulatory setting bodies, IASB and FASB:



3. History repeating – what have we learned?

We should never underestimate the fact that the capacity to achieve a true valuation is in fact the key to success in the domain of financial services, because in order to buy or sell a financial instrument, it is imperative to know its value. In addition, after one buys a financial asset or contracts a financial debt, valuation represents the key to success in risk management implied by this element, but also in reporting the created value, to the stakeholders. The credit crisis begun in 2007 was the cause of the job loss of numerous financial directors, but also of the bankruptcy and selling of numerous financial institutions. In time, 2 great problems seemed to be the base of this crisis. On of these is represented by the methods used to determine the fair value for financial instruments that started from the mortgage credits and were furthermore structured through a more or less complex setting. The second problem is the lack of information flow necessary to be known by investors, lack that could stop even the best valuation technique from generating a significant level of accuracy. (Deventer, 2008).

Derivative financial instruments such as those in CDO's category causes often significant losses to investors, but it has to be kept in mind that, by their nature, often they exist only with the goal that the companies that make their structure to sell them in trenches formed at a price greater than the cost of the collateral who is referred to. The investors who ignore this reality of possible losses resulted after the structure is done are too naïve for the CDO's market (Deventer, 2008). In fact, the most naives of these have been guiding just after the ratings of the trenches within CDO's and after they made acquisitions, without trying to obtain a confirmation of the fact that

473 Defining, allowing the utilization, soliciting the utilization or making other references to the fair value.

474 Each standard is positioned at the date of the first apparition, without mentioning the following amendments, and the abrogated standards are correspondingly marked.

the price that was asked, represented a "fair value" (Matis and Bonaci, 2008). Through this, they have practically chosen to ignore the fact that rating agencies are paid by the entity that realizes the securities structuring and that this could be in favour of a superior rating compared to the real level of the implied risk. If the trenches within the CDO's wouldn't have gained a more favourable rating than the one it deserved, these structures would not have been able to produce money through grouping some titles accessible on the market that would have been resold afterwards at a higher price under the form of trenches. Those investors that have participated within the CDO market, having been based only on the ratings offered by the rating agencies should be sanctioned correspondingly by the management of the entities that are directly implied in making the investment or even by regulation organisms on the market (Deventer 2008).

We can state that the current financial crisis is due to the relaxations of the underwriting process within the credit market, and a far too high-accepted leverage in the last years for mortgage credits offered on the market (Wallace, 2008). These factors have raised significantly the underwriting process risk, but it was not correctly valuated at the moment when the mortgage was issued. The mass process through which these credits have been transformed in shares that gave the investors the right to a part of the cash flow generated by these (assets securitization) didn't do anything except to exacerbate the problem, when the rating agencies, despite the raised risk, gave high scores to some similar derivatives having as a base mortgage credits. This has determined an excessive increase in the demand for such securities, supporting in this way the demand on the real estate market and determining the increase in prices over time.

Nevertheless, fair value accounting within this process is just to capture the changes appeared in the market prices, as they materialize themselves. Even though the utilization of inadequate assuming in the initial valuation of the mortgages has surely contributed to mastering the actual problems, this represents finally an error of valuation and not a problem caused by the application of fair value accounting *per se*. That which the fair value actually does is to bring the true dimension of these errors of valuation, in the eyes of the investors, in a short interval of time (Wallace, 2008). The main difference between the reflection of an asset at the fair value or at a depreciation cost is represented by the recognition of some unrealized losses or gains in the alternative of fair value. However, these losses or gains represent in fact changes in the value of future generated incomes by the so-called asset. As a following, coming back to the actual financial crisis, the losses that the banks are ought to confess under the option of fair value, captivates in fact the true impact (upon the present and future incomes) at considering a higher degree of underwriting the mortgage credits that had been already given.

Despite all evidences proving how things happened and how the mechanism that created the crisis were created, fingers keep pointing toward fair value, but we should take a closer look at who are the ones pointing them. Since late September and the beginning of October 2008, Wall Street Journal published a series of articles that described how the banking industry is revolted against the fair value accounting, bringing a series of critics, the majority because these would impose to the banks to diminish the asset value within the balance sheet, at lower values as the ones showed on the market. It seams that the financial institutions militate for an elimination of the fair value, seen as a partial solution for the banking industry nuisances. Wall Street Journal presented a letter to the American Bankers Association – ABA, asking them that until the end of the third trimester to recognize that fair value is laced of significance within some liquid markets. However, considering the financial mechanisms previously presented, that state the major role the financial institutions had at the root of this financial crisis, can we still "point out" towards fair value? Moreover, much more than this, would the elimination of fair value lead to the solvency of the problems the financial institutions face? (Bonaci and Matis, 2008).

Starting with the beginning of fair value as a concept and ending by defending it under current circumstances, we would just like to kindly ask you not to forget the tales of the past, the Enron collapse inevitably coming to our thoughts. At that time, the new fair value accounting paradigm was progressively incorporated into the framework of Generally Accepted Accounting Principles to serve along with the well-established historical-cost accounting, but, as today, the Enron debacle involved misuses of both paradigms. Then was also an opportunity to argue against “mark-to-model” valuation, and even more to suggest the time of fair value accounting had not yet come (Barlev and Haddad, 2004). Enron used, to a large extent, level 3 and level 2 inputs for its external and internal reporting. Level 3 valuation was first used for energy contracts, then for trading activities generally and undertakings designated as “merchant’” investments, these fair values simultaneous being used to evaluate and compensate senior employees. As proven later, Enron’s accountants (with Andersen’s approval) used accounting devices to report cash flow from operations rather than financing and to otherwise cover up fair-value overstatements and losses on projects undertaken by managers whose compensation was based on fair values (Benston, 2006). Unfortunately, once again we find how *we learn from history that we learn nothing from history*, as George Bernard Shaw concluded.

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