# FAIR VALUE ACCOUNTING AND THE CONCEPTUAL FRAMEWORK

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***ABSTRACT***
*Even before the Financial Accounting Standards Board (FASB) had issued Statement of Financial Accounting Standard No. 157 (SFAS 157),* Fair Value Measurements *in 2006, there was controversy over the use and application of fair value accounting (FVA). This paper compares FVA to the conceptual framework of accounting embodied in FASB's Statements of Financial Accounting Concepts (SFAC's). FVA is found to deviate significantly from this set of guiding accounting principles in several respects. FVA sacrifices reliability for a questionable degree of relevance; it fails to faithfully represent what it purports to represent; it focuses on investors to the detriment of other user groups; and it changes the focus of financial reporting from earnings to asset valuation, from business transactions to market events, and from management performance to entity liquidation value. In addition, variations in the application of FVA among firms reduce comparability, consistency, and (although not in the conceptual framework) transparency—an oft-cited benefit of FVA. Pushing forward with FVA even beyond their international peers, US standard-setters seem more concerned with foreign approval than with the needs of their domestic constituents. FVA needs to be reevaluated, and FASB should adopt a mixed model approach that faithfully represents the values of assets and liabilities as they are intended to be used by management. Ultimately, the "new" FVA standards that emerge from this process should be thoroughly grounded upon and in agreement with the conceptual framework of accounting to serve the needs of all stated users of financial reporting.*

## INTRODUCTION

Controversial accounting pronouncements are not new to the accounting profession. Involved and complicated accounting issues such as leases, deferred income taxes, pensions, and business combinations are, by nature, controversial; and despite the passage of standards related to these issues, some would still say that the underlying accounting questions are still unresolved. Yet there have been only a handful of accounting standards that have generated the degree of controversy as Statement of Financial Accounting Standard No. 157 (SFAS 157), *Fair Value Measurements*. Even years after its adoption and application, there may not be a phrase that will spark more controversy in financial circles than "mark-to-market" or "fair value" accounting. In fact, Jenkins (2008) says that the more appropriate term may be "mark-to-mayhem."

In 2006, the Financial Accounting Standards Board (FASB) issued SFAS l57 (FASB 2006, now referred to as Accounting Standards Codification (ASC) 820) to prescribe the methodology for carrying certain financial instruments at fair value. In 2007, SFAS 159 (FASB 2007) extended FVA by permitting all financial assets and liabilities to be carried at fair value. SFAS 159 (FASB 2007) also permitted entities to apply FVA to nonfinancial assets. During and after the financial crisis of 2008, some alleged that FVA was the primary cause of the crisis. Although it was not the primary cause of the crisis, FVA played a peripheral role, and the ensuing debate resulted in additional scrutiny of FVA guidance and application.

This paper will address the issues surrounding FVA and the conceptual framework of accounting. The following three sections of the paper will explain what is required under the fair value standards of financial accounting; compare the fair value standards to the relevant portions of the conceptual framework in existence at the time that SFAS 157 was issued (and to FASB's recent conceptual framework update); and provide analysis and comments on FVA. The final section will summarize this discussion.

**FAIR VALUE ACCOUNTING STANDARDS**

In 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard No. 157 (SFAS 157) to establish fair value accounting standards under United States generally accepted accounting principles (US GAAP). In 2009, FASB recodified its accounting standards, and SFAS 157 was included under topic 820 of the Accounting Standards Codification (ASC 820). Although both original (SFAS 157) and recodified (ASC 820) source documents are cited throughout the paper, "ASC 820" will be used to refer to both sources of documentation unless a difference between SFAS 157 and ASC 820 is being highlighted.

Under ASC 820, US GAAP requires that fair value measurements be recognized in the financial statements for certain financial statement elements. The recognition process requires adjustments to the carrying amount of assets and/or liabilities which results in the recognition of unrealized gains and losses. ASC 820 (ASC 820-10-35-2, originally SFAS 157, para. 5) provides a single definition for fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." Thus, ASC 820 defines fair value as an "exit price" (AICPA 2010b). ASC 820 also establishes a framework for measuring fair value, and requires enhanced disclosures regarding fair value measurements. ASC 820 does not require any new fair value measurements, but it does standardize measurement and disclosure practices (Grant Thornton, 2008).

The main purpose of ASC 820 was to increase consistency and comparability in fair value measurements. Thus, ASC 820 (FASB 2006, SFAS 157, paras. 22-30) prescribes a framework for performing fair value measurements using a three-tiered hierarchy of inputs (Grant Thornton, 2008). Level 1 inputs are observable inputs based upon quoted market prices for identical assets and liabilities in active markets. Level 2 inputs are quoted prices from sources other than Level 1 which are observable either directly or indirectly, such as an interest rate swap which utilizes observable data points like the yield on Treasury bonds. A good example of Level 2 inputs is provided in a case written by Gore and Herz (2010, 59). In this case, estimating the fair value of the properties in the Mountain Division of the Snowy Ridge Ski Resort requires use of a market multiple based upon the sales revenue of comparable properties that were sold during the year. Level 1 and Level 2 inputs are considered "mark-to-market" methods.

Level 3 inputs are unobservable assumptions, such as an entity's internal valuation model, that incorporate management assumptions that cannot be corroborated with observable market data. Thus, the use of Level 3 inputs is sometimes referred to as "mark-to-model" accounting (King 2006), and it is used when observable inputs are not available (FASB 2006). It is interesting to note that at the time of issuance of SFAS 157, textbooks depicted Level 3 inputs as consisting of present value computations of either net income or cash flows; however, the same interpretation did not carry over to practice. In any event, Level 3 inputs provide fair value prices that are entirely dependent upon management's assumptions and are therefore less neutral than Level 1 and Level 2 inputs.

In 2008, ASC 820 was amended by FASB Staff Position (FSB) No. 157-3 (FASB 2008) to relax the measurement requirements with regard to financial assets that are no longer part of an active market.

Securities no longer part of an active market are measured using Level 3 inputs instead of Level 1 inputs. This change in categories results in a shift in measurement schemes which affords entities the opportunity to find a valuation alternative other than a zero market value when such securities are no longer traded in an active market place.

Even more recently, FASB and the International Accounting Standards Board (IASB) agreed that ASC 820 should be amended to reflect FASB's decision that the "highest and best use" concept should apply only to measuring the fair value of nonfinancial assets; to add guidance for measuring the fair value of financial assets and financial liabilities; and to amend related guidance for determining premiums and discounts in a fair value measurement (AICPA 2010a).

ASC 820 also includes disclosure requirements related to FVA (Stines and Auteri 2010). Without focusing on technical disclosure details beyond the scope of this paper, ASC 820 requires that the fair values for all affected assets and liabilities be reported as of the statement date along with the input level (i.e., Level 1, 2, or 3) and valuation techniques used to measure each asset or liability. In addition, all transfers in and out of the Level 3 category, and significant transfers in and out of the Level 1 and Level 2 categories, must also be disclosed. For those elements measured using Level 3 inputs, additional disclosers are required for period gains and losses, and category purchases and sales.

## CONCEPTUAL FRAMEWORK ISSUES

The establishment of a recognized conceptual framework of accounting was an arduous task that spanned decades. Beginning in 1978, FASB issued six Statements of Financial Accounting Concepts (SFACs) over the span of seven years with SFAC 6 replacing SFAC 3 in 1985. In 2000, FASB issued SFAC 7 on present value based measurements. These seven concepts statements formed the conceptual underpinnings of financial standard-setting during the time that ASC 820 (then called SFAS 157) was enacted. More recently, FASB issued SFAC 8 in 2010 to replace the two foundational concepts statements, SFAC 1 and SFAC 2.

The concepts statements were and are a significant advancement in the field of accounting standard-setting. Although there are a number of reasons for the demise of the US private-sector standard-setting bodies that existed prior to FASB (i.e., the Accounting Research Board (ARB, 1938-1958) and the Accounting Principles Board (APB, 1958-1972)), one of the issues was a lack of (or failure to produce) a cohesive set of concepts upon which financial accounting standards could be established. Instead of looking to a set of consistent guiding principles, the ARB and APB set accounting standards *ad hoc* based upon the needs of its constituents. When financial transactions are simple and few, this method can potentially work well; but with the increased complexity and volume of accounting issues, a formal framework was needed. The purpose of FASB's conceptual framework was "to set forth fundamentals on which financial accounting and reporting standards will be based. More specifically, the SFACs are intended to establish the objectives and concepts that the FASB will use in developing standards of financial accounting and reporting" (FASB 1978). Because the SFACs serve as the underpinning of FASB Standards, all financial accounting standards should be aligned with the concepts.

The following discussion will summarize the portions of the SFACs that are relevant to the FVA debate. Specifically, issues in SFAC 1, SFAC 2, and SFAC 5 will be addressed. Additionally, the content of SFAC 8 will be reviewed. Although this latter concept statement did not exist at the time that ASC 820 (then called SFAS 157) was issued, the alignment of ASC 820 with SFAC 8 could have significant implications for the future of FVA. Alignment between ASC 820 and the conceptual framework will be discussed and analyzed within each section.

SFAC 1, *Objectives of Financial Reporting by Business Enterprises*, provides a foundation for the other SFACs by defining the purpose of financial reporting for business enterprises. In summary, it states that financial reporting should communicate transaction-based financial information about the earnings of a particular firm that is useful to internal and external parties for the purpose of determining future cash flows for investment, credit, and similar decisions. This discussion of SFAC 1 will begin by identifying the intended users of financial information, continue by examining the usefulness of the information for the intended users, and conclude by considering the content and focus of this information.

SFAC 1 (FASB 1978, paras. 24, 32) recognized several possible users of financial statements but remarked that the information reported externally was geared primarily for investors and creditors—user groups who should be informed about such matters. Therefore, accounting information should be understandable and understood by these user groups. However, Hague (2009) cites financial illiteracy as one of the factors contributing to the financial meltdown. This was not entirely the fault of the users, though. The use of Level 3 inputs under FVA is not applied comparably across firms nor consistently within each individual firm, and it allows firms to "produce subjective, unobservable information out of thin air." (Pounder 2010, 15).

For example, the presentation and discussion of Level 3 inputs found in intermediate accounting textbooks indicates that fair value amounts should be determined based on the present value of cash flows or net income as determined by the entity's own internal data. Yet during the recent market collapse, when the valuation of collateralized debt obligations (CDOs) changed from Level 1 inputs to Level 3 literally overnight, the measurement approach should have changed from that of an actively traded market to that of the present value of income or cash flows. Instead, financial statement preparers continued to apply the market value approach even though there was no longer an actively traded market and despite the fact that FASB had provided clear guidance on present value measurements (FASB 2000). Thus, FVA contributed to the financial meltdown because it permitted fair value measurement based on an incorrect measurement attribute. Therefore, the users of fair value information did not adequately understand the reporting and interpretation of FVA information as provided by financial statement preparers, and this misapplication and misunderstanding of FVA resulted in contagion in the marketplace as discussed by Laux and Leuz (2009).

With respect to the usefulness of the information provided, SFAC 1 states that the role of financial reporting is to provide information to users regarding the amount, timing, and uncertainty of cash flows (FASB 1978, paras. 33, 37). Wesbury and Stein (2009) and Forbes (2010) assert that the gains and losses arising from fair value accounting are paper losses, not realized losses, and have no relationship to cash flow. In their economic analysis of the banking sector, Allen and Carletti (2008) note that application of FVA allowed short-term fluctuations in market prices to drive the amounts reported on the balance sheet and income statement, thus distorting banks' portfolios and causing contagion. It is important to note that changes were solely the result of applying FVA and had no relation to cash flows.

Historically, measuring stock compensation expense was one of the early applications of fair value measurement whereby the reported value was based upon something other than a value obtained in an active market. In accounting for stock options, the entity determines the value of the option based upon the Black-Scholes model and then uses that value to determine the compensation expense to be recognized in the income statement. Thus the model, not the market, ultimately determines the expense to be recognized. The objection to this approach, other than the magnitude of subjectivity, is that the actual economic cost to the entity is the cost of covering the options either through treasury stock repurchased in the open market or via issuance of securities from a shelf registration. Either way, the compensation expense recognized for stock options is completely unrelated to the cash consequence of covering the options**.** Similarly, measuring financial assets such as CDOs based upon a market value is unrelated to the cash flow associated with the financial asset. Young (Young *et al*. 2008) also finds that it does not appear that fair value has afforded investors and creditors with any more relevance about the cash flows of financial instruments. In summary, FVA fails to provide useful information with regard to the amount, timing, and uncertainty of cash flows for an entity.

Furthermore, SFAC 1 (FASB 1978, paras. 42, 50, 51) states that financial reporting should provide information about the financial performance of an enterprise during a period and about management's stewardship of business resources on behalf of the owners. Earnings performance is the most common measure for assessing both enterprise performance and management stewardship—two measures which financial reporting does not and cannot separate (FASB 1978, para. 53). In particular, investors, creditors, and others use earnings to evaluate management performance, estimate "earning power" or other measures of long-term earnings, predict future earnings, and/or assess risk (FASB 1978, para. 47).

Cherry and Hague (2009), Johnson *et al* (2010), and Arya and Reinstein (2010) concur that FVA is a market-based measurement system, not an entity-based measurement system. The gains and losses recognized via fair value accounting all too easily become the result of market events and not management performance. Returning to the example of CDOs, valuing CDOs at the present value of the future cash flows allows for the measurement of management performance relative to controllable factors; but valuing CDOs based upon seized market prices measures management performance relative to uncontrollable market forces. Management performance should be assessed by comparing actual results with predicted results; and this assessment is usually carried out by evaluating the results of operations, either by comparing predicted versus actual results or by comparing the results of this period to last period. To measure management performance versus uncontrollable market results, management would have to predict fair values (market events) and manage to them. This could have the perverse incentive of driving mangers to manage events instead of devoting their attention to managing operations (transactions). This is, in part, what lead to Enron's demise. As Enron began to generate more and more of its profits from trading paper, they began managing assets for their market value instead of producing products from central operations.

Flegm (Young *et al* 2008) asserts that in controlling a company's operations, managers forecast an income statement and compare actual results to the prior month's forecast. On the other hand, the balance sheet is used by the treasury department to analyze cash flows and evaluate the need for financing. Flegm (Young *et al* 2008) states that he does not know of any company that compares the values of the beginning and ending balance sheets to determine the success of its operations. It appears that the standard-setters no longer consider the stewardship needs of the manager but focus instead on investors and creditors and potential values rather than transactional results. However, in 1999 banks responded negatively to the feelers put out by the FASB with regard to FVA indicating that fair value was not relevant for investors, did not suit the business model of most banks, and was not appropriate for illiquid assets or held-to-maturity assets. Nevertheless, Flegm (Young *et al*. 2008) believes that FVA's emphasis on the balance sheet (an asset-liability approach) does a better job of measuring the "well offness" of a firm than the results of operations reported via the traditional income statement. The rationale for this shift is that fair value data is more relevant than the traditional accounting model and not as subjective with regard to matching costs with related revenues. It is further argued that fair value data is more relevant and of more value to investors and creditors while ignoring the needs of the managers and/or owners.

FVA's emphasis the balance sheet is also in conflict with SFAC 1 which states that earnings performance is the most commonly used measure to assess stewardship. Earnings are derived from a transactions approach to accounting and not an events-based measure. Power (2010) cites a report from a 2000 Joint Working Group of the International Accounting Standards Committee (now the IASB) that recommends that economic pricing methodology be permitted for financial assets when other reliable estimates for their fair value (i.e., market prices) are unavailable. Power (2010) concludes that FVA changes the focus of financial reporting from transaction-based measurements to economic valuation models. In so doing, FVA attempts to place an economic value on the firm as a whole, a purpose that is expressly outside the scope of financial reporting (FASB 1978, para. 41).

The word "transactions" refers to actual, verifiable activity in which a firm is engaged. These stand in contrast to events that can be broadly significant but lack the concreteness normally associated with transactions (Ohlson *et al*. 2010, 476). Transactions are a component of operating activities while fair value measurements tend to be the result of events. Ohlson *et al*. (2010, 477) state that financial reporting recognizes the income statement as the centerpiece in financial reporting. The primary function of the income statement is to report the results of operations because operating income provides a logical starting point for forecasting future results of operations. From this, the value of the firm can be estimated in at least two ways, via fair value measurement and by forecasted earnings (market value versus intrinsic value).

In May of 1980, the FASB issued SFAC 2 entitled *Qualitative Characteristics of Accounting Information*. In the summary of principal conclusions, FASB states that relevance and reliability are the two primary qualities that make accounting information useful for decision making. Relevant accounting information is capable of making a difference in the decision-making of financial statement users by providing predictive and/or feedback value in a timely manner. The reliability of a measure rests on the faithfulness with which it represents what it purports to represent and on the appropriateness of the representational quality. In addition, reliable information should be verifiable and neutral. For information to be useful to the financial statement user, it must be both relevant and reliable. The discussion of SFAC 2 will evaluate FVA in the light of each of these primary qualitative characteristics and their components.

SFAC 2 (FASB 1980, para. 32) introduces "A Hierarchy of Accounting Qualities" (Hierarchy) which tends to imply a balance between the primary decision specific qualities of relevance and reliability. Although Power (2010) believes that relevance and reliability are not in opposition, the truth is that reliability and relevance often impinge on each other (FASB 1980, para. 90). The tradeoff between relevance and reliability has long been the source of an ongoing philosophical debate (Grant Thornton 2008; Laux and Leuz 2009) which has become an element of several authors' comments with regard to FVA (Allen and Carletti 2008, Arya and Reinstein 2010, Cherry and Hague 2009, Duangploy and Pence 2010, Johnson 2005, Power 2010). Proponents of FVA argue that financial statements based on historical cost are not relevant because the information is not transparent with regard to current market values. FVA detractors argue that the information provided by financial statements based on fair value measurements is not reliable because it is based on volatile and subjective measurement assumptions (Grant Thornton 2008). Critics further argue that fair value does not provide relevant and reliable information when companies must use complex mathematical models to measure fair value (Chasan 2008) as is the case with stock compensation expense. "It seems…that the recent meltdown in the finance industry as well as the Enron experience would have made it clear that to be relevant the data must be reliable" (Young *et al* 2008). The trade-off between relevance and reliability is at the core of the discussion surrounding the usefulness of fair value measurements (Grant Thornton 2008).

FVA is said to tip the scale more toward relevance and away from reliability; but Johnson (2005), discussing FVA well before the present market difficulties, indicated that neither relevance nor reliability should be the dominant trait of useful accounting information. Referring to SFAC 2, Johnson (2005) also cautions that neither relevance nor reliability can be entirely eliminated. The Hierarchy supports these assertions indicating that relevance and reliability are primary decision-specific qualities. In order for FVA to place a greater emphasis on relevance it must sacrifice the three components of reliability—verifiability, neutrality, and representational faithfulness. At the same time it must place greater emphasis on the three components of relevance—predictive value, feedback value, and timeliness. All of this must be accomplished while satisfying the secondary and interactive qualities of comparability and consistency (FASB 1980, Figure 1).

SFAC 2 (FASB 1980, para. 51) indicates that "information can make a difference…by improving decision makers' capacities to predict or by confirming or correcting their earlier expectations. Usually, information does both at once, because knowledge about the outcome of actions already taken will generally improve decision makers' abilities to predict the results of similar future actions." It goes on to state that disclosure requirements almost always have the dual purpose of helping to predict and to confirm or correct previous decisions (FASB 1980, para. 52,).

The notion that information should be reliable as well as relevant is central to accounting (FASB 1980, para. 58). For information to be reliable it must be verifiable, neutral, and representationally faithful. Level 1 inputs provide such reliability because they are based upon values from active markets (Pounder 2010). With the lack of an active market for most assets and liabilities, fair value is left to be determined by models based upon management assumptions using surrogate values (i.e., Level 2 and Level 3 inputs). Our financial reporting system does not need a valuation model other than those already in place (Chasan 2008). The subjectivity involved in fair value accounting renders the values based upon Level 2 and Level 3 inputs suspect. Level 1 fair value inputs are neutral while the assumptions utilized by management in deriving Level 2 and 3 inputs are far from unbiased. Not surprisingly, Hoffman (2009) found that users consider Level 3 inputs to be less reliable than Level 1 or Level 2 inputs.

The cornerstone of reliability is representational faithfulness: "Accounting information is reliable to the extent that users can depend on it to represent the economic conditions or events that it purports to represent" (FASB 1980, paras. 59, 62). Representational faithfulness is the correspondence between a measure or description and the phenomenon it purports to represent. In accounting, the phenomena to be represented are economic resources and obligations and the transactions and events that change those resources and obligations (FASB 1980, para. 63). The financial information should depict the entity and its position in the marketplace, not the marketplace itself.

There are two important elements to the preceding paragraph. First, fair value information based upon Level 1 inputs is not only verifiable and neutral, but also representationally faithful. Although Level 2 and Level 3 inputs may or may not be representationally faithful, Magnan and Thornton (2010) point out the moral hazard of permitting management to determine their own models for FVA measurement. In the case of the financial meltdown, CDOs that were considered worthless were not depicted in a representationally faithful manner. Since there was no active market to establish the fair values of the CDOs, the value of the CDOs should have been based upon the present value of their future cash flows and not on their supposed "market value."

Second, paragraph 63 of SFAC 2 (FASB 1980) clearly indicates that balance sheet, cash flow, and income statement data work in concert to faithfully represent economic phenomena. As Flegm (Young *et al*. 2008) pointed out, fair value information captures the events to be depicted but not the transactions that should be depicted. Reporting on the results of operations primarily requires the depiction of transactions and not events. Managers manage based upon transactions and not events; and while presenting "events" might seem to provide a broader perspective, Power (2010) notes that FVA provides only point estimates of asset and liability values.

Under ASC 820, property is valued at its "highest and best use," which may be totally unrelated to the intent of management or the business model. The "highest and best use" concept comes into play when determining the fair value of nonfinancial assets, and it clearly violates representational faithfulness. This approach does not depict the financial position of the entity because fair value accounting does not faithfully represent the operating value of the entity. It reports market values and not the intrinsic value of the entity. Gottlieb *et al*. (2009) state that assets have long been valued based upon the entity's intended use, and Johnson *et al* (2010) go so far as to conclude that determining values according the "highest and best use" concept is outside the scope of an accountant's skills.

The FASB's recent announcement that they may require held-to-maturity securities to be carried at fair value is a clear violation of representational faithfulness. The IASB prefers a mixed-measurement approach which divides financial assets into those intended to be traded and those to be held to maturity (Christodoulou 2010). Accounting "idealists" find a mixed measurement model flawed (Power 2010), but using fair value for all financial assets requires entities to take artificial reductions to capital without respect to the actual performance of the underlying assets and/or liabilities (Magnan and Thornton 2010, Wesbury and Stein 2009). This fails to satisfy the concept of representational faithfulness. Conversely, accounting "pragmatists" find FVA useful for some measures, but not all (Power 2010). Overall, though, the mixed measurement approach provides a better measurement system in terms of representational faithfulness, and it better reflects the business model followed by the entity because it depicts what it purports to represent. Because of this, the mixed-measurement concept has wide support from several authors (Allen and Carletti 2009, Allon 2009, Arya and Reinstein 2010, Johnson *et al* 2010, Laux and Leuz 2009, Magnan and Thornton 2010, Power 2010) as well as from the AICPA (Lamoreaux 2010).

Although transparency is not mentioned anywhere in the Hierarchy as a qualitative characteristic of accounting, several authors cite transparency as a benefit of FVA (Allon 2009, Cherry and Hague 2009, Del Core and Barbagallo 2010, Laux and Leuz 2009). It may be possible to make the leap and conclude that transparency is analogous to disclosure. But if that were the case, then traditional accounting data could simply be supplemented with fair value information. In addition, if FVA provides transparent information, why is there latitude to value assets and liabilities inappropriately (e.g., valuing CDOs at fair value derived in a seized market instead of at present value of cash flows)? Third, why were the knowledgeable, primary users of financial information—investors and creditors—fooled by FVA? Additionally, how does the additional information required to understand FVA information, especially when Level 3 inputs are used, promote transparency? With respect to transparency, is appears that FVA does little to improve transparency while greatly increasing the potential for confusion and misunderstanding.

SFAS 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (FASB 1984, para. 27), reiterates the scope of financial reporting set forth in SFAC 1 (FASB 1978, para. 41) that the statement of financial position does not purport to show the value of a business enterprise but, together with the other financial statements and disclosures, should provide information that is useful to those who desire to estimate an enterprise's value. Financial statements articulate because they relate different aspects of the same transactions or events affecting an entity. No single financial statement is likely to provide all of the financial information desired by users for a particular decision (FASB 1984, para. 23). The statement of financial position is often used to assess liquidity and financial flexibility, but it provides an incomplete picture of either (FASB 1984, para. 24a). FVA emphasizes the balance sheet where traditional accounting emphasizes reporting on the results of operations.

SFAC 5 (FASB 1984, para. 79) defines "earnings" as the primary measure of entity performance during a period. The income statement and statement of comprehensive income generally reflect a great deal about the profitability of an entity during a period, but this information is more meaningful if it can be compared with that of the entity for other periods (FASB 1984, para. 24b). This corroborates Flegm's (Young *et al*. 2008) assertion that management actually evaluates operations on comparative earnings results. Thus, FVA measurement of industry, market, or even management performance based on point estimates is precluded according to the definition of "earnings" as stated in SFAC 5. In addition, the income statement is based on the concept of financial capital maintenance, not physical capital maintenance (FASB 1984, paras. 45-48). Under financial capital maintenance, "earnings" or "income" is achieved only when the *capital* of the entity is increased during a period. In contrast, physical capital maintenance would recognize "earnings" when the *assets* of an entity increase during a period. SFAC 5 (FASB 1984, para. 48) also indicates that recognition of fair value adjustments for held assets should be omitted from "earnings" and recognized directly as a portion of equity under both methods.

SFAC 5 reflects the model used by management to evaluate operations and to make decisions when it states that the statement of financial position has limited value unless used in conjunction with the other financial statements, such as the income statement, when comparing current financial results with those of prior periods. SFAC 5 (FASB 1984, paras. 66-70) also recognized the use of different attributes for measuring financial statement elements (e.g., historical cost, current cost, market value, net realizable value, present value) and anticipated that such diversity would continue due to the varying degree of relevance and reliability that each attribute contributes with respect to various types of assets and liabilities. Miller and Bahnson (2010, 431) conclude that the relevant attribute is actually found in the financial reporting objectives described in SFAC 1: investors and creditors are interested in the amount, timing, and uncertainty of cash flows. Cash flows are overwhelmingly driven by transactions occurring in the normal course of business and not by changes in fair value.

In 2010, FASB (2010) issued SFAC 8, *Conceptual Framework for Financial Reporting*, replacing SFAC 1 and SFAC 2 and making significant modifications to the Conceptual Framework. In chapter one, SFAC 8 reaffirms that the reporting focus should be on the *entity* (FASB 2010, para. OB2, *emphasis added*) and that determination of the value of the reporting entity is *not* the purpose of financial reporting (FASB 2010, para. OB7, *emphasis added*). Chapter three changes the two fundamental qualitative characteristics of accounting information from relevance and reliability to relevance and *faithful representation* (FASB 2010, paras. BC3.11, BC 3.19). Thus, SFAC 8 elevates faithful representation to the level previously occupied by reliability. Faithful representation is the faithful depiction in financial reports of an economic phenomenon, and it is accomplished when information is complete, neutral, and free from error (FASB 2010, QC12). The concept of "substance over form" is explicitly excluded from the terminology of SFAC 8 because FASB felt this term was redundant (FASB 2010, para. BC3.26). Interestingly, the concept of "transparency" is also explicitly omitted from the qualities listed in SFAC 8 (FASB 2010, para. BC3.44).

The usefulness of the information about an enterprise increases greatly if it can be compared with similar information about other enterprises and with similar information about the same enterprise for some other period or some other point in time (FASB 1980, para. 111, retained in SFAC 8, para. QC 20). Comparability addresses comparing information among different entities while consistency addresses comparing information over time for the same entity. Comparability between firms has always been problematic. Different firms may use different accounting principles making comparison among firms, even within the same industry, difficult at best. FVA does not ease the comparability problem and likely exacerbates it. FVA also has a significant impact upon consistency. When the market for a financial asset declines precipitously and the valuation inputs are changed from Level 1 to Level 3 overnight, it is impossible for the information to be consistent. The change in measurement attributes from market-traded financial assets to those that use more subjective schemes will also vary from firm to firm. The assumptions used for Level 3 inputs would vary even more dramatically from one firm to another. The highest and best use premise for nonfinancial assets will vary from firm to firm and from period to period. In short, FVA seems to result in a situation where comparability and consistency are more compromised than in the traditional accounting model. SFAC 8 mentions comparability and consistency but does not attempt to explain how this would be possible under FVA since each manager would be required to make his or her own value judgments, which would not be comparable to any other company's evaluation. Nevertheless, McConnell (2010) believes that universal application of FVA throughout all financial statements will reduce earnings management and enhance inter-company comparability (though without stating why or how).

Before the present FVA debate, Johnson (2005) noted the departure of standard-setters from the perspective of preparers and auditors (who desire reliability) toward the perspective of investors (who want relevance). Flegm (Young *et al*. 2008) confirms this line of reasoning, stating that documents released by the FASB in 2006 indicate that the FASB has abandoned the users who apply traditional accounting to manage their businesses. The issuance of both ASC 820 (despite its many violations of extant concepts statements) and SFAC 8 provide further corroboration of FASB's current change in focus away from management and preparers and toward investors. Power (2010) also supports this conclusion, charging that standard-setters are more concerned about global recognition for their international appeal than they are about meeting the needs of their domestic constituents. In response to Power, McConnell (2010) declares that "thought leaders" in the US support FVA. As a former member of the investment community, she also notes that FVA has strong support in the investment community and concludes that preparers, auditors, and regulators just need time to adjust to the new system. Power (2010) asserts that individuals with a "certain perspective on accounting" have been elevated into standard-setting positions, have redefined reliability to mean "market value," and have collapsed reliability into the concept of relevance. Power (2010) also proposes that the battle over FVA ensues at the application level (where FVA has significant deficiencies) because there is no competing conceptual rebuttal for FVA.

**ANALYSIS AND COMMENTS**

How did FVA come to be a "generally" accepted accounting principle when it is surrounded by so much debate? Furthermore, how was ASC 820 passed by FASB when it disagrees significantly with several points of the Conceptual Framework?

It is argued that the recognition and measurement process prescribed in FVA marks a move toward relevance and away from reliability (Grant Thornton 2008, Laux and Leuz 2009), and this is a primary reason that fair value accounting cannot be reconciled to the conceptual framework. Neither relevance nor reliability need to be sacrificed for a technical perception of what "good accounting" should look like. The recognition and measurement process should reflect the character of the item being displayed. As accentuated in SFAC 8, "representational faithfulness" should be the overriding criteria affecting measurement and display in financial statements. The financial information should depict what it purports to represent, an entity's results of operations, and not some artificial concept. Fair value accounting fails to encourage the use of the most appropriate measurement attribute for different financial statement elements—measurement attributes that agree with the conceptual framework.

This is why a complete set of financial statements is composed of financial position at the end of the period, earnings for the period, comprehensive income for the period, cash flows for the period, and a statement of changes in equity for the period (FASB 1984, para. 13). This is also why the financial statements have been composed of a mixture of measurement attributes for decades. If an entity expects to hold a financial asset to maturity, then the amortized cost or the present value of future cash flows is more appropriate than market value (if there is a market value). If the financial asset is likely to be sold or is not to be held to maturity, then reporting it at the market value levels the playing field for all concerned. If there is no active market for the financial instrument, then it should be carried at acquisition cost, unless it can be substantiated that market is less than cost. For example, Whalen (2007) points out that an asset like a CDO is not sold in an "active market," but through specially-negotiated auctions. In this case, the use of discounted net future cash flows would serve as the appropriate measurement attribute whether or not a secondary market for the security exists.

FVA changes the focus of the financial statements from presenting entity performance to reflecting market performance. The divergence between the fair value of an entity and its intrinsic value is exacerbated by the "highest and best use" concept which requires valuation of financial statement elements without regard to their actual intended use. Although both fair value accounting and historical cost accounting have shortcomings, different elements of the financial statements necessitate different measurement schemes (FASB 1984, paras. 66, 67). Because a mixed model (now touted as the "Tweedie model") tends to report each element of the financial statements at the value most appropriate for that item (Allen and Carletti 2008, Allon 2009, Arya and Reinstein 2010, Christodoulou 2010, Laux and Leuz 2009, Magnan and Thornton 2010, Power 2010), neither fair value nor historical cost, alone, is the optimal measurement model.

Fair value of an entity relies heavily on market values while the intrinsic value of an entity is derived from its earning power. SFAC 6 (FASB 1985, paras. 82-86) defines gains as losses as changes in equity arising from peripheral transactions. Peripheral transactions should not be a significant component of operations, hence the term "peripheral." However, FVA can result in gains and losses becoming a major component (if not *the* major component) in reporting "earnings." The results of operations should reflect management's performance and stewardship, and management should not be encouraged to manage profit by manipulating peripheral transactions and events (e.g., Enron). In the case of nonfinancial assets, if real property is held for use in the production of income, then it should be carried at some form of amortized cost.

FVA is also contrary to the objectives of consistency and comparability. The use of Level 3 inputs for valuation diminishes, rather than enhances, comparability and consistency in financial reporting. The use of Level 3 inputs, which are designed and evaluated by management, also violates the concepts of freedom from bias and neutrality set forth in the concepts statements.

Examination of the conceptual underpinnings of accounting standard-setting embodied in FASB's Statements of Financial Accounting Concepts (SFAC), from which US accounting standards are supposed to flow, reveals that ASC 820 violates several assertions of the conceptual framework. ASC 820 clearly was enacted despite many of the established conventions and foundational concepts of US GAAP that were in place at the time. However, given the *post hoc* changes to the foundational SFACs, ASC 820 is unlikely to be repealed or substantially changed despite its divergence from the principles that have explicitly guided accounting standards for almost 40 years and have implicitly guided standard-setters for decades more.

It is also worth noting that US standard-setters prior to FASB failed, at least in part, because of their failure to establish and follow a conceptual framework for accounting. Although a conceptual framework is in place, FASB appears to be reverting to *ad hoc* standard-setting based not on the conceptual framework (as it existed at the time ASC 820 was enacted), but on a technical (rather than practical) notion of what "good accounting " ought to be (Power 2010). Interestingly it appears that either the replacement of SFAC 1 and SFAC 2 by SFAC 8 was a *post hoc* attempt to put the conceptual framework in line with FVA, or that ASC 820 was enacted in anticipation of a change in the underlying accounting concepts. Johnson (2005) hints at such a forthcoming change a year before ASC 820 (then called SFAS 157) was passed, and McConnell (2010) presents FVA as an inevitable outcome endorsed and driven by "thought leaders" regardless of practitioner and practical concerns.

Accounting standard-setters in the US seem to be less concerned with the needs of their constituents than they are with the global perception of their efforts. Convergence with international accounting standards is a major issue facing FASB right now, but FVA (as set forth by FASB for US GAAP) overreaches even the fair value methods endorsed by the IASB. Thus, FVA under US GAAP moves the US *away from* rather that *toward* convergence with international accounting standards.

Beyond the conceptual framework, FVA also fails to provide the "transparency" desired by many of its supporters. According to a ranking member of the audit staff of one of the major international CPA firms, if fair value measurements using Level 3 inputs are encountered during an audit, that information is passed along to a team that does nothing but evaluate Level 3 inputs. That team evaluates Level 3 inputs for all of that firm's audits nationwide. If the on-site audit team is not permitted to audit or cannot audit the fair value numbers using Level 3 inputs, then how can this information be relevant, reliable, or representationally faithful? How can this information be transparent for investors and creditors if it can be evaluated only by a staff that does nothing else but evaluate Level 3 inputs? This is especially odd since FVA tends to tailor financial statement information in favor of investors, neglecting the needs of other stated user groups (i.e., creditors and other interested parties). Yet this hyper-focus on investors is also contrary to the conceptual framework.

**CONCLUSION**

It appears that FVA may have been an attempt to provide desirable information but was simply not well thought out in practice. At the time that ASC 820 (then SFAS 157) was issued, it was in violation of the several of the basic concepts of accounting as established in SFAC 1, SFAC 2, and SFAC 5.

More specifically, FVA has failed to provide the appropriate information to the primary users of financial statements—investors and creditors. These two groups are interested in the amount, timing, and uncertainty of cash flows; but fair value reports unrealized amounts that are not tied to cash flow. Fair value information based upon Level 3 inputs should be carried at the present value of cash flows or net income to better reflect the information desired by investors and creditors. Further, FVA does not appropriately reflect the stewardship performance of management. Application of the "highest and best use" concept may not have anything to do with the business model and tends to reflect liquidation values instead of earning power. FVA, as presently reported, is not consistent with the day-to-day operating practices of management. Managers manage the central ongoing operations of the entity and not the fair value of the assets/liabilities on the balance sheet.

FVA's balance sheet is in violation of SFAC 5 which states that traditional accounting emphasizes reporting the results of operations and that financial position is not intended to depict the market value of the entity. While FVA reports the results of market events in the financial statements, SFAC 5 calls for "earnings" to reflect the results of the transactions in which the business was engaged. SFAC 5 focuses on earnings which are tied to the central ongoing operations of the entity instead of managing the values of assets and liabilities.

SFAC 8 seems to have been written to justify FVA, yet the elevation of faithful representation as a key characteristic of useful accounting information is a positive change. Representational faithfulness (SFAC 2, retained in SFAC 8) should be the overriding qualitative characteristic of accounting information. For information to be representationally faithful, it should retain the character of the element of the financial statement being depicted, which implies a mixed-model approach. However, current fair value methodology seems to be at odds with the concept of faithful representation. FASB needs to redefine what should be represented—an entity's long-run earning power and not the market value of the firm as of a particular date.

Finally, it is said that FVA is more transparent than information reported via the traditional accounting model; but the controversy surrounding FVA tends to lead one to conclude otherwise. If FVA information is transparent, why were CDOs reported using the wrong measurement attribute? Why were investors and creditors fooled by the misinformation? Why do CPA firms retain teams of specialists that do nothing but evaluate fair value information reported using Level 3 inputs? Each of these would seem to add layers of complexity, not transparency.

The fair value model needs to be reevaluated. FASB should adopt a mixed model approach and should improve or refine the inputs used in the valuation process for fair value information. Ultimately, the "new" fair value accounting that emerges from this process should be soundly based upon the conceptual framework of accounting, should provide relevant information to all stated user groups, and should be relevant *and* reliable through appropriate representational faithfulness.

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