

AN ANALYSIS OF THE FAIR VALUE CONTROVERSY

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ABSTRACT

During the recent financial crisis fair value accounting received its share of the blame for the meltdown. There were those that argued that the measurement system used in fair value accounting was not related to cash flow, worked well in an orderly market but not in a market requiring forced liquidation, did not clearly spell out that financial instruments should have been valued at Level 3 inputs instead of Level 1 inputs in a seized market, and created an arena in which accountants were not fully equipped to participate. People also questioned exactly what was to be depicted by fair value accounting—the market value of the entity or the success or failure of management in operating the business. Then there were others that argued that the financial meltdown was caused by a host of factors totally unrelated to fair value accounting. These factors included financial illiteracy, excessive leverage, rampant speculation, relaxed lending standards, mortgage innovations, failed regulation, unqualified borrowers, contagion in the market, and greedy investment bankers/institutional investors. Fair value accounting may have exacerbated the problem but, it was argued, served only as a scoreboard. However, it appears that the contribution of fair value accounting to the mortgage crisis was more the result of the fact that accountants, auditors, and investors were uneducated or undereducated with regard to fair value accounting. Fair value accounting has only been on the scene since 2006. As such only a handful of those in the financial arena have a firm grasp on fair value accounting. Most of the people in the financial community studied the traditional accounting model—the accrual basis model that is grounded in cash. Fair value accounting changes the recognition and measurement criteria that financial statement users are accustomed. Fair value accounting is not grounded in cash. Management ran the business as if the unrealized gains arising via fair value accounting were realized in the form of cash. Fair value accounting obscured the intrinsic value of the firm in favor of the market value, failed to adequately reflect the stewardship function of management, and stakeholders were ill prepared to adequately analyze the performance of an entity using fair value accounting. The fact is that fair value accounting is now only being fully absorbed into college curriculums. Finance textbooks are at least a decade behind with regard to the changing nature of financial statements, still teaching the same old performance metrics that may not apply to current financial statements. The only financial statement that transcends fair value accounting and the traditional accounting model is the cash flow statement. There should be increased emphasis placed on the cash flow statement, both in practice and in education. Maybe the cash flow statement should be moved to the front of the financial statements instead of the rear. The numerous financial ratios that have been developed for the cash flow statement are mostly only used by auditors. These ratios should make their way into textbooks and stakeholders also need to become acquainted with these analytical tools.

INTRODUCTION

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) said that the more appropriate term may be mark-to-mayhem. Lawrence Smith, a member of the Financial Accounting Standards Board (FASB), recently likened the controversy surrounding attempts to move to fair value accounting to that of a “religious war” (Christodoulou, 2010). Indeed, both those in favor of and those against fair value accounting voice strong opinions (and in some cases, dire consequences) should their position be ignored. So, what is fair value accounting, and why is fair value accounting such a highly-charged issue both inside and outside of the accounting and finance community?

Given the widespread and sometimes heated debate over fair value accounting, this paper will provide a brief explanation of what is required under the fair value standards of financial accounting, will summarize the debate over fair value accounting standards, and will provide an analysis of the controversy and make recommendations about fair value accounting.

FAIR VALUE ACCOUNTING STANDARDS

In 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157 to establish fair value accounting standards under United States generally accepted accounting principles (U.S. GAAP). (In 2009, FASB codified its accounting standards, and SFAS 157 was included under topic 820 of the Accounting Standards Codification (ASC 820).) SFAS No. 157 did not require any new fair value measurements. Its purpose was to standardize the measurement and disclosure practices. It provided a single definition of fair value, established a framework for measuring fair value, and required enhanced disclosures regarding fair value measurements. It does not require any new fair value measurements, but it does standardize the measurement and disclosure practices (Grant Thornton, 2008).

SFAS No. 157 defined 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.” What is commonly referred to as an “exit price” (AICPA 2010).

The main purpose of SFAS No. 157 was to increase consistency and comparability in fair value measurements. Thus, SFAS No. 157(FASB 2006, 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 (FASB 2006). Level 2 inputs are quoted prices from sources other than Level 1 which are observable either directly or indirectly (FASB 2006, Grant Thornton 2008). Level 1 and Level 2 inputs are considered “mark-to-market” models.

Level 3 inputs are unobservable assumptions, such as an entity’s internal valuation model that incorporates management assumptions that cannot be corroborated with observable market data (Grant Thornton 2008). This is sometimes referred to as “mark-to-model” accounting (King 2006). This is used when observable inputs are not available (FASB 2006). Thus, 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. Upon issuance of SFAS No. 157 textbooks depicted Level 3 inputs as the present value of either cash flow or net income. Unfortunately that interpretation did not translate into practice.

In 2008, SFAS No. 157 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. Those securities that are 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.

SFAS No. 157 also included disclosure requirements related to fair value accounting (Stines and Auteri 2010). Without focusing on technical disclosure details which are beyond the scope of this paper, SFAS No. 157 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 disclosures are required for period gains and losses, and category purchases and sales.

SFAS No. 159 (FASB 2007) modified the fair value standards implemented in SFAS No. 157. SFAS No. 159 permitted entities to elect to fair value all financial assets and liabilities. It also permitted entities to use fair value on non financial assets (which was subsequently suspended).

CONTROVERSY SURROUNDING FAIR VALUE ACCOUNTING

Over the past few years, an increasing number of U.S. accounting standards have required companies to use fair value accounting. Given this broad application of fair value accounting to more financial statement elements, the definition of fair value given in SFAS No. 157, and the three levels of measurement categories, one might question the reason for controversy over marking certain financial statement elements to their market values. After all, since the market provides unbiased values for many types of assets and liabilities, why should these values be omitted from an entity's financial statements? Referring to the requirements of SFAS No. 157, Pounder (2010, 15) concludes that "conceptually, the measurement of fair value under U.S. GAAP is straightforward," but he goes on to say that "complications arise . . . when reporting entities go to apply this concept in practice."

There are a trio of issues that standard-setters must balance with respect to fair value accounting. On a conceptual level, standard-setters must balance relevance and reliability (Laux and Leuz 2009). Relevant accounting information is capable of confirming decisions that stakeholders have already made and/or of making a difference in stakeholders' future decisions; and daily quoted market prices certainly seem to be a timely source of confirmatory and predicative information about the firm's actions. However reliability requires that accounting information also independently verifiable, unbiased, and an accurate portrayal of the underlying reality of the transactions and events. In so far as fair values are based upon unbiased market prices, it would seem that market prices would serve to provide accounting information for stakeholders that is both relevant and reliable. However, when fair values are based upon factors other than unbiased market prices, or when the market prices themselves become biased, there is concern that the information presented may be less relevant or reliable and that such information might even be misleading. (Magan and Thornton 2010). Hague (2009) contends that fair value accounting removes *both* transparency *and* integrity, both of which are important to investors.

In the middle ground between concept and practice is the ever present balance between recognition and measurement; and in the case of fair value accounting, recognition and measurement are at the crux of the controversy. Recognition has to do with *when* an item should be reported in the financial statements, and measurement has to do with *how much* (or at what value) an item should be reported in the financial statements. The measurement issue was highlighted in the wake of the mortgage-crisis. Observers of the crisis noted that "mark-to-

market accounting rules forced financial institutions to value securities for capital purposes as though they were day-trading accounts.... When panic set in, regulators and auditors forced banks and insurers to write down the values of assets to absurdly low levels that weren't even remotely justified by their cash flows" (Forbes 2010, 15). The price of many of the securitized mortgage pools were priced well below their value when viewed from a cash flow standpoint (Wesbury and Stein 2009). One observer even opined that a few years from now, there will be a magazine cover with someone the financial world has never heard of who bought all of those mortgages and derivatives for next to nothing on the correct assumption that they were indeed valuable (Karabell 2008).

One of the major veins of criticism against fair value accounting is the claim that fair value accounting is that it adds both volatility and contagion to the market (Laux and Leuz 2009). Steve Forbes (2010, 15) stated, "an economic version of the bubonic plague is ready to reemerge: mark-to-market accounting. This rule was the principal reason that the financial disaster of 2007-09 threatened to destroy our financial system." Arya and Reinstein (2010) also conclude that fair value accounting exacerbated the recent financial crisis by forcing the write-down of "good" assets because of reduced market prices.

Indeed, some investors question why accounting standards require that a market value be placed on hard-to-price assets when the markets for those assets to evaporate as they did in the recent credit crunch (Chasan 2008). Why should accounting rules force banks to take artificial capital reductions without reference to actual loan performance (cash flow)? This accounting treatment affects growth, wipes out capital, and undermines the banking system (Wesbury and Stein 2009). As Moyer (2008, pp.) put it, "Accounting rules that discourage rational behavior can't be all that great." There is no doubt that mark-to-market accounting rules affect the economy and amplify financial market problems (Wesbury and Stein 2009).

Critics argue that fair value does provide a realistic view when quoted prices are readily available, from efficient, liquid markets, but the recent seizure of the credit markets stemmed from uncertainty about the value of mortgage-backed financial instruments, specifically collateralized debt obligations (CDOs), as well as from the illiquidity present in the market. Ealsey and O'Hara (2010) propose that buyers' and sellers' decisions not to trade despite quoted bid and ask prices resulted from optimistic and pessimistic assumptions about uncertainty. These different perspectives left a gap between the prices at which buyers and sellers were willing to buy or sell. Considering the joint movement of unrelated financial assets, Allen and Carletti (2008) find that although market prices are normally considered an unbiased measure of value, when markets work imperfectly (as they did during the financial crisis), market prices can reflect buyers' illiquidity as well as (and perhaps instead of) an asset's fair value.

William Isaac, FDIC Chairman from 1978-1995, speaking before an SEC panel on mark-to-market accounting and the subprime meltdown said that before SFAS No. 157, subprime losses were a "little biddy problem. . . . The accounting system is destroying too much capital. . . . The devastation that occurred in the marketplace stemmed largely from the tendency of accounting standards-setters and regulators to force banks, by means of their litigation-shy auditors, to mark their illiquid assets down to 'unrealistic fire-sale prices.' I am asking that a very bad rule be suspended" (Katz 2008). The write-offs are not real losses; they are just the result of mark-to-market according to Stephen Ross (Reuters 2008). Christopher Whalen stated, "It's ridiculous to apply fair value accounting to assets that have no market" (Reuters 2008). Basically the accounting rules are forcing the banks to take artificial hits to capital without reference to the actual performance of the loans (Wesbury and Stein 2009).

The central issue in this area of the fair value accounting debate is the nearly overnight change in measurement criteria from Level 1 to Level 3 inputs. Level 3 inputs are unobservable inputs to be used in situations where active markets do not exist or are illiquid, and at this point fair value becomes highly subjective (AICPA 2010). Obviously, the more removed fair value models are from actual prices in active markets, the more volatility is introduced into value measurement.

With respect to the credit crunch, many CDOs had been valued using Level 1 inputs, and established models (i.e., Level 3 inputs) for valuing those same financial instruments were not in place (Young *et al.* 2008). Instead of making things clearer, fair value accounting rules muddied the waters, requiring assets to be priced as though they continued to have daily price quotes when, instead, the markets for those assets were frozen (Moyer 2008). Thus financial statement elements that had been measured using observable, unbiased prices in active, liquid markets, switched almost instantaneously to being measured using unobservable management assumptions about the assumptions made by participants in the now vacant, frozen marketplace (Young *et al.* 2008). Arya and Reinstein (2010) also question the wisdom of using unobservable (i.e., Level 3) inputs to mark assets to their fair values when the market for the asset is inactive. If the market cannot provide a fair value for the asset, why should fair value be contrived from non-market factors?

Because SFAS No. 157 holds that the objective of market-to-market accounting is to set a price that would be received in an “orderly” transaction, forced liquidations and distressed sales are specifically omitted from fair value consideration. Laux and Leuz (2009) summarize the charge that fair value accounting results in contagion stating that contagion occurs when fair value accounting exacerbates swings in the financial system and causes overreaction by investors and creditors. This causes the market prices of unrelated assets to fall along with the prices of truly distressed assets (Allon 2009). In response to the accusation of contamination, FASB eased the accounting rules to give banks more flexibility in applying mark-to-market accounting to their toxic assets; but this concession did not come without significant pressure. FASB also withdrew the presumption in mark-to-market accounting that all transactions in an inactive market are distressed unless proven otherwise (Reuters 2009).

Even when markets run efficiently, Magnan and Thornton (2010) question the purpose of marking all financial statement elements (i.e., assets and liabilities) to their market values. Are the financial statements supposed to present the value of the entity in operation or in liquidation? Enron’s misuse of mark-to-market accounting makes this question even more poignant. Are investors and creditors interested in the current value of the entity or the long-run earning power of the entity? What should the financial statements depict: the state of the marketplace or the state of the business entity?

Power (2010) takes this line of reasoning to its logical conclusion: assuming that financial statements and financial markets could perfectly reflect each other, accounting would be unnecessary. Magnan and Thornton (2010, 25) seem to concur when they propose focusing on the fundamental cash flows of the underlying assets.”

Other critics of fair value accounting (Magnan and Thornton 2010, 24) express concern that standard setters’ focus on fair value accounting tailors financial statements to “the information needs of investors, especially shareholders, to the potential detriment of other financial statement users.” McConnell (2010) states that investors want fair value and that fair value is the central issue in financial statement analysis. Power (2010) suggests that standard-setters are not as concerned about the needs of the constituencies they serve as they are with being internationally recognized as “legitimate” standards-setters.

Johnson *et al* (2010, 151) indicate that FASB is creating an arena in which accountants are not fully equipped to participate. In their opinion, a correct fair value accounting analysis with respect to real property “necessarily [requires] a comprehensive assessment of alternative uses for a property.” They conclude that such analysis “...is outside the accountant’s area of expertise.” Magnan and Thornton (2010, 24) make a similar observation stating that: “fair value accounting pulls accounting away from its traditional stewardship role, for which verifiability and conservatism ensure that payouts are based on delivered, not expected, performance.” Power (2010, 201) extends this line of reason proposing that as they place more reliance upon other experts’ opinions, accountants become “compilers rather than valuers” of financial information. Power (2010) goes on to conclude that if accountants are to retain a place at the financial services table, then the accounting profession will have to redesign the core knowledge base of the profession.

Elevating this argument to the institutional level, several writers have noted that FASB’s recent fair value accounting proposals requiring that all financial instruments, including held-to-maturity securities be marked-to-market, are out of line with the direction of the international accounting community as represented by the IASB (Arya and Reinstein 2010, Aubin 2010, Easley and O’Hara 2010, Landy 2010). While International Accounting Standard (IAS) 39 is still under consideration by the IASB; if IAS 39 were enacted in its present form it would require maximum use of observable inputs, would allow more management flexibility in applying fair value accounting, and would reduce the number of fair value categories from four to two: leaving amortized cost and fair value, but eliminating held-to-maturity and available-for-sale (Duangploy and Pence 2010, Johnson *et al* 2010, Laux and Leuz 2009). Johnson *et al* (2010) believe that global momentum will sway the ultimate decision on FVA in favor of the IASB position.

Wider use of fair value accounting also poses an additional obstacle for auditors. The PCAOB noted that fair value accounting, while promising financial statement users with more relevant information, results in a new area of audit risk (Grant Thornton 2008). Auditors will now have to assess the process and assumptions made by management with regard to assets valued via Level 2 and Level 3 inputs and will have to place more reliance on estimates from external experts. (Magnan and Thornton 2010)

However, on the other side of the argument Hague (2009) wrote that blaming fair value accounting for the mortgage crisis is like blaming the scoreboard for the Detroit Lions losing sixteen games in a season. Penman (NYSSCPA 2009) concurred, “...accountants are often the scapegoats for investors’ excesses.” PricewaterhouseCoopers (PWC) partner, Vincent Colman stated that the root causes of the crisis go beyond accounting and financial reporting (Katz 2008); and Miller (Young *et al*, 2008) contributes a number of additional factors in the complex intermediation chain such as:

- Borrowers who sought credit beyond their reach
- Investment bankers who earned fees for bundling and selling vaporous bonds without adequately disclosing risk
- Institutional investors who sought high returns without understanding the risk and real value

Hague (2009) adds that a fundamental truth that many seem to avoid is that at the heart of this crisis was financial illiteracy, excessive leverage, rampant speculation, failure to recognize the fundamentals of economics, relaxed lending standards, mortgage innovations, and ratings agencies’ failure to assess risk. It was a toxic brew that poisoned the patient, not an accounting rule. Miller states that (Young *et al*. 2008) a problem that did not stem from poor accounting,

won't be relieved by worse accounting. Value-based financial reporting did exactly what it was supposed to by revealing risk and its consequences.

Cherry and Hague (2009, 19) further support the notion that fair value accounting is not to blame for pointing out fundamental financial problems stating that fair value accounting "is the best measure that allows investors and other market stakeholders to clearly understand the current health of a company and make decisions based on that understanding." They laud the fact that fair value accounting focuses on market-based exchange values instead of entity-based use values claiming that such treatment allows investors to see what is "actually happening" inside the company when economic conditions change. Thus, fair value accounting is encouraged as a means of boosting transparency to investors (Chasan, 2008). This concept of "transparency" is cited by many writers (Cherry and Hague 2009, Del Core and Barbagallo 2010, Laux and Leuz 2009) as a fundamental benefit of fair value accounting. This push for transparency posits that a firm's financial statements are more useful to investors if the firm's assets and liabilities are reported at their fair values. (Reason 2008)

Several authors call for a middle-ground solution to the fair value accounting debate. Laux and Leuz (2009) believe that fair value accounting is neither responsible for the crisis nor is it merely a measurement system that reports asset values without economic consequences. Some of the problem may simply be the unintended consequences of fair value accounting. Power (2010) reminds readers that a mixed model approach that uses both fair value accounting and historical costs has been accepted by stakeholders for many years. Magnan and Thornton (2010) suggest that assets held for sale be measured using fair value accounting while assets held for use be measured using existing accounting rules for impairment. Hinks (2010) reports that a majority of investors and analysts surveyed by PWC also support this mixed measurement dichotomy because it better reflects management's reasons for holding a financial instrument, making it more inline with the conceptual framework of accounting.

Allen (2009) parses the issue more finely, proposing the use of fair value accounting for credit-impaired debt but encouraging the use of amortized historical cost for liquidity-impaired debt. Concerning the concept of "value" itself, Power (2010) considers "value" to be simultaneously affected by firm market value, asset value in use, and asset exit value; fair value accounting is thus defective since it emphasizes only one of these three measures of value.

In addition to the conceptual arguments within accounting and finance, the effects of fair value accounting range far outside these fields. Areas as diverse as alternative investment funds (Del Core and Barbagello, 2010), employee benefit plans (Stines and Auteri 2010), appraisals (Johnson *et al* 2010), minority interests measurement (Magnan and Thornton, 2010), and life insurance (Horton *et al* 2007), have been affected by fair value accounting; and those affected are giving voice to their concerns on either side on the debate.

Although they may not concur on which is more important, both sides generally agree that the central issue in the fair value accounting debate is balance: balance between relevance and reliability, between transparency and stability, and between recognition and measurement (Arya and Reinstein 2010, Cherry and Hague 2009, Magnan and Thornton 2010, Laux and Leuz 2009). As a practical matter, then, support for either entity-based or market-based values for financial statement reporting reveals one's position in the debate.

ANALYSIS

It is obvious from the preceding discussion that a host of factors played a role in the financial crisis. Those factors included both political and regulatory factors that are beyond the scope of

this paper. It is also clear that fair value accounting was not at the core of the financial crisis. What is within the purview of this paper are why fair value accounting was seen as the culprit and how that can be rectified.

Hague mentioned that one of the elements at the heart of the financial crisis was financial illiteracy. The form of financial illiteracy that played a role in the recent economic downturn was a lack of knowledge. It was not fair value accounting, but the financial statement preparers, auditors, and analysts who were not familiar with fair value accounting that played a role in the financial crisis. Fair value accounting, as defined by SFAS No. 157 has only been on the scene since 2006. Only a handful of accountants and financial analysts are up to speed on fair value accounting. It is a lack of knowledge about and understanding of fair value accounting that played a role in the financial meltdown

The overwhelming majority of accountants and analysts on the job are well schooled in the traditional accounting model. The traditional accounting model revolves around the accrual basis of accounting. Transactions are recorded when they occur rather than with the movement of cash. Business performance is measured by net income as calculated using the traditional accounting model. Revenue is recognized when realized or realizable which means that revenue has resulted in cash inflow or should result in cash inflow. Net income is generally seen as a predictor of future cash flows because cash flow usually lags behind accrual basis revenue. This is significant because the theory is that stock prices are a function of intrinsic value which is tied to profit.

The FASB's conceptual framework of accounting clearly spells out the traditional accounting model. In the traditional accounting model problems tend to revolve around two major concepts--recognition and measurement. For every business transaction one must ask; (1) should this transaction be recognized, (2) how should the transaction be recognized (booked or disclosed or both), and (3) how should the transaction be measured? Fair value accounting recognizes and measures elements of the financial statements differently than the traditional accounting model and the bulk of people now using this fair value information were schooled on the traditional accounting model.

Fair value accounting revolves around recording changes in market values. This results in the recognition of unrealized gains and losses. Unrealized gains and losses will only have an impact on cash flow if sold on the balance sheet date. As such, unrealized gains and losses may or may not ever have an impact on cash flow. This is one area where financial illiteracy played a key role. Management made decisions regarding the future of the business entity as if the unrealized gains were realized in the form of cash. Then when the market seized and the market value of CDOs dropped to near zero, management had overextended the commitments of the business, because management had treated the unrealized gains in the same manner as realized gains. Thus, financial institutions failed to have adequate capital to cover the entity in the economic downturn. This scenario was the result of a lack of adequate knowledge about fair value accounting on the part of management. Management did not fully comprehend that changes in market value should have been ignored when making operating decisions.

Once this problem started it continued to snowball. What Laux and Leuz referred to as contagion took place in the market. If accountants, analysts, and auditors had been well schooled in the fair value model the snowball effect may not have occurred or may have been minimized. Fair value accounting is more closely aligned with reporting the fair value of the entity. However, the overwhelming majority of accountants and analysts have been schooled in evaluating the intrinsic value of the entity. Intrinsic value focuses on the value of the firm based upon continuing

profitability (carrying on the central operating activities of the business). Despite arguments that fair value accounting is more relevant than the traditional accounting model, it fails to provide the stakeholders in the entity with information about the future profitability of the firm. As discussed earlier, profitability should translate into cash flow. Thus fair value information failed to provide the users of financial information with adequate information to assess the amount, timing, and uncertainty of future cash flows.

Proponents of fair value accounting argue that it is more transparent. One has to ask with regard to what? It may be more transparent in terms of depicting the market value of specific assets and liabilities of the entity but not in terms of enabling stakeholders to evaluate the intrinsic value of the firm or the future cash flows. If fair value accounting is as transparent as is claimed, it is doubtful that market contagion would have occurred.

The fact is that it will take years to properly educate management, accountants, auditors, and financial analysts in the fair value accounting model. Not only is it not what they were initially taught, it is in direct contradiction to the manner in which management operates a business. Sound management focuses on the long run profitability of the firm and not short-run market values. The fair value accounting model is a balance sheet/capital maintenance (economic) approach to reporting financial information. The traditional accounting model is based upon the transactions approach to accounting which is much more closely aligned to the manner in which management operates the business.

Fair value accounting is only now being fully absorbed into the accounting curriculum. Finance texts are at least a decade behind with regard to current financial accounting and reporting requirements. Finance texts are still teaching the same old ratios that have been used for years on the same old financial statements prepared under the traditional accounting model. Are these old performance metrics of equivalent value when used on financial statements prepared on the fair value model? The only financial statement currently in use that transcends both the fair value model of accounting and the traditional model of accounting is the cash flow statement. There needs to be an increased emphasis on the cash flow statement both in the classroom and in the real-world. Over the past couple of decades a number of ratios have been developed for the use on the cash flow statement but there has been little emphasis on the use of performance metrics stemming from the cash flow statement. Possibly the cash flow statement should be placed first in the set of financial statements to indicate its increased importance under fair value accounting. The cash flow statement not only transcends both the traditional accounting model and the fair value model but it provides a summary of the operations of the enterprise on the transactions approach. Thus, under the fair value model of accounting the performance metrics that have been developed for the cash flow statement should become increasingly more useful for financial statement users in evaluating the amount, timing, and uncertainty of cash flows.

CONCLUSION

Many tried to make fair value accounting the culprit for the recent financial meltdown. The fact is there is much blame to go around. Political intervention and regulatory failures abound around this event. However, Hague mentioned one factor that did tie fair value accounting to the financial crisis—financial illiteracy. There was a clear lack of knowledge and understanding by management, accountants, auditors, and analysts with regard to the application of SFAS No. 157 when it came to valuing CDOs when the market seized. There was a clear misunderstanding on the part of management regarding the impact of the recognition of unrealized gains and losses on the business. Financial statement users were unable to properly evaluate the amount, timing, and uncertainty of cash flows from the financial statements prepared under the fair value accounting model. It will take time and a concerted effort to reeducate all of the practicing accountants,

auditors, and financial analysts from the traditional accounting model to the fair value accounting model. The cash flow statement should emerge as the prominent financial statement because it transcends both the traditional accounting model and fair value accounting model enabling stakeholders to better evaluate the day to day operations of the business.

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