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THE CRISIS AND FAIR VALUES: ECHOES OF EARLY TWENTIETH CENTURY DEBATES?

Abstract: The recent global financial crisis has led to extensive criticism of the role of accounting and its use of fair value measurement in causing and spreading the crisis. This paper argues that the debate surrounding fair value vs. historic cost, and *relevance* versus *reliability*, is nothing new; it was at the center of early accounting discussions in the AAA (especially by A.C. Littleton and W.A. Paton), the AICPA (especially G.O. May), and the SEC. Although prominent accounting scholars and practitioners in postdepression 1929 focused on the use of historic cost, the paper discusses the decision of the IASB/FASB to move reliability to a secondary characteristic in its recent conceptual framework. This action ignores lessons learned from a century of research, teaching, and practice of accounting.

INTRODUCTION

The world is barely emerging from the most severe global economic downturn in living memory, a banking crisis that resulted from the collapse of the U.S. housing market in 2008 that subsequently spread to the rest of the world. Several contributory factors have been identified, of which the most widely accepted include unprecedented low long term real interest rates related to the excess supply of savings from Asian exporting economies [Wolf, 2009]; excessively lax monetary policy [Cooper, 2008]; the housing bubble and associated boom in consumer and other forms of credit, masking problems in loan quality [Demyanyk and Van Hemert, 2009]; undercapitalization of banks and excessive maturity mismatch [Brunnermeier, 2008]; an explosion of new structured instruments many of which were poorly understood, notably by rating agencies many of whose ratings now appear suspect [Gorton, 2008; Mason and Rosner, 2007]; and weaknesses in regulation and supervision that failed to prevent some individual institutions taking on extremely risky

exposures [Brunnermeier et. al., 2009].

Given that accounting is critical for well-functioning capital markets, there has been extensive criticism of its role in the crisis. A large number of capital market participants, regulators, politicians, and media pundits have blamed the use of fair value accounting as a major cause of the crisis [Whalen, 2008; Forbes, 2009; Katz, 2008; Johnson and Leone, 2009].¹ However, the accounting profession, most accounting academics, the Securities and Exchange Committee (SEC), and other commentators have consistently asserted that accounting should not be blamed [Badertscher et al., 2010; Barth and Landsman, 2010; Laux and Leuz, 2010; SEC, 2008; Turner, 2008; Veron, 2008]. Their position has been that the function of accounting is merely to record events and that the stability of financial markets rests on bank regulation, not accounting.

This criticism of accounting is the result of its intellectual trajectory in which the fair value paradigm replaced the historic cost paradigm [Barlev and Haddad, 2003]. Before the crisis, experts posited that fair value improved relevance and augmented the stewardship function of accounting numbers, reduced agency costs, and boosted managerial efficiency. This paper examines the role of fair value accounting in the economic crisis and argues that the debate of relevance (as in the usage of fair value) versus reliability (as it pertains to historic cost) is not new but reflects the discussions from the early part of the 20th century. Referring to the works of A.C. Littleton, W.A. Paton, and G.O. May, this paper highlights the implications of this ongoing debate for accounting. Moreover, it outlines current developments in the conceptual framework of the Financial Accounting Standards Board (FASB)/International Accounting Standards Board (IASB) that moved *reliability* to a secondary characteristic, giving more emphasis to *relevance*, and indirectly, to fair value. Thus, the current FASB/IASB framework ignores lessons learned from almost a century of accounting research and practice, including those from the Great Depression of 1929.

This paper addresses the following research question: how does the recent subprime crisis, and ensuing fair value vs. historic cost debate, relate to similar debates in the post-depression

¹ Speaking at an SEC panel on mark-to-market accounting and the recent period of market turmoil, William Isaac, FDIC chairman from 1978 to 1985, exclaimed: "I gotta tell you that I can't come up with any other answer than that the accounting system is destroying too much capital, and therefore diminishing bank lending capacity by some \$5 trillion, It's due to the accounting system, and I can't come up with any other explanation." See Katz [2008].

era. Additionally, the paper examines how developments in the IASB/FASB conceptual framework further undermine the efficacy of accounting from the perspective of the above mentioned debate. In doing so, the paper aims to contribute to the extant accounting literature, and in turn to the ongoing fair value vs. historic cost debate, by shedding light on an enormously similar turn of events almost a century ago, the reverberations of which are very much applicable in modern times.

The remainder of this paper is organized as follows: The next section discusses the recent debate on fair value. The third section draws on the early cost versus value debate, and the following section examines the conceptual framework of the FASB/IASB and its implications for current standard setting. The final section offers a discussion and conclusion.

THE FAIR VALUE DEBATE

Factors leading to the subprime crisis: The burst of the credit bubble and the following subprime mortgage crisis have resulted in large-scale impairment and credit-related write-downs on assets held by banks in the United States and around the world.² A key question regarding this crisis is why credit traders and bank managers, who were well aware that the boom in credit conditions could not last forever, did not take steps to limit their exposure before the bubble eventually burst. Some argue that fair value accounting contributed to this failure to act and thus was a main cause of the crisis.

Until the puncturing of the bubble in the summer of 2008, the extension of riskier forms of credit—subprime mortgage lending and securitization, leveraged lending used for financing private equity deals, and trading of collateralized debt obligation (CDO) and similar assets—occurred at a record pace. It seems that bankers were simply pursuing ever more daring strategies to continue to increase their compensation without regard to long-term consequences.³ These problems followed a major

² Milne (2009) finds that total impairments and credit-related write-downs by 28 of the world's largest banks, including those of the insurance company AIG, recorded in 2007 and 2008 accounts totalled nearly \$1 trillion. The International Monetary Fund (IMF) projects that total credit-related losses across the financial services industry will eventually rise to \$2.2 trillion [IMF, 2009]. Some other projections (e.g., that by Nouriel Roubini) are even more pessimistic.

³ See, for example, Buttonwood [2009] and Institute of International Finance [2009] presenting survey results in which bankers admit the existence of compensation plans that encouraged high risk taking with little regard to the long-term success of their investments.

structural shift in U.S. banking policies during the 1990s. Relaxation and erosion of regulatory restrictions gradually allowed commercial banks to engage in a range of new fee-earning activities, such as underwriting municipal bonds, commercial paper, mortgage-backed and asset-backed securities; the sale of insurance products; discount brokering; and managing and advising open- and close-ended mutual funds [Yeager et al., 2007]. Banks were also able to engage in other investment banking activities, such as proprietary trading, through Section 20 subsidiaries. These changes resulted from the passage of the Financial Services Modernization Act of 1999, which effectively abolished the separation between commercial and investment banking that resulted from the adoption of the Glass-Steagall Act of 1933 [Gibson et al., 1999]. Subsequently, from 2002 to 2007, commercial banks increasingly securitized their various loan exposures, packaging them into agency and private-label mortgage-backed securities (MBS) and asset-backed securities with a correspondingly rapid expansion in the use of broker-dealer balance sheets [Adrian and Song, 2009]. These changes both served as the basis for the credit bubble and set the stage for the subsequent credit crisis.

Fair Values and the Crisis: The resulting shift in bank strategy during the 1990s toward traded credit exposures changed the composition of banks' balance sheets and income shown on them. Consequently, the effective measurement of bank performance—and, hence, of executive and trader compensation—relied increasingly on fair value accounting. It is important to discuss the applicable requirements used under existing accounting standards concerning the dependence of accounting treatment on managerial intent. *Trading securities* are assets measured at fair value on balance sheets with changes taken to income; trading gains and losses, inclusive of changes in fair values for trading securities, are reported as trading income on the income statement. Importantly, according to *SFAS No. 115*, trading securities are purchased with the intent to make short-term profits. *Available-for-sale assets (AFS)* are measured at fair value on the balance sheet date with changes taken to comprehensive income (thus bypassing income). These AFSs are purchased for medium- to long-term investments. *Impairments* to AFS securities are typically taken to trading income, which are either due to an irreversible decline in available market values or are based on declines in forecasted cash flows.

To appreciate the impact fair value has on banks' financial

statements, as of the first quarter of 2008, 50% of assets reported in fair value changes were recognized as income [SEC, 2008]. It is crucial to stress these fair values did not represent *realized* cash flows but *estimates* of future cash flows that would be properly discounted.⁴ Finally, and of specific concern to many users of banks' financial statements, whenever quoted market prices are not available, banks use fair value accounting in the context of "mark to model," thus requiring valuation techniques.⁵

The role of fair value in the crisis has come under fierce criticism, leading to calls from both sides of the Atlantic for the suspension of its use. Standard & Poor's presentation at a recent SEC roundtable expressed the current criticism of fair value accounting:

We support the basic premise that fair value ...is a relevant basis of accounting for financial assets and liabilities. However, we recognize that accounting for assets and liabilities at theoretical market-price measures may produce results that could mask the underlying economics for certain businesses and activities, especially during volatile and uncertain economic and market conditions.⁶

If *reliability* of information is desired, historical costs are more useful.⁷ If its *relevance* is desired, fair value is more useful. However, during the recent crisis, a great deal of criticism was leveled at accounting and its use of fair value in valuing investment securities. The crisis raised the discussion to an important debate. On one side, accounting professionals, academics, and

⁴ Derivatives are also presented at fair value. If they are stand alone or part of fair value hedges, any gain or loss on them is to be recognized in income. Gains and losses on derivatives used in cash flow hedges are to be taken to equity.

⁵ Such calculations include the use of financial/mathematical models grounded on a variety of assumptions, e.g., the Black-Scholes formula for valuing executive stock options. Whenever market values are not observable, financial models are employed which are referred to in *Topic 820* (formally known as *FAS No. 157*), relying on Level 2 and Level 3 inputs. A study by the SEC finds that for a sample of 50 U.S. financial institutions, about 45% of them, measured total assets at fair value. Furthermore, more than 85% of the fair values of these assets were assessed using either Level 2 or Level 3 inputs (SEC, 2008).

⁶ "Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting," Office of the chief accountant, SEC 2008.

⁷ It can be argued that historic cost accounting causes reliability concerns because managers can smooth income by manipulating the timing of asset sales. However, this type of reliability involves actual managerial actions rather than simple manipulation of model inputs.

the SEC posited that the crisis was caused not by the use of fair value accounting but by unscrupulous managers' actions. On the other side of the debate, bankers, various market players, and politicians blamed overleveraging first because of the increased use of fair value and the "death spiral" caused by declining fair values as the second one.⁸

Overleveraging resulting from the use of fair values signifies that rising asset prices, such as those of real estate, lead to a corresponding inflation of balance sheets. Consequently, firms with healthy short-term financial positions can leverage upward without fear of future downturns or procyclical movements in prices. The *death spiral* signifies that reductions in asset prices lead to circular and contagious effects across a host of related firms. In effect, the death spiral results when one firm's fire sale results in price reductions that affect a host of entities, leading to a systemic decrease in prices and a deterioration of financial position. Once asset prices drop, other firms are forced to sell their remaining assets to satisfy liquidity concerns, leading to increased pressure on prices for other asset classes, and, by association, pressure on other firms holding similar securities. Historic cost accounting often shields firms from such a contagious downward spiral.

Recently, other accounting transactions that utilize fair value, such as off-balance-sheet transactions, have also been criticized. Although this continues to this day, such transactions received considerable negative publicity related to the fall of Enron in 2001. For example, evidence suggests that before the 2008 crisis, banks had around US\$5,000 billion of assets and liabilities in off-balance-sheet accounts; those by Citigroup alone represented about US\$1.23 trillion of off-balance-sheet assets [Sikka, 2009].⁹

From an auditing point of view, even before the crisis the accounting profession was aware of the difficulties and limitations in auditing fair values [Martin et al., 2006]. For instance, the Public Company Accounting Oversight Board (PCAOB), the oversight regulator of the audit profession set up by the Sarbanes-Oxley Act of 2002, had already noted that the expanded use of structured securities "put reliable auditing of financial

⁸ Academic evidence so far has found contradictory evidence of a death spiral [Laux and Leuz, 2009; Sapra, 2009]. Nevertheless, the anecdotal evidence concerning the death spiral remains constant in the view of the public and regulators.

⁹ These include the "off-loading" of MBS to third parties while offering some guarantees and retaining some eventual ownership interest.

reporting at risk” [Johnson, 2007].

Audit firms in their role as advisers were actively involved in a trillion dollars’ worth of securitization and off-balance-sheet vehicles, which could have distorted investors’ and regulators’ perception of the severity of the problems [Arnold, 2009]. For instance, Deloitte & Touche advertises that the firm has been involved in more than 14,000 securitizations worth trillions of dollars. A multitude of third parties relies on auditors to ensure that financial statements present a true and fair view of operations and financial condition. By certifying fair value numbers based on a myriad of assumptions and models, however, auditors have added another level of legitimacy to statements that actually masked underlying risks. For instance, in 2009 and 2008, the Federal Deposit Insurance Corporation put into receivership 14 and 25 banks, respectively, with total assets of \$170 billion and \$372 billion [FDIC, 2009]. Although auditors act as watchdogs on behalf of third parties [Kalbers and Fogarty, 1998], auditors evidently failed to do so. Instead, audit firms helped their clients move toxic assets off the financial statements. As a consequence of auditors’ actions or lack of them, financial statements may have misrepresented or failed to reflect various financial institutions’ leverage or risk. Acting in such contrasting roles as auditing and advising off-balance-sheet transactions for clients is paradoxical regarding the role of accounting.

A 2,200-page report submitted in 2010 to the Bankruptcy Court of the Southern District of New York illustrates how the quality of auditing could have been compromised in the period leading to the crisis. The court asked Anton R. Valukas, the examiner, who is also the chair of the law firm Jenner and Brock LLP, to investigate the demise of Lehman Brothers; Valukas asserted that Lehman’s financial statements were misleading. He criticized executives who certified the financial statements and their auditors, in this case Ernst & Young. A key element in Valukas’ assessment is Ernst & Young’s handling of Lehman’s structured securities and off-balance-sheet transactions: Ernst & Young failed to question and challenge improper or inadequate disclosures in the firm’s financial statements and stood silent rather than investigate the merits of its accounting for sale and repurchases (repos).¹⁰

¹⁰ Repos are agreements by which one party transfers an asset or security to another party as collateral for a short term borrowing of cash and agrees to repay the cash and take back the collateral at a specific point in time.

Repos allowed Lehman to significantly enhance its capitalization ratio and hide its true level of debt. Although it can be argued that Lehman's collapse was unavoidable, it does appear that the audit function failed to sound early warning alarms of impending danger to alert investors and other stakeholders. Over-leveraged positions coupled with investments into highly risky and illiquid assets and off-balance-sheet transactions created an inevitable time bomb [Tibman, 2009]. Early warning during the auditing process could have allowed Lehman's problems to surface earlier when the market could have better absorbed the firm's problems, potentially allowing it to survive.

Financial instruments are very difficult to value, and methods for doing so vary. Consequently, modern auditing determines values of complex financial instruments whose reported number depends on the specific methodology used. These methodologies include making a multitude of assumptions and estimates about uncertain future outcomes. The specific valuation technique that a client employs could be one of many acceptable methodologies the auditor might use to certify amounts, which in turn could vary by billions of dollars had a different technique been used. Such complex instruments have been primary factors in the collapse of a number of financial and nonfinancial firms, such as Barings, Enron, and Parmalat [Deakin and Konzelmann, 2004; Zhang, 1995]. We have learned from the U.S. government-initiated bailout of long-term capital management that even economists who are Nobel Prize Laureates and the "fathers" of structured financial instruments failed in their valuation of such complex instruments [Dunbar, 2000]. If Nobel Prize recipients failed, assuming that auditors are better equipped to audit/value such instruments is quite bold [Martin et al., 2006]. We have possibly reached the limits of what conventional auditing can do [Sikka, 2009]. Additionally, if markets were inactive, the use of "price" indicators would be unnecessary because without "markets," trading is frozen. Consequently, cost valuation/assessment could depend more on models and assumptions than on transacted prices (as historic cost provides). The result would increase the chance of reporting unreliable numbers and material misstatements. Bruce Wasserstein, CEO of Lazard, stated October 30, 2008, that accounting has become a "new exercise in creative fiction" in which banks have balance sheets congested by "sludge" assets.¹¹

When it comes to disclosures relating to fair value, it is still

¹¹ See Giannone and Davies [2008].

unclear whether those made by financial institutions during the crisis were deceptive or incomplete. Nevertheless, providing additional disclosure does not seem to solve the problem. At its core is the conflict between the quantity of disclosures versus its quality [Bukh, 2003]. In efficient markets, disclosures can reduce friction and alleviate information asymmetry between sellers and purchasers. This is the standard response because stock prices are thought to “instantaneously reflect all publicly available information relevant to the value of traded stocks” [Fama, 1970]. But not all types of information have the same value relevance and processing costs [Merton, 1986]. Complex financial products can undermine such informational efficiency. The 2008 crisis has well illustrated that such products exist with few informed participants in thinly traded markets. Thus, Gilson and Kraakman [1984] argue that a structured financial product would take more time for the market to understand as compared to a change in interest rates by the Federal Reserve. Hence the usage of fair values is problematic not only from a measurement point of view, but also from a disclosure perspective, given the inherent difficulty in clearly articulating positions and exposures.

Given the criticisms of fair value in its alleged role in the crisis, Congress voted to suppress fair value accounting rules through the Emergency Economic Stabilization Act of 2008, claiming issues of social welfare and investor protection. Moreover, this act required the SEC to review the process by which the FASB promulgates accounting standards. A congressional hearing on the usage and implication of fair value accounting took place, with the objective that fair value accounting be modified, with the threat to create a bipartisan Federal Accounting Oversight Board to supervise accounting practices [Bougen and Young, 2012].

Under this immense political pressure, reminiscent of Congress's threat to disband the FASB over the stock option expensing debacle in the early nineties, the FASB responded by issuing the FASB Staff Position 115-2 and 124-2, entitled “Recognition and Presentation of Other-Than-Temporary Impairments” which addresses concerns regarding undue impairments of financial assets in times of crises. More specifically, entities do not need to report losses on the income statement, if they can demonstrate that they are able to hold the asset until such a time that permits price recovery. Consequently, although fair values have been the *modus operandi* for a good part of the last two decades, their use was “conveniently” relaxed in times of duress.

FAIR VALUE VERSUS HISTORIC COST: ECHOES OF LAST CENTURY DEBATES

The debate in the literature concerning the use of fair value versus historic cost has a long history, where the current debate on the subject parallels the debate for nearly a century. The revenue Acts of the early part of the 20th century, particularly the one of 1918, led to the establishment of an income tax on corporate profits. Consequently, the historic cost concept directly resulted from the desire of powerful businesses to minimize taxes rather than pay periodic profit on unrealized gains. During that era, this issue was a focal point in the accounting debate regarding current value versus cost. The debate over what constitutes correct accounting practice fueled the creation of the U.S. Securities Exchange (SEC) in 1934 with the goal to establish structured and systematic rules for income determination. Additionally, the requirement for public companies to publish financial statements supported by an independent accountant's certificate regarding the statements' content accuracy led some accounting scholars to advocate the use of accounting information that is verifiable and based on "objective" principles—hence, historical cost [see May 1943b; Reighard, 1932].

The historic cost concept fitted well in the regulatory environment of that time. For example, in 1935, the SEC insisted on the use of historic cost so that financial statements would not contain "misleading disclosures" [Kripke, 1970]. In 1936, the American Accounting Association (AAA) under the presidency of Erik Kohler issued "A Tentative Statement of Accounting Principles Affecting Corporate Reports." Although the American Institute of Accountants (AIA) disliked this memorandum because it would result in the AIA's loss of power and newly found competition on standards and principles that would affect its practitioners, the SEC received it well and praised it. The publication proclaimed historic cost to be a fundamental accounting principle.

Support for historic cost drew ambivalent responses from a variety of sources. For example, G.O. May consistently criticized the notion of the superiority of historic cost over fair value.¹²

¹² Hall of Fame inductee George O. May, with a vast academic output was a practitioner with the most significant effect on accounting practice. As a vice president of the AIA (now the AICPA) and a senior partner in Price Waterhouse & Co., he convinced the SEC of the need for uniform accounting standards that should be set by the accounting profession. He also helped promulgate through the Committee on Accounting Procedure early authoritative guidance on accounting rules and principles.

Rather, he favored an optimal combination of the two. For instance, he favored using the lower-of-cost-or-market method for inventory valuation, which was a common practice in England, and employing historic cost for valuing other fixed assets [May, 1943].

May's view on the valuation versus costing role of accounting offers insight on current debates related to accounting methodology. He argued that in pioneer economies whose capital is scarce and growth is rapid, the valuation role of accounting is important, but in established economies whose firms are large and complex, valuation approaches to accounting are impractical and accounting is better suited to costing. This is seen today in the difficulties and the inadequacy of accounting in valuing high-tech start-ups. Moreover, when discussing the stewardship role of accounting, May observed a decline in accounting's role for credit providers versus the rising role for equity providers (and a resultant emphasis on fair value), which continues to this day [May, 1945].

In writing on the concept of business income, May discussed the various ways in which accountants, economists, and businesspeople determine profit. An accountant would not accept a "discounting of the future" methodology when determining income because that would entail "counting chicks before they are hatched" [May, 1945: p. 3]. In addition, discount rates and realizations are subjective and hence unverifiable. In his later work, May focused on the concept of income, and discussed separating core income due to operations from non-core components such as created surplus and price appreciation. In recent years, current statements on comprehensive income, mark-to-market accounting, and, to a lesser extent, mark-to-model reflect some of the early views on whether price appreciation constitutes a component of income [May, 1954].

In contrast, A.C. Littleton's early work focused on theories of profit [1928] and whether an income figure, or a focus on the balance sheet, has more significance. His early work also touched on the concept of risk as a determinant of profits without dealing with accounting for risk. One of Littleton's main arguments during 30 years of writing was for a cost-based profit calculation as opposed to a value-based one because value-based profit changes and is hard to verify [Littleton, 1928, 1935, 1958]. As an historic cost advocate, Littleton made an early and persuasive argument for cost-based accounting [Bedford and Ziegler, 1975]. Therefore, Littleton considered the primary function of accounting to be record keeping and the disclosure of such re-

cords but never valuation.

In contrast to A.C. Littleton's view on profit, W.A. Paton, an economist by training, considered profit to be a change in the economic value of the business between the beginning and the end of the period [Paton, 1932]. Hence, Paton equated "cost" with "value." As early as 1936 in his writings on valuation [Paton, 1936], he supported an income-based approach to valuation, ignoring the cost versus value debate in regard to assets and liabilities. For him, earning power was key. His early work "Valuation of the Business Enterprise" preceded by one issue of *The Accounting Review* another famous work, Preinreich's 1936 article entitled "The Fair Value and Yield of Common Stock."

Although Littleton's and Paton's views on what constituted profit differed, their 1940 joint monograph, "An Introduction to Corporate Accounting Standards," revealed their agreement on the role of accounting. They believed that accounting is not to measure cost price, replacement cost, or liquidation value but to measure "earnings power." From this perspective comes the position of the income statement as the most important financial statement [Paton and Littleton, 1940]. This work, reprinted 16 times, has become a true classic of far-reaching consequence in shaping the world of accounting, in the United States and internationally. The monograph's most important contribution is setting historic cost as the basis of accounting.

Paton and Littleton's work superseded the earlier 1936 monograph "A Tentative Statement of Accounting Principles Affecting Corporate Reports" by the AAA, which was widely criticized for its lack of a basic unifying theory. Paton and Littleton stated in the preface to their monograph that they set out to fill this void. One of the main emphases in Chapters 2 and 6 was the need for "verifiable and objective" information. Consequently, they supported historic cost because they are verifiable and objective and are based on a transaction that has occurred, unlike replacement cost, liquidation value, market values, and other valuation methods (by extension, fair values such as those in use today). In opposition to the latter, they rejected the concept of *appreciation* because it provides no claims to meet creditors, suppliers, and customers. Their final argument in support of historic cost rested on the concept of *accountability*: historic cost provides easily verifiable numbers that form the basis of sound accountability. Their only exception to the use of historic cost was for reorganization when assets are reassessed and revalued according to prevailing price conditions. This principle continues today in business mergers and acquisitions.

Some might argue that Littleton's stance on cost versus value as outlined in "An Introduction to Corporate Accounting Standards" might have prevailed. The monograph's approval of historic cost, which was then more widely accepted in practice, led it to become the basic paradigm in accounting education and practice, for much of the 20th century. However, in their final chapter, entitled "Interpretation," the authors, chiefly Paton, objectively discussed the advantages and disadvantages of replacement cost accounting and "common dollar" accounting. As to the latter, they stated, "At the most what is needed is a special report supplementing the usual periodic statements and designed to trace the main effects of general price movements upon the affairs of the enterprise" [1940, p. 141]. Although this was a bold proposal for that time [Zeff, 2007], the monograph was widely received and has enjoyed an enduring legacy.

Most importantly, Paton and Littleton's work came at a time when pressure from the federal government on private accounting bodies, to establish formal accounting guidelines, had reached a pinnacle. Hence, practitioners and academics alike quickly accepted the use of historic cost because it provided a "lowest common denominator" solution. The bankruptcy in the early 1930s of Kreuger and Toll (i.e., Swedish Match), a multibillion-dollar entity with 400 subsidiaries, no doubt was fresh in people's minds. Kreuger and Toll had kept few financial records and freely used derivatives and other fair value-based transactions, creating a gigantic fraud [Flesher and Flesher, 1986]. While the United States was still reeling from the scandals related to Kreuger and newly created derivatives schemes and fluctuating prices, historic cost provided a simple solution in the postdepression regulatory environment.

The Securities Exchange Act of 1934 created the SEC to restore investor confidence in the stock market after its 1929 crash, which had been accompanied by financial manipulations, especially the creative use of asset write-ups that were used to inflate income. The SEC was also influential in making historic cost a key in U.S. accounting standards, and it eventually dictated accounting rules for the larger part of the 20th century [Zeff, 2007]. Robert Healy, one of the founding members of the SEC, abhorred the creation of unrealized gains, many of which were accompanied by dividend payments and had wreaked havoc during the 1929 market crash.¹³ Healy's strong view asserting

¹³ Healy was the director of the Federal Trade Commission's and U.S. Congress sponsored investigation into fraud in accounting in the years leading to the

“the purpose of accounting is to account—not to present opinions of value” [Healy, 1938] dominated the SEC’s intellectual trajectory in the 1930s and 1940s.

Although it is difficult to isolate the effect of the SEC from that of the work of the AAA, the AAA proclaimed in its 1936 statement, “If values other than unamortized [historical] costs are to be quoted they should be expressed in financial statements only as collateral notations for informative purposes” [AAA, 1936, p. 189]. Hence, the stance by Healy and the SEC on historic cost became rooted in accounting standards of the 1930s and early 1940s, and was a direct consequence of the crash and ensuing great depression.

This firm move toward historic cost was supported by both the SEC and the FTC, both of which opposed arbitrary asset markups, and was also supported by the executive committee of the AAA, and where Paton and Littleton (1940) provided a conceptual rationale for its wide usage. Ten years after the great depression, the practice of upward revaluation of assets had fully disappeared from U.S. based financial reporting entities [Swieringa, 2011]. Future generations of SEC members would accept only historic cost approaches in determining value [Zeff, 2007]. Until the inflationary periods of the 1970s, the SEC rarely accepted departures from historic cost accounting.

DEVELOPMENTS IN THE IASB/FASB FRAMEWORK POSTCRISIS

The preceding discussion clearly shows that the early fair value versus historic cost debates resulted in favor of historic cost. The two primary reasons for its acceptance were the post-depression era need for reliability and the belief that opinions on value should not be offered held by accountants and accepted by the SEC and accounting practice. As noted, this decision affecting the accounting profession has lasted almost a century but has recently been challenged by the acceptance of fair value accounting, especially in the FASB/IASB conceptual framework.

After a joint meeting on September 18, 2002, the IASB and the FASB issued a joint Memorandum of Understanding, commonly known as the Norwalk Agreement. It officially and explicitly expressed the interest of both standard setters to move toward full convergence and cooperation on joint projects to achieve the goal of developing a single set of high-quality in-

crash and great depression.

ternational accounting standards by 2011 [FASB, 2002]. When finalized, this framework is to be composed of seven statements regarding financial accounting concepts and will supersede the FASB concept statements of 1978–2000 and the 1989 Framework for the Preparation and Presentation of Financial Statements by the International Accounting Standards Committee, the IASB's predecessor.

Since beginning work in 2002, the IASB and the FASB have experienced several obstacles in developing this joint conceptual framework that have slowed their progress. Global standards indicate acceptance of fair value, which the international financial reporting standards (IFRS) advocate instead of historic cost, on which U.S. generally accepted accounting principles (GAAP) are based. The FASB's conceptual framework, outlined in Concept Statements Nos. 1–7 dating from the 1970s, has been criticized by both academics and practitioners [Henry and Holzmann, 2012; Shanklin et al., 2011]. Similarly, the IASB's conceptual document, Framework for the Preparation and Presentation of Financial Statements dating from the late 1980s, has also received its share of criticism because of its limitations and brevity [Kaminski and Carpenter, 2011].

While some progress has been made, the project has not been completed because of these obstacles. The first progress report that served as a road map for the complete plan was issued in 2006 and the second in 2008, during the height of the financial crisis. In 2006, the FASB issued a document outlining new changes to the joint IASB/FASB conceptual framework. Recognizing this document's significance, the AAA Financial Accounting Standards Committee published a critical analysis of it. The committee argued that if the proposed changes were to be adopted, they "will serve to move accounting increasingly toward an approach that emphasizes the balance sheet rather than the income statement, emphasizes investment in corporate equities, and de-emphasizes the stewardship role of accounting" [Benston et al., 2007, p. 229].

The issue of historic cost versus fair value continues to be the focus of debates, particularly after the 2008 economic crisis, which began only a few years after the convergence project did. After the crisis, some have argued that U.S. standard setters should reconsider the move toward convergence, in essence a move toward fair value.

Phase A of the joint conceptual framework, which is in the public domain, describes the "qualitative characteristics of accounting information." As such, accounting should present

“decision useful” financial reporting information. Hence, to be useful, it should possess two fundamental qualitative characteristics: relevance and faithful representation. For the first time, the term *reliability*, which was present in both the previous FASB and IASB concept statements, was dropped from the document.¹⁴

Dropping *reliability*, which includes substance over form, neutrality, and completeness, from the joint conceptual framework makes faithful representation a secondary fundamental qualitative characteristic.¹⁵ *Faithful representation* is the depiction of phenomena in a manner that is complete, neutral, and free from material error [IASB, 2008]. This change of language eradicates the possibility that trade-offs between relevance and reliability might be considered whereas in the past, arguments against the use of fair value were from the perspective that they are not “reliable.” Moreover, both *conservatism* and *prudence* are eliminated as desirable characteristics of financial report (since they conflict with neutrality). Reliability is replaced by faithful representation with the stated reason being that it is not possible to explain “reliable.”

As it stands, Geoffrey Whittington, a former member of the IASB, argues that:

The proposed sequence will involve selecting an accounting method first on the basis of highest relevance and then subjecting this selection to a filter based on some absolute minimum level of representational faithfulness. Above this threshold there will be no question of saying that greater representational faithfulness might compensate for less relevance, even if the latter loss is very small” [Whittington, 2008, p. 146].

While Henry and Holzmann [2011], describe the turn of events:

Yet arguably, the changes in the framework have significance beyond what might be widely understood and may represent a final shot in a battle between fair value and historical cost (p. 94).

¹⁴ *Reliability* is defined as “information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it purports to represent” [IASB, 1989, par. 31].

¹⁵ It is to be noted that in the FASB’s *SFAC No. 2*, reliability is composed of three components: representational faithfulness, verifiability, and neutrality. *Representational faithfulness* is in turn composed of completeness and freedom from bias (FASB, 1980). Hence, in the current framework, the value criteria are reversed: representational faithfulness is elevated while reliability is demoted.

The conceptual framework issued jointly by the FASB/IASB includes many other differences with the original FASB 1978–2000 concept statements (and earlier accounting concepts). Also importantly, the term *as a result of past events* was deleted in the joint framework for being redundant. However, this change of language signifies an important departure in the structure of accounting and financial statements. If economic outcomes no longer need to belong to past transactions, this could enable, for example, the recognition of fair value of internally generated goodwill: patents, human capital, customer and supplier relationships, and so on. Moreover, the FASB/IASB conceptual framework states, “*The usefulness of financial information is enhanced if it is comparable, verifiable, timely, and understandable.*” [IASB/FASB conceptual framework, 2010: A33; emphasis added].

Another change affects *verifiability*, which the new framework describes only as an “enhancing” qualitative characteristic in significant contrast to earlier accounting principles. For example, Chapters 2 and 6 of “A Tentative Statement of Accounting Principles Affecting Corporate Reports” [AAA, 1936] stressed the need for “verifiable and objective” information, supporting the use of historic cost because they are verifiable and objective. The current inclusion of verifiability also has resulted in criticism. For example, Andrew Lennard (of the UK’s Accounting Standards Board), writes that “Verifiability also seems to be an inadequate substitute for reliability: it requires merely that different observers will reach consensus, and not that they either base their views on reliable evidence or that the method used for ‘indirect verification’ should be” [2007, p. 53].

Finally, another change of note in the latest version of the conceptual framework, is the change in the primary definition of “users” of financial statements. Where in the prior framework, users had been defined as “present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public” (IASB, 1989, paragraph 9), the 2010 framework defines users as “existing and potential investors, lenders and other creditors” (FASB/IASB, 2010, paragraph OB2). This change in definition, which is non-trivial in nature, further cements the role of fair value in the financial reporting process: capital providers emphasize the return on their capital, as measured through market prices, as the main benchmark in providing the above-mentioned capital.

These changes in the conceptual framework notwithstanding, to date, the goal of full convergence by incorporating IFRS

into U.S. GAAP has yet to be fully realized [Zeff, 2007]. The process can be described as being at a standstill, with numerous commentators describing the process as dead, and some arguing for a U-turn [see Selling, 2013].

DISCUSSION: THE WAY FORWARD

The issue of the use of historic cost versus fair value has generated intense debate, dominating the media in unprecedented ways. At the heart of the debate is the position whether only one accounting system reporting performance and financial position can exist. The use of multiple systems for various objectives—whether contracting, control, or performance measurement—is admittedly, problematic [see Belkaoui, 2004; Burchell et al., 1980]. Furthermore, reported financial numbers have far-reaching effects, including social welfare [Solomons, 1991]. If the purpose of accounting is to stimulate growth [Biddle and Hilary, 2006; Plantin et al., 2008], then fair value promotes efficient investment.¹⁶ If the desired outcome is to avoid steep economic declines, such as one allegedly induced by the “death spiral,” historic cost is preferred [see Magnan and Markarian, 2011; Sapra, 2009]. Because the current economic outlook prefers the avoidance of steep declines at the expense of speedy growth, acceptance of historic cost could be the way to move forward. Furthermore, fair value is more open to manipulation to meet managerial incentives in reported financial outcomes, as compared to historic cost [Laux and Leuz, 2010]. Consequently, if the objective is to combat the managerial self-interest and zeal that contributed to the most recent financial crisis, perhaps the use of historic cost should be accepted.

Although there are opposing points of view regarding historic cost versus fair value, the strength of the arguments depends on accounting’s objective. None of the arguments seems to be *ex ante* superior but depends on whether we choose investment efficiency versus loss aversion or reliability versus relevance. In terms of reliability, accounting did a poor job in measuring asset values and violated the convention of conservatism because managers appear to have used fair value accounting to inflate numbers from their myriad of assumptions and inputs [Hildyard, 2008, p. 30].¹⁷ Additionally, in the recent economic

¹⁶ Fair value is useful for firm valuation, which is an objective of GAAP. Proper valuation, in turn, enhances efficient investment allocation

¹⁷ See Magnan (2009) and Magnan and Thornton (2010) for a review of empirical evidence on this issue.

downturn, politicians called for the suspension of fair value accounting because of allegations of its cause of a death spiral.

Because having different accounting systems for different macroeconomic conditions is not possible and switching back and forth between systems is not desirable, the only solution appears to be to revert to the use of historic cost. If the use of fair value is an important element in firms' contracting/investing environment, these values can be disclosed in the footnotes and in supplemental voluntary disclosures in which the market would find information for valuing the efficacy of fair values and decide on its usefulness. Such remedies echo old debates with respect to the use of historic cost or fair value as highlighted in the work of Paton and Littleton who stated that "common dollar accounting" [1940] needs to be relegated to supplementary disclosures where the information is available for all users.

However, other intermediary solutions could also be possible. For example, for Level 1 assets that are fairly liquid and have fewer reliability issues, fair value can be obtained from current market.¹⁸ The use of fair value is possible and even desirable provided that proper disclosures explain positions and the extent of exposure. However, because of the reliability argument for Level 2 and Level 3 assets, only historic cost could be desirable.¹⁹

Nevertheless, using mixed measurement models have long found opposition from intellectual purists [see Power, 2010]. He argues that fair value accounting changes a transaction-based measurement system to an economic valuation system. However, valuation is a purpose that is beyond the scope of financial reporting, as per prior conceptual frameworks [FASB 1978, para. 41]. The use of historic cost is not per se detrimental to measuring and assessing a firm's performance. For example, recording short-term assets at historic cost would be desirable because the quick trading horizons of these assets would continuously appear on the income statement. For intermediate to long-horizon assets, historic cost would also be desirable

¹⁸ In their discussion regarding the efficiency/efficacy of using fair values in financial reporting, Kothari et al. [2010, p. 14] observe, "Use of fair values in circumstances where these are based on observable prices in liquid secondary markets is consistent with economic GAAP."

¹⁹ On this point, Kothari et al. [2010, p. 92] observe, "In the absence of verifiable market prices, fair values depend on managerial judgments and are subject to opportunism. Accordingly, we caution against expanding fair-value measurements to balance sheet items for which liquid secondary markets do not exist."

because fair value fluctuations are not significant given that they are held for the long term.

Regarding specific remedies concerning the usage of fair values, many come to mind. Although described as decision useful and value relevant, fair values fail in both respects because structured products have long been a “powerful tool for inflating company profits by hiding losses and hence the risks of company operations” [Hildyard, 2008, p. 30]. Numerous works cite the benefits of securitizations when it comes to reducing risk and obtaining favorable financing terms [Barth and Taylor, 2010; Dechow et al., 2010]. However, caution is warranted when securitization is used to hide liabilities or bad assets. As such, all securitizations for which the issuer retains control or guarantees the transferred assets/liabilities must be accounted for “on balance sheet.” Citibank lost \$14 billion when it guaranteed off-balance-sheet assets during the economic crisis. At the time, it was unknown that Citi held more than \$1 trillion worth of off-balance-sheet securities [Sikka, 2009]. This “on balance sheet” approach, would be consistent with the recent IASB/FASB proposal regarding lease contracts [IASB/FASB, 2010].

In various aspects, financial reporting experienced a number of shortcomings during the most recent economic crisis. From a disclosure perspective, it provided a lack of information about firm riskiness. Although extensive disclosures have been made, important assumptions were reported under “key sources of estimation uncertainty.” Such disclosures were made in boilerplate responses that are inadequate for informing investment decisions [Schwarcz, 2008; Sikka, 2009]. Nevertheless, informative disclosures that are material to decision making can be adequately provided to the capital markets despite banks’ annual reports that have hundreds of pages regarding the complexity of numerous structured positions held. Preparing appropriate disclosures about key judgments is a challenge. Because many assumptions and a multitude of techniques are used in arriving at numbers, material disclosures need to be concise and clear. Firms must find appropriate ways to disclose in their financial reporting such data in a succinct manner that provides a complete picture of their businesses.

Although some assert that accounting simply documents vanishing values and disappearing fortunes, numerous discussions repudiate this notion. It is true that accounting documents transactions and assesses valuations. If market values are volatile, accounting valuations will reflect that. However, this conflicts with much of the accounting research literature

consistently showing that accounting has both constitutive and reflective powers—that it creates a reality as well as reflecting it [see Hopwood, 1987].²⁰ When assets are being marked to model, fair value accounting creates a specific reality. Thus, accounting is moving beyond its traditional role of recording economic events and transactions so that financial statements can reflect a firm's underlying economic performance. Fair values are an approximate market value at best and fully irrelevant at worst and did not exist until accounting regulations allowed and required it [Woods et al., 2009]. Nevertheless, given the current trajectory of political-economic thought, historic cost is demoted to being a minor blip in the longer realm of human history [Georgiou and Jack, 2011].

The last decade has witnessed the most extensive overhaul of public accounting since the original Securities Acts of 1933 and 1934 were passed. The regulations emanating from the new legislation were intended to restore public trust and to avoid sudden corporate meltdowns, primarily by enacting improvements to the audit and disclosure processes and to corporate internal controls. This has led to a major overhaul of the fundamental principles that govern accounting practices and began the transition of U.S. GAAP from a rules-based system to a principles-based one [Benston et al., 2007].

The scandals of the past decade had the expected culprits: managerial greed, sky-high expectations, “funny” accounting, lax auditing, and cheerleading capital markets. Lessons learned from scandals past remain relevant today: human nature is fallible, and greed is the cardinal sin of executives of modern corporations. Followers of the 2008 economic crisis recognized that many of the factors that led to the prior accounting scandals still exist today, and the regulations implemented to fight these mistakes did not lead to desired outcomes.

Many have blamed accounting principles that are cited as enabling transaction structuring in which clever accountants followed the rule of law but violated the spirit of GAAP. Joe Berardino, Arthur Andersen's CEO, claimed that “everyone followed the rules.....”.²¹ Harvey Pitt, then the chairman of the SEC, politicians, and media commentators led the charge to abolish rules-based accounting because “following technical prescriptions is neither sufficient nor the objective” [SEC, 2002].

²⁰ See Macintosh et al. [2000] for further elaboration on this perspective.

²¹ Interview on Public Broadcasting Station (PBS), with FRONTLINE correspondent Hedrick Smith, on May 1, 2002.

Numerous materials have linked financial performance to human instinct and behavior [Schumpeter, 1942; Simon, 1960]. Behavioral phenomena such as following the herd, overconfidence, illusions of control, and irrational selectivity of information are commonly identified with the advent of behavioral finance [Fromlet, 2001]. Akerlof and Shiller [2009] argue that we will not understand economic phenomena unless we understand humans' thoughts, ideas, and feelings. These authors contend that although humans rationally pursue economic interests, they are also irrational and misguided.

In reaction to the scandals that preceded the Great Depression beginning in 1929 in the United States, powerful players in academia, practice, and politics embraced the use of historic cost. During the development of modern accounting, academics including W.A. Paton and A.C. Littleton, practitioners such as George O. May, and the SEC influenced the use of historic cost as the acceptable accounting method for valuing resources. This paper has reviewed decisions on the use of historic cost versus fair value and questioned the preference of the FASB and IASB of fair value in their conceptual framework, thus ignoring past debates on the subject that led to the acceptance of historic cost and the use the term *representational faithfulness* rather than *reliability* in that framework now.

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