

A Susan Campbell Writing Sample

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Ask the Expert

Fair Value Accounting and the FASB

All's fair in love, war and financial accounting, right? Not yet. The Financial Accounting Services Board (FASB) has embarked on a movement to require US corporations to mark more and more balance sheet items to their fair value. Unlike in the more static economic environment of the early 1970s, when the FASB first began to develop concept statements about financial reporting, today's rapid price changes and shorter cycles due to improved technology can shock the economic system in a much more dramatic way.

This changed environment requires different forms of financial measurement of fair value on a balance sheet, some argue. But, requiring corporations to mark assets and liabilities to their current value, rather than using static, historical cost information from original transactions, may make financial reporting too subjective, too volatile and too difficult for comparing companies for investment – three of the very problems that the new FASB movement is attempting to solve.

The Financial Journalist asked an expert, Tony Sondhi, CFA of A. C. Sondhi & Associates of Maplewood, New Jersey to weigh these three issues under debate, and to evaluate future implications of fair value accounting for analysts and investors. Sondhi is founder and President of the firm, which develops and markets analytical databases to institutional and individual clients for investment purposes.

On Subjectivity...

In the ideal world, "fair value" is the amount of value that would exchange hands if one were to sell an asset or settle a liability today. But in the real world, hard assets such as plant facilities, land or other illiquid securities are valued on the balance sheet at historic purchase prices typically. In recent years, standard setters such as the FASB, which guide the principles of balance sheet reporting, have asked companies to more accurately reflect changes in the value of assets and liabilities in the absence of actual transactions. The intent is to arrive at more realistic, although albeit more subjective, numbers based on management's best understanding of fair value.

"All fair values are subjective because they are based on and sensitive to the estimates, assumptions and accounting methods that management chooses to determine fair value," says Sondhi. "But subjectivity need not be a deterrent to using fair value accounting. Because whether we like to admit it is not, subjectivity is the basis for the economic decisions that everybody makes. Just as when you go out to lease a car, or turn it in, you want the best estimate of the car's fair value at the current time, regardless of what the price of the car was originally. This movement by the FASB reinforces how highly relevant fair value is to effective decision making."

On Volatility...

Many fear that fair value will bring a level of volatility to the financial statements that will make it more difficult for investors to make sense of them. In Sondhi's opinion, historical cost isn't the solution; it's the problem. "I think that historical cost hides a significant amount of actual volatility in the marketplace," said Sondhi. "There is more market volatility today. Historic cost is a snapshot in time that masks present price fluctuations."

On Comparability...

While the FASB has required companies to report fair value for certain items such as derivatives and other securities on the balance sheet, many other items are still held at historical cost. Sondhi gave the example of a paper company that owns timberlands carried as an asset at its original cost. But land is bought and sold on the basis of *current* fair value. Variables like this make it harder for investors to compare companies for investment.

"Historical costs are never comparable," he said. "If an investor is looking at two paper companies each with a paper mill, but one company bought their mill years ago and the other just completed construction, the prices on the balance sheet are not comparable. The FASB move to fair value will significantly increase comparability."

Another part of the problem that the FASB is trying to solve is that disclosures are inadequate. According to Sondhi, perhaps the best way to explain balance sheet items fully is to show the numbers accompanied by substantive footnote disclosures that explain the background, policies and procedures management used to arrive at their best estimates.

There is much debate today about what fair values are, and there are obstacles to overcome as people get used to looking at financial statements in a different way, but Sondhi believes that debate is very healthy for the economic system. Long term, the move to arrive at consensus on better fair value measurement tools, combined with better disclosure, will ultimately help investors make more informed decisions.

Susan Campbell has more than 20 years of experience implementing creative solutions to financial services marketing communications problems

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