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Is 'Fair Value' Accounting Actually Fair?

The practice is loved by government accountants and scorned by bankers and investors.

On Oct. 8, 2008, investors were desperate to understand why stocks were cratering and banks had quit lending. It was the height of the financial crisis. That day William Isaac, a former chair of the Federal Deposit Insurance Corporation, went on television and blamed an unlikely culprit: bankers' accountants. "The Securities and Exchange Commission has destroyed $500 billion of bank capital by its senseless marking to market of these assets for which there is no marking to market," he said. "That has destroyed $5 trillion of bank lending." In other words, accounting rules enforced by the federal government were at the heart of the then-unfolding financial catastrophe. Many bankers and investors shared Isaac's view.

By contrast, government accountants, led by the Governmental Accounting Standards Board (GASB), have embraced these same rules — known as "fair value" accounting — with the same enthusiasm that bankers' and investors' accountants have scorned them. In fact, during the past three years the people who write accounting standards for states and localities have made fair value a key factor in how governments manage their pensions, investments and retiree health care. Strange as it might sound, that's a good thing.

How could fair value be deemed unfair by some and fair by others? It's all in the eye of the beholder. If you ask an accountant what something is worth, you'll get one of two answers. The usual one is "whatever you paid for it." If a local government purchased a piece of land 10 years ago for $1 million, the fair value of that land is $1 million. Accountants call this "historical cost."

But what if a developer really wants that land and is willing to pay three times the original purchase price? Is that a fair market value? The accountant's answer would be no. Until someone actually pays that price, it's just a guess. That's why accountants are credible. They deal in real numbers.

Of course, sometimes the real and the hypothetical converge. For instance, the prices of stocks offered on the New York Stock Exchange are updated every second. Those prices are technically estimates, but they're based on millions of real transactions. That's why accountants are comfortable equating a stock's offered price to its fair value. The same applies to other types of investments that can be "marked to market" because they're bought and sold in an active market.

Banks and other financial institutions mark their investments to market constantly. That's great when market prices are up. If markets run dry, however, as they did during the financial crisis, the damage is obvious and immediate. That can shake investor confidence. That's also why in the throes of the crisis, the finance industry put enormous pressure on the Securities and Exchange Commission to suspend mark to market accounting. The better approach, they argued, was to report fair market values averaged over time to better reflect "normal" market conditions. Regulators almost capitulated then — but didn't. Now they're reconsidering.

GASB, by contrast, has upped its own fair value ante. In its new standards on pension liabilities, it restricted governments' ability to "smooth" the fair value of their investments. That is, to report the average value of pension investments over time, rather than a specific point in time. With interest rates low and the stock market volatile, those investments have not performed well, and that could mean higher pension funding costs and less certainty when budgeting for those costs. GASB's new standards on other post-employment benefits like retiree health care could have the same effect. The accounting group also broadened its own fair value framework for governments.

Many of GASB's most important stakeholders have disagreed with its interpretation of fair value. That said, there's no question that they've applied that definition clearly and consistently. Put differently, they have resisted the temptation to politicize this arcane but crucial corner of accounting. That's bringing some badly needed fairness to fair value.

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