Fact, Fiction, and Fair Value Accounting at Enron

By Robert G. Haldeman, Jr.

NOVEMBER 2006 - Most investors and creditors have an image of accountants as professionally careful and conservative. Even recent accounting scandals are viewed as an aberration that will be addressed by changes in law, oversight, and penalties. This benign, conservative view of accountants may change as the real meaning of Enron becomes clearer with time. The last 30-odd years have produced a paradigm shift in corporate accounting theory. The new theory assumes that the 412-year-old “accounting model” is broken and must be replaced by an “economically satisfying” method for valuing assets and liabilities. Implementation of economic valuation techniques requires that accountants abandon traditional accounting principles (historical cost accounting, conservatism, and matching of costs and revenues). Yet, the movement toward fair value accounting (the general name for economic valuations) has been undertaken without evidence that the valuations produced are actually “better” than the old valuations. In contrast, recent evidence indicates that use of fair valuation has the potential for spectacularly misleading results.

FASB recently adopted SFAS 157, *Fair Value Measurements*. The purpose of SFAS 157 is to provide guidance on how to measure fair value, and “applies under other accounting pronouncements that require or permit fair value measurements.” It provides for exceptions such as for share-based payment transactions and for practicability. FASB defines 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.”

The fair value should be thought of as an “exit price” that can apply to assets or liabilities on a standalone basis, as “a group, a reporting unit, or a business.” Fair value derives from “a hypothetical transaction at the measurement date … A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The principal market is the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability. The most advantageous market is the market in which the reporting entity would sell the asset or transfer the liability with the price that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability.”

SFAS 157 identifies three approaches for estimating exit prices:

- **The market approach** uses “prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.” Valuation techniques include market multiples and matrix pricing.
- **The income approach** “uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted) … Valuation techniques include present value techniques; option-pricing models … and the multiperiod excess earnings method.”
• The cost approach uses current replacement cost.

SFAS 157 defines “inputs” into various valuation techniques as “the assumptions market participants would use in pricing the asset or liability, including assumptions about risk.” Inputs may be:

• **Observable inputs** “reflecting the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity.”

• **Unobservable inputs** “reflecting the reporting entity’s own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.”

SFAS 157 then establishes a hierarchy of fair value measurements for financial disclosure. The hierarchy is intended to convey information about the nature of the inputs (the assumptions, not the valuation techniques) used in creating the reported fair values.

• Level 1 inputs are “quoted prices (unadjusted) in active markets for identical assets or liabilities.”

• Level 2 inputs include “quoted prices for similar assets and liabilities in active markets[,] … quoted prices for identical assets and liabilities in markets that are not active …[,]” observable market data that are not prices (yield curves, volatilities, payment spreads, default rates, etc.), or evidence corroborated by correlation with observable market data.

• Level 3 inputs are “unobservable inputs … Therefore, unobservable inputs shall reflect the reporting entity’s own assumptions about the assumptions that market participants would use in pricing the asset or liability … Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity’s own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity’s own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.”

Enron made extensive use of what it called “mark-to-market” accounting. Enron’s mark-to-market—actually, “mark-to-estimate”—practices would have fallen into the income approach for valuation using unobservable, i.e., Level 3, inputs under SFAS 157. References to “fair value accounting” in the remainder of this article depend on Level 3 inputs and not Level 1 or Level 2.

This article will assess the impact of fair valuation on Enron’s financial statements, question the hoped-for results from widespread adoption of fair value accounting, and urge rule makers to prove the usefulness of sweeping changes in accounting standards.
The principal complaint about historical cost accounting is that it often understates the value of corporate assets, as well as of equity and income. Conservatism, a long-standing and pervasive property of financial reporting, has always placed greater focus on the concern of financial performance being overstated. Careful, conservative investors (hereafter, including creditors as well) must be advised of the potential risks when the new accounting theory is applied by aggressive corporate managers.

**Enron: A Case Study in Fair Value Accounting**

The earliest revelations about Enron indicated that the company’s financial statements were seriously misleading. When the company announced massive write-offs and restatements in October and November 2001, it seemed that fraud must have been involved. As the Enron story unfolded, it was revealed that the company had pursued so many accounting artifices in its financial reporting that “its financial statements bore little resemblance to its actual financial condition or performance” [“Third Interim Report of Neal Batson, Court-Appointed Examiner,” U.S. Bankruptcy Court, S.D.N.Y., *In re: Enron Corp., et al., Debtors*, Chapter 11, Case No. 01-16034 (AJG), Jointly Administered, June 20, 2003]. It could even be argued that Enron resembled an organized crime syndicate; efforts to mislead investors required the coordinated efforts of many people. As a result of their combined efforts, equity losses to Enron shareholders were $65 billion and losses to creditors will be $51 billion. Although nearly 20 individuals have been charged with crimes, penalties for some former employees have been disappointing in light of the massive harm that resulted from Enron’s failure. Prosecutors may have judged that favorable plea arrangements could be justified by the ultimate convictions of the two really big targets: former CEOs Ken Lay and Jeffrey Skilling.

Lay and Skilling had a unique strategy in preparing for their criminal trial. The *Wall Street Journal* carried a page-one story titled “An Audacious Enron Defense: Company’s Moves Were All Legal” (John R. Emshwiller, January 20, 2006). A principal contention of the prosecution was that Enron hid losses through improper and misleading use of special-purpose entities (SPE) and outside partnerships; however, the defense was prepared to argue that “Enron’s use of the entities met all necessary accounting and legal criteria.”

It is important to emphasize that Lay and Skilling did not plan to claim that: a) they “didn’t understand” the accounting; b) they “didn’t know” that the accounting was misleading; or c) that subordinates, acting on their own, were responsible. Their attorneys’ strategy was to argue, “[W]ith a few irrelevant exceptions, there were no crimes at Enron … [N]either their clients nor almost all of those former Enron executives who have pleaded guilty did anything illegal” (John R. Emshwiller and Gary McWilliams, “Enron Defense: What Crimes?: Lawyers for Lay, Skilling Set Off on Tricky Tack of Challenging Underlying Guilt Set in Plea Deals,” *Wall Street Journal*, February 6, 2006). Effectively, Lay and Skilling were willing to admit that they fully understood the accounting rules, they understood the picture of Enron that these rules presented to investors, and they (and their subordinates) intentionally applied the accounting rules to their logical conclusion.
Enron’s use of SPEs is not the only accounting practice that deserves scrutiny. Enron also made extensive use of fair value accounting (see Bethany McLean and Peter Elkind, *The Smartest Guys in the Room*, Portfolio, 2003). Despite its likely overstatement of fair value assets, Enron’s use of fair value accounting was never an issue in the criminal case against Lay and Skilling. Eugene H. Flegm’s forthright article (“Accounting at a Crossroad,” *The CPA Journal*, December 2005) called attention to the importance of fair value accounting at Enron: “Surprisingly, no regulatory body, including Congress or the SEC, has criticized FASB for its part in enabling frauds … It is my belief that FASB pursues the fair-value measurement base out of hubris.” Enron certainly has raised some questions.

**How Important Was Fair Value Accounting to Enron’s Misleading Financial Statements?**

Because of Enron’s swift and dramatic default, it is worthwhile to try to isolate and measure exactly what was “wrong” with its financial statements—what made them misleading. One way to do this is to investigate how various changes in Enron’s financial statements might have affected the way the company was perceived by investors. The risk of default is a central focus for most creditors and many equity investors. For example, bond ratings carry implications for the probability of default. Exhibit 1 presents the historical one-year average default experience associated with the ratings issued by Standard & Poor’s Corporation and Moody’s Investors Service.

Enron’s senior unsecured bond ratings are shown in Exhibit 2. S&P rated Enron BBB+ from 1995 through late 2001 (Exhibit Series 1). Moody’s (Series 2) rated the company Baa2 until March 2001, when the rating improved to Baa1. These ratings are considered “investment grade” and they communicated the agencies’ belief that Enron had much-lower-than-average default risk (i.e., about one quarter of the average risk for all U.S. corporations). The ratings help illustrate how misleading Enron’s financial statements were. Long-term credit ratings generally depend on financial statement information such as the relationship of debt to equity, liquidity, and profitability. Because bond ratings also incorporate subjective information (e.g., analyses of management, markets, and competition), it is difficult to know exactly how much different (lower?) these ratings might have been with “correct” financial statements.

The most frequently criticized accounting issue at Enron was the company’s use of off–balance-sheet financing. Regarding Enron’s use of “SPEs and aggressive accounting practices,” Neal Batson, the court-appointed examiner-in-bankruptcy for Enron, concluded the following in his report:

Although evidence suggests that Enron’s financial engineering began years earlier, the Examiner focused on 2000, the last year for which Enron issued audited financial statements. That year, Enron’s use of six accounting techniques produced 96% of its reported net income and 105% of its reported funds flow from operating activities, and enabled it to report $10.2 billion of debt rather than $22.1 billion of debt.
This suggests that an adjusting entry could be used to recast the 2000 financial statements. Because the impact of the adjusting entry on S&P’s and Moody’s ratings cannot be measured directly, an alternative approach would be to devise a mechanical credit-rating model that uses only financial statement information. The mechanical credit rating can first be calculated using the original financial statement data and then re-estimated after posting the hypothetical adjusting entry. Any change in rating would serve as an estimate of the impact that changes in financial information might have had on bond ratings.

This can be accomplished using the well-documented proprietary Zeta credit risk model, which combines variables that measure traditional credit-rating concepts of capital structure, liquidity, profitability, debt service capacity, and predictability of income flow. Series 3 in Exhibit 2 shows the historical record of Zeta credit ratings. These ratings use only Enron’s originally reported financial information. In 2000 and 2001, the base Zeta bond rating was equivalent to BBB-/Baa3 (slightly lower than S&P and Moody’s, but still investment grade). Series 3 provides a base of comparison for proposed adjustments to the financial statements.

The next step is to demonstrate what effect the bankruptcy examiner’s proposed adjustments might have had on Enron’s credit rating. Series 4 in Exhibit 2 shows how the Zeta bond rating would change after posting Batson’s suggested adjusting entry to Enron’s financial statements. (The entry increased assets by $4 billion, reduced other liabilities by $4 billion, reduced minority interest by $1 billion, reduced equity by $3 billion, and increased debt by $12 billion.) The adjusted Zeta rating in late 2001 would have been BB/Ba2.

Note that the ratings in Series 4 don’t fully explain the company’s astonishingly rapid failure. A rating of BB/Ba2 is considered less-than-investment-grade, but it still has a lower risk of default than an average U.S. corporation. It certainly does not reflect the very-high risk profile that Enron in retrospect demonstrated. The outlook for Enron’s creditors is bleak. The bankruptcy plan is expected to generate only $12 billion to satisfy $63 billion in claims. After posting the examiner’s adjustments, Enron’s total assets would have been $70 billion, enough to satisfy outstanding creditor claims. According to bankruptcy court filings, the $12 billion in funds available for recovery will be derived primarily from the sale of Enron’s power-generating and gas-transmission utility businesses. What about the other $58 billion in assets? Something besides the recognition of off-balance-sheet debt is required to explain Enron’s dramatic loss of value.

The most obvious explanation is that the balance sheet contained “assets” that had little or no value. Most of the asset captions on Enron’s 2000 balance sheet look quite ordinary: cash ($1 billion), trade receivables ($10 billion), inventories ($1 billion), deposits ($2 billion), goodwill ($3.6 billion), property, plant, and equipment ($12 billion). These assets alone would appear to be worth more than the amount creditors will realize (although security analysts frequently discount the value of goodwill). Some or all of these assets may have been overvalued, but it does not look as though these accounts should have given Enron’s independent auditor much difficulty.
Enron’s balance sheet also included current and noncurrent accounts captioned “price risk management assets” (PRMA). These were Enron’s fair value accounting assets. Skilling and Enron persuaded the SEC in January 1992 that Enron should be able to use mark-to-market accounting to value long-term gas contracts and derivatives (McLean and Elkind). Thus, the SEC handed Enron the tools to abandon traditional principles and introduce the bookkeeping analogue of financial engineering into nonfinancial companies. Enron eagerly applied the tools and soon began discounting to present value as much as 29 years of income from customer contracts. The result, after considerable manipulation, was instantaneous increases in assets and offsetting equity and, of course, income. By 2000, Enron’s PRMA amounted to $21 billion (31% of reported assets), quadruple their 1999 carrying value ($5 billion, or 15% of reported assets).

The next step in unraveling Enron’s accounting is to calculate the effect that PRMA might have had on investors’ perceptions. Absent any other reasonable explanation as to why Enron’s assets lost so much value in bankruptcy, McLean and Elkind tested the idea that PRMA never had any value. The author wrote off Enron’s PRMA year by year from 1992 through 2000. This is arbitrary treatment, but it is intended to demonstrate the magnitude by which fair value accounting affected Enron’s financial statements. Series 5 in Exhibit 2 shows the effect on Enron’s Zeta credit ratings during the period. Note that these revised numbers also include the Examiner’s adjustments in 2000 and 2001. From 1992 through 1999, these adjustments resulted in an average rating reduction of about one notch. In 2000, however, the year in which Enron’s PRMA ballooned from $5 to $21 billion, the adjusted Zeta rating would have yielded B+/B1. A rating of B+/B1 would have alerted the public that Enron’s probability of default was about three and a half times higher than that of the average U.S. corporation.

Enron’s use of PRMA very likely obscured the depth of its problems. In light of the fact that virtually all of the recovery to creditors will come from the sale of electric and gas-transmission utility assets, it is tempting to speculate that these were the only Enron businesses that had any value. Obviously, shrinkage of asset values is a common problem in bankruptcy, but it looks as though Enron was never much more than a simple utility company.

The larger question here is the relative importance of off–balance-sheet debt and PRMA in Enron’s financial statements. The bankruptcy examiner’s discovery of off–balance-sheet debt was material and would have reduced Enron’s credit rating by about one notch, using Exhibit 2’s Zeta analysis in 2000. The additional step of removing the highly questionable PRMA would have lowered the rating an additional three notches. The use of fair value accounting should probably receive more blame for Enron’s misstated financials than the use of SPEs.

Not only did fair value accounting probably contribute more to Enron’s collapse than SPEs did, but it was also partially responsible for Enron’s decision to use them. George Benston noted, “Although mark-to-fair-value accounting allowed Enron to record substantial profits, it did not provide cash flow. Enron had to deal with analysts who were suspicious of accounting net income and looked to cash flow as a superior measure of
performance … Enron attempted to bring these alternative performance measures into balance, as well as obtain cash for its operations and projects without having to sell stock or report debt, primarily with four [off–balance-sheet debt] schemes” [George J. Benston, “Fair-Value Accounting: A Cautionary Tale from Enron,” Journal of Accounting and Public Policy, 2006 (forthcoming)]. Batson, the bankruptcy examiner, concurred: “Enron’s use of mark-to-market … accounting created a timing gap between recognition of net income and the receipt to associated cash. This ‘quality of earnings’ problem made it particularly challenging for Enron to raise cash without issuing equity while maintaining its credit rating.” Enron used the SPEs to cover up the cash flow gap created by fair value accounting “income.”

Lay and Skilling’s criminal trial is over. Apparently, the prosecution decided to deemphasize accounting issues, but the analysis of the misleading aspects of Enron’s financial statements suggests that a surreal defense might have been available to the defendants. If they had been more realistic about their claims regarding the financial statements, they might have been able to deflect much of the responsibility through the following argument: “The SPEs were legal, but even if they weren’t legal, SPEs and off–balance-sheet financing techniques cannot be blamed for misleading investors, because they were barely material. What really misled investors was the far more material accounting for fair value assets that was approved by the SEC.”

**Are Investors Served by Widespread Implementation of Fair Value Accounting?**

For most financial statement users (whether they invested in Enron or not), the company’s reporting was unintelligible. A few investors who consciously avoided Enron may have done so because they understood what the company was doing. More of those who avoided it did so, in this author’s opinion, because they couldn’t understand the accounting. It is probable that no amount of additional disclosure would have rendered Enron’s complex transactions sensible even to reasonably sophisticated investors. The value to investors of forward-looking fair value accounting is questionable.

While investors will always be vitally interested in what is likely to occur in the future, more than anything else they need an accurate record of what has happened in the past. At its best, fair value accounting does not provide this. Instead, Benston noted, “the practice of public accounting has become similar to tax practice, with clients demanding and accountants providing expertise on ways to avoid the substantive requirements of GAAP while remaining in technical compliance.” [“The Quality of Corporate Financial Statements and their Auditors Before and After Enron,” Policy Analysis, No. 497, November 6, 2003. Benston was writing about rules-based GAAP, but it is clear that his comment is also applicable to fair value accounting.] Bentson also commented: “What [accounting authorities (SEC, FASB, IASB)] do not appear to recognize sufficiently is that numbers that are likely to be manipulated by opportunistic or overoptimistic managers are considerably worse for investors than numbers that are not current. Consequently, the authorities have required fair values, at least for financial assets, even when they are not based on reliable market values.”
What Does Fair Value Accounting Mean for Market Efficiency?

The traditional model for dissemination of financial information follows a certain path:

- Companies generate financial statement data.
- Independent accountants verify financial statement data.
- Independent security analysts use data to assess value.
- Portfolio managers use value assessments to allocate capital.

A critical element of this process is the presentation of independently verified financial statements to security analysts. Hundreds, perhaps thousands, of security analysts in turn use their best efforts to model or value a company. Market efficiency results from the collective efforts of many analysts assessing a relatively objective set of financial statements.

Broad implementation of fair value accounting will change the dissemination of financial information, which will proceed along the following path:

- Companies generate financial statement data.
- Independent accountants verify financial statement data and value companies.
- Portfolio managers use value assessments of public accountants to allocate capital.

FASB, knowingly or not, is pushing to change the role of the independent accountant from objective reviewer of financial information to subjective valuation specialist. Accountants will become both judge and jury regarding financial valuation. The role of security analysts in creating market efficiency will be dramatically reduced because they will be receiving a highly processed end-product based on thousands of assumptions by a single firm about a company’s future. Even if independent accountants have no intentional bias, the capital allocation formula will transform from a review by many analysts to a review by a single analyst. Independent security analysts are unlikely to have access to all the accountants’ assumptions.

Benston proposes a solution: “[F]air values could be presented to investors in supplementary schedules and even attested to by [independent public accountants] as having been derived from models or sources that [they] find acceptable.” Security analysts would retain the historic baseline, but would have access to projected data. After that, markets, not independent accountants, would determine the meaning of the additional data.

Who Will Be Responsible for the Failures of Fair Value Accounting?
The American Assembly, a nonpartisan public affairs forum affiliated with Columbia University, recently sponsored a study titled “The Future of the Accounting Profession” (see http://www.americanassembly.org/). For more than two years, a blue-ribbon steering committee sought “to determine whether America’s current ‘accounting model’ was able to deal effectively with contemporary business practices.” According to Robert Bloom, the committee’s report:

[S]tresses the subjectivity and judgmental nature of financial statements … The public, not to mention audit committees, may be calling for a degree of certainty in audits and accounting that cannot be achieved … The participants recommended that auditors exercise judgment to a greater extent … The report forecasts that the balance sheet of the future will include assets reflecting alternative valuation methods … The participants contend, in perhaps the report’s most significant recommendation, that auditors, who have to make many judgments and form subjective opinions, need to be protected from legal exposure; therefore, their liability ought to be limited. [Robert Bloom, “‘The Future of the Accounting Profession’ Report,” The CPA Journal, November 2005]

The American Assembly, with its reference to “assets reflecting alternative valuation methods,” seems to endorse FASB’s commitment to expand fair value accounting. The committee emphasized that accounting methods are subjective and, consequently, accountants must be shielded from liability when required to provide subjective analyses. Yet the committee doesn’t seem to appreciate that independent accountants are not passive bystanders of subjectivity in financial statements. The accounting profession increases its own vulnerability as its standards progress toward the increased application of Level 3 fair value accounting. It drives itself toward ever greater subjectivity! Fair value accounting is turning corporate financial reporting into speculation about future events and forcing independent accountants to speculate about whether a corporation’s speculations are “reasonable.”

Bloom characterizes the call to limit accountants’ liability for subjective application of accounting rules the committee’s “most significant” recommendation. Perhaps he should have called it the most stunning recommendation. Is no one going to be held responsible for the next Enron? If auditors are required to create financial statements that don’t make sense, should they be held responsible when their clients fail without warning? Of course not. On the other hand, no standards setter, regulator, or academic body has offered to accept responsibility for materially flawed accounting standards. In the end, increasingly subjective financial statements, combined with insulation from liability, will make it nearly impossible to hold anyone accountable for the inevitable opportunistic bookkeeping.

Earlier in these pages, Walter P. Schuetze pioneered new ground for evading responsibility for financial statements (“In Defense of Fair Value Accounting,” The CPA Journal, February 2006). Schuetze called for fair-valuation “in all balance sheets for all assets and liabilities as soon as possible.” However, he freely admitted that “CPAs are neither qualified nor competent to judge fair-value amounts ascribed to noncash assets and liabilities.” This dilemma is to be solved by reliance on valuations from outside
specialists. As far as Enron was concerned, Schuetze (the SEC’s Chief Accountant at the
time it approved Enron’s use of fair value accounting) does not view the approval of fair
value accounting as having been a regulatory failure. He sees the regulatory error as
failing to require “Enron to get [valuation] opinions from outside, independent valuation
experts.” Schuetze seems to acknowledge that Enron misstated its fair value assets, but
minimizes the problem as merely one of degree. By his reckoning, outside experts would
have corrected (i.e., lowered) the valuations.

Schuetze has commented elsewhere about mark-to-market accounting (“Accounting that
Adds Up: Testimony of Walter P. Schuetze before the United States Senate Committee
on Banking, Housing, and Urban Affairs,” The CPA Journal, April 2002). Unlike
academics who use the perceived understatement of corporate net assets (relative to
market equity values) to justify fair value accounting, the thrust of Schuetze’s
congressional testimony was that mark-to-market accounting can reduce the
overstatement of net assets in cases like Enron. He argues that historical cost accounting
and the current impairment standard are not adequate for this purpose, citing several
examples where specific assets should have been marked down using mark-to-market
valuations. Conceptually, I have no quarrel with these examples, but they are relatively
straightforward valuations where market (Level 1) or near market (Level 2) prices exist.
Assets that fall under FASB’s Level 3 proposal are a different matter.

Enron invented whole businesses—including trading desks, fixed assets, and capitalized
software—in order to create and maintain Level 3 PRMA. These businesses never had
any real business purpose, and never created tangible cash benefits for shareholders.
Their purpose was to manipulate into current years as much speculative future income as
they could, so that management could profit from their incentive compensation
agreements. It would have been nearly impossible for any outsider to call these
businesses, employing thousands of workers, worthless, especially because the SEC said
it was all legal. There is no guarantee that Enron’s financial statements would have been
different if its auditors had used outside valuation specialists. How could a valuation
consulting firm have had more leverage over Enron than its independent auditor?

Judging by Enron’s asset recovery experience, it is likely that Enron’s PRMAs were
worthless from the day their use was approved and should never have been permitted at
all. Until now, the accountants could blame only management, and vice versa. Schuetze’s
proposal would shift responsibility for a flawed accounting concept onto “experts” and
promises an era of endless finger-pointing in the wake of the next corporate failure. In the
case of Enron, Andersen might still exist under such a regime, because the subsequent
investigation would have focused on the valuation “experts.”

When Will We Have Proof That New Accounting Rules Are Better for Investors?

This final question may be the most important. For more than 30 years, FASB has
developed new accounting standards, guided by its “conceptual framework” for
accounting. Enormous effort has gone into re-evaluating every aspect of accounting, but
this may be overthinking the problem. In this author’s opinion, many accounting changes
have been reasonable (e.g., the capitalization of financing leases and the consolidation of captive finance companies), while other changes have produced awful results (e.g., pension accounting). Others may disagree. Accounting changes are expensive to implement and audit, but all accounting standards share the same problem: No one knows if they have made a difference in the utility of financial statements for investors. There is usually vigorous argument about a new standard before it is made effective. Yet there is no effort, before an accounting release or after, to collect verifiable evidence that the new standard allows investors to better invest their capital, or creditors to better quantify default risk. After a crisis, investors and creditors are told that misleading results couldn’t have been foreseen, and legislators are asked to shield independent accountants from liability.

A more important goal for accounting than a conceptual framework is developing a way to collect evidence that shows whether changes in accounting standards allow investors to make better judgments about future performance. This author is not sure what the measure of effectiveness for new accounting rules should be, but FASB should be trying to solve that problem. In 1966 renowned accounting professor and researcher William Beaver proposed that prediction of business failure (i.e., bankruptcy or default) might be a reasonable metric for evaluating the effectiveness of accounting alternatives (“Financial Ratios as Predictors of Failures,” Journal of Accounting Research, Vol. 4, Empirical Research in Accounting: Selected Studies 1966). Other authors have proposed links between accounting information and stock market values (George Benston, “Published Corporate Accounting Data and Stock Prices,” Journal of Accounting Research, 1967; Ray Ball and Philip Brown, “An Empirical Evaluation of Accounting Income Numbers,” Journal of Accounting Research, Vol. 6, No. 2, 1968; and James A. Ohlson, “Earnings, Book Values, and Dividends in Equity Valuation,” Contemporary Accounting Research, Vol. 11, No. 2, 1995). If a satisfactory metric can’t be found, how can changes to accounting standards be justified? Without any evidence of usefulness, Flegm may be correct: “FASB pursues the fair-value measurement base out of hubris.”

**Measuring the Value of Accounting Standards**

A very material portion of Enron’s assets were fictional by any reasonable definition of the word “asset,” even though much of what Enron did was approved by the SEC and may have been consistent with evolving GAAP. Accounting theory is undergoing a major conceptual change, and the most recent manifestation—the application of Level 3 fair value accounting under SFAS 157—has the potential for widespread deception of investors.

Issuers of corporate securities ask investors to trust them with their money. Financial statements provide the vehicle through which companies communicate to investors what has been done with that money. This is no theoretical exercise and should not be treated as one. I believe that until FASB can produce evidence of its value, the fair value accounting project should be limited to footnote or schedule disclosures. Otherwise, investors must become even more skeptical of accounting information than they now are, and questions about the quality of earnings will possess greater urgency.