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Statements 627: Fair Value Accounting In The Wild

Plenty of ink has been spilled in the financial press about the coming implementation of Statement 157, "Fair Value Measurements." Most of that coverage is negative: companies have been pushing back on the standard, petitioning the FASB to delay its implementation for one more year. "Level 3" has worked its way into investment jargon, synonymous with the already-clichéd "mark-to-myth" designation.

What casual observers miss: Statement 157 doesn't appreciably expand the use of fair value measurements. What it expands, however, is the amount of disclosures surrounding fair value reporting. Without those disclosures, nobody could make clever "mark-to-myth" remarks about Level 3 assets. Another miss: fair value reporting is nothing new. In fact, before the controversial Statement 157 was issued, the FASB's two previous statements actually expanded the use of fair value measurements - and their arrival went unheralded. That may be due to the fact that Statements 155 and 156 were elective, rather than required to be adopted by companies. Statement 159, issued after the Statement 157 demonification began, was also elective - and it's come in for its share of criticism ever since.

This report looks at the implementation of "Statements 627" in the real world. (That's 155 + 156 + 157 + 159.) Lessons: you don't hear gripes about fair value reporting when firms want it. And for all the clamor about Statement 157 at the large investment banks, there's been surprising level of adoption among the small firms.

I. Fair Value Reporting That Firms Like

When firms want fair values, you won't hear them complain about implementing them. The last monolithic fair value standard implemented in the United States was Statement 133, "Accounting for Derivative Instruments and Hedging Activities." At the time it was issued, firms were adamant in their opposition to it. That particular standard weighed in at about 35 pages; throw in the examples, background information, and implementation guidance, and "monolithic" is indeed the operative word: the whole bundle approaches 900 pages. Yet, through fair value reporting, Statement 133 brought badly needed visibility for derivative financial instruments. Chief financial officers and controllers hate the standard passionately, but they ultimately got what they wanted: specific guidance on specific transactions, which drove the standard to such outsized proportions and complexity.

Ironically, they found relief from some onerous provisions of Statement 133 in the form of ... more fair value reporting. Statement 133 required firms to separate embedded derivative instruments from their host contract in certain circumstances - a messy exercise that added to Statement 133's unpopularity. Statement 155 brought firms relief: they were permitted to skip the separation process if they elected to remeasure the instruments at fair value at each reporting period. Simplification through fair value: not exactly what you hear in the financial press these days. Statement 155 was also rather lenient in its implementation methods. Firms could adopt it prospectively as they bought or issued such hybrid instruments, and they could also apply it on a selective basis to existing instruments already in the balance sheet. Goofy, because it allows a firm to have a bunch of the same instruments on its balance sheet with entirely different accounting treatments for them.

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When Statement 159 went into effect, however, the “elective” provisions of that statement were often criticized.¹ Such criticism was justified: if fair value reporting is better for investors and analysts, why not require it instead of making it an optional choice? How are investors served better by non-comparable balance sheets and earnings due to selection of fair value versus historical cost reporting? The same arguments could just as well have been raised about Statement 155.

Nevertheless, at least 348 firms have adopted Statement 155 since it was issued in March 2006 and became effective for fiscal years beginning after September 15, 2006. The table on the next page lists them.

Statement 155: 2Q07 Assets/Liabilities

(\$ in millions)	Assets	Liabilities	YTD Pretax Income Effects
Advanced Cell Technology	NA	\$12.5	NA
Allied Defense Group	NA	32.6	(8.7)
Bear Stearns	NA	9,851.8	NA
Cincinnati Financial	\$192.0	NA	NA
Citigroup	664.0	35,284.0	352.0
Eastern Insurance Holdings	221.8	NA	NA
Energizer Holdings	45.7	NA	9.6
First Mercury Financial	29.7	NA	0.1
Flagstar Bancorp	20.5	NA	NA
H&R Block	27.6	NA	(16.8)
Liberty Global	NA	932.4	(209.4)
Liberty Media	NA	4,171.0	61.0
MBIA	NA	364.2	(0.5)
Monogram Biosciences	NA	21.1	(0.4)
MPC	NA	29.6	NA
Neomedia Technologies	NA	15.1	(7.4)
Novastar Financial	168.9	NA	NA
Odyssey Re Holdings	239.0	NA	4.4
PNC Financial Services Group	167.0	NA	NA
Radian Group	595.4	NA	NA
Satcon Technology	NA	9.8	(0.2)
SLM	429.0	NA	57.0
Temecula Valley Bancorp	9.8	NA	(3.5)
White Mountains Insurance Group	544.7	NA	3.8
	<u>\$3,355.0</u>	<u>\$50,724.0</u>	<u>\$240.9</u>

While many firms adopted Statement 155, continuing information about its fair value effects became scarce after initial adoption. Of the 348 firms adopting Statement 155, information about the magnitude of the ongoing fair value effects for Statement 155-elected items could be found for only those 24 firms shown in the table at left.

What matters is that the firms presenting “certain hybrid instruments” on a fair value basis are presenting values that are representative of financial reality. Statement 155, while expanding the use of fair value reporting, didn’t expand the required disclosures surrounding those fair values. For most of these 24 companies, there was really no way to tell anything about the nature of those fair values reported - or the change in the values that affected earnings.

That’s “most of these 24 companies,” because four of them - **Bear Stearns, Citigroup, Monogram Biosciences, and Novastar Financial** - adopted Statement 157 as well. The fair values of their “certain hybrid instruments” are framed in the context of Statement 157’s Level 1, 2, and 3 hierarchy. After Statement 157 becomes effective, that hierarchy will cover all Statement 155-applied items.

Executive Summary

- Fear and loathing of fair value reporting runs rampant in advance of the implementation of Statement 157 for fiscal years beginning after November 15, 2007 - at least, implementation for most of the standard. Parts related to non-financial assets will likely be delayed for a year.
- Statements 155 and 156, respectively dealing with hybrid financial instruments and servicing rights, were “fair value standards” that were delivered by the FASB in response to requests from financial statement issuers. Those standards were actually received quite well by the issuer community. At least 348 firms adopted Statement 155; and at least 221 firms adopted Statement 156.
- Statements 157 and 159, respectively covering the use of fair value measurements and allowing the selection of fair value measurement for certain items, have been less well-received in the financial community. More than the other two standards, Statement 157 does very little to increase the use of fair value reporting. Instead, it greatly increases the level of disclosure surrounding fair values. Statement 159 is an option for issuers; it doesn’t necessarily expand the use of fair value reporting.
- Critics of Statement 157 take issue with its “hierarchy of fair values” and in particular, with its reporting of Level 3 assets. The reported prices of those assets are unobservable in markets and are basically calculations made by the reporting firm. There’s a nearly-automatic presumption among market observers that such assets are worthless. While that could be true, it might also be true that they’re actually stated fairly.
- Best case: Investor angst over Level 3 valuations might cause firms to rethink their investment strategies in the future to avoid or reduce involvement with these kinds of instruments. Worst case: someone with a lot of these kinds of instruments finds out that they really are worth nothing and sees its shareholders get wiped out.

¹See Volume 16, No. 4, “Fair Value Free-For-All: Statement 159 Arrives” and Volume 16, No. 7, “The Good, The Bad, And The Ugly Of Statement 159.” Both reports discuss the “optionality” of the standard.

Statement 155 Adopters

3M*	Central Pacific Financial	First South Bancorp	Macy's	Reins. Group Of America
99 Cents Only Stores	Chancellor Group	<i>First United Ethanol</i>	<i>Main Place Funding</i>	Resolve Staffing
<i>AAB National</i>	Chandler USA	Flagstar Bancorp	Marathon Oil	Rim Semiconductor
Abatix	Cheviot Financial	Florida Community Banks	MBIA	<i>Riversource Life Insurance</i>
Aca Capital Holdings	Chubasco Resources	<i>Fluid Media Networks</i>	Medallion Financial	RLI
Ace	Cincinnati Financial	Flushing Financial	Mercury General	S&T Bancorp
Advance Auto Parts	Citi Investor Services	FNB	Merrill Lynch	Safeco
Advanced Cell Technology	Citigroup	Franklin Bank	Metlife	Safety Ins. Group
Aflac	Citizens Republic Bancorp	Frederick County Bancorp	<i>Metlife Ins. Co-Connecticut</i>	Sandy Spring Bancorp
Alesco Financial	Citizens South Banking	Friedman Billings Ramsey Grp.	<i>Metlife Life & Annuity Co-CT</i>	Satcon Technology
Alfa	<i>City National Bancshares</i>	<i>Fund American</i>	MFA Mortgage Investments	Security Capital Assurance
Allergan	<i>Classified Ad</i>	Gainsco	Mirant	Sedona
Allied Defense Group	Clear Channel Outdoor Holdings	General Mills	<i>Mirant Americas Generation</i>	Selective Ins. Group
Allin	Clear Channelcommunications	<i>Genworth Life & Annuity Ins.</i>	<i>Mirant Mid Atlantic</i>	Seneca-Cayuga Bancorp
Allstate *	Cobiz Financial	Geokinetics	<i>Mirant North America</i>	Sento
Amcore Financial	Colonial Banc Group	Gladstone Capital	Moldflow	<i>Sierra Pacific Power</i>
Amedia Networks	Commodore Applied Technologies	Gladstone Investment Corp.	Moneygram Int'l	Sky Financial Group
<i>American Environmental</i>	Community Bancorp	Globalscape	Monogram Biosciences	SLM
American Express	Computer Software Innovations	GMAC	Morgan Stanley	Solitario Resources
American Home Mortgage Invstm.	Conns	Golden Cycle Gold	Mountain National Bancshares	South Financial Group
American Oil & Gas	<i>Core Medical Group</i>	Goldman Sachs Group	MPC	Southern Community Fin'l
American Real Estate Partners	Corning	Goodyear Tire	Nara Bancorp	SPX
<i>American Skandia Life Assurance</i>	<i>Corporate Property Associates</i>	Graftech Int'l	<i>National Bank-Indianapolis</i>	Stage Stores
<i>Ameriprise Certificate</i>	Countrywide Fin'l	Graham Packaging Holdings	National City	Stem Cell Innovations
Ameriprise Fin'l	<i>CRT Holdings</i>	Great West Life & Annuity Ins.	National Health Realty	Student Loan
Amkor Technology	CSK Auto	Green Energy Group	Nationwide Fin'l Services	Sun Bancorp
Ampal-American Israel	Cummins	Green Energy Holding	<i>Nationwide Life Ins.</i>	Suntrust Banks
Applied Signal Technology	<i>Da-lite Screen</i>	Greene County Bancorp	NBTY	<i>Super Deal.Com</i>
Apria Healthcare Group	Davi Skin	GTC Telecom	Neomedia Technologies	Sussex Bancorp
Arotech	DCB Fin'l	H&R Block	New Century Bancorp	Sweet Success Enterprises
<i>Art Design</i>	Deere & Co	Hanmi Fin'l	New Jersey Mining	Synovus Fin'l
Associated Banc-Corp	<i>Deere John Capital</i>	Hanover Ins. Group	Newstar Fin'l	Sysview Technology
Assurant	Delta Fin'l	Hawaiian Electric Co	<i>Nitrous Oxide</i>	<i>Tampa Electric</i>
Assured Guaranty	<i>Duane Reade Holdings</i>	Heartland Fin'l USA	Noble Energy	Temecula Valley Bancorp
Astoria Fin'l	Dynex Capital	Hillman Companies	North Central Bancshares	Tenfold
Aurelio Resource	Eagle Broadband	Homebanc	<i>North State Bancorp</i>	Terremark Worldwide
Autodesk	Eagle Rock Energy Partners	Horizon Offshore	Novastar Fin'l	<i>Textron Fin'l</i>
AVP	Eastern Ins. Holdings	HSBC Finance	Nyfix	TFS Fin'l
Baker Hughes	Ecom Ecom Com	HSBC USA	Oak Hill Fin'l	Thornburg Mortgage
BancorpSouth	EMC Ins. Group	Huntington Bancshares	Odyssey Re Holdings	Tompkins Trustco
Bank-America	Emrise	IBT Bancorp	Onebeacon Ins. Group	Torchmark
Bank-Hawaii	Ener1	Icahn Enterprises	Opteum	Toreador Resources
Banner	Energas Resources	Indymac Bancorp	Oriental Fin'l Group	Tower Group
Barrett Business Services	Energizer Holdings	Infinity Property & Casualty	Origen Fin'l	Toyota Motor Credit
BB&T	Epic Bancorp	ING Life Ins. & Annuity	Ormat Technologies	Travelers Companies
Bear Stearns	<i>Esecuresoft</i>	ING USA Annuity & Life Ins.	Partnerre	UCBH Holdings
<i>Belden & Blake</i>	Espeed	Int'l Business Machines	Petramerica Oil	<i>Union Security Insurance</i>
Berkshire Bancorp	EV Energy Partners	Investment Bancshares	PHH	Uni-Pixel
Bigband Networks	Evergreenbancorp	Irvine Sensors	Philadelphia Cons. Holding	United America Indemnity
Blackrock	Fannie Mae	Istar Fin'l	<i>PHL Variable Insurance</i>	United Bancorp
Botetourt Bankshares	<i>Fed'l Home Loan Bank-Atlanta</i>	IT Group Holdings	Phoenix Companies	United Bancshares
Bristol West Holdings	<i>Fed'l Home Loan Bank-Boston</i>	J P Morgan Chase & Co	Photronics	United States Antimony
Brookside Technology Holdings	<i>Fed'l Home Loan Bank-Chicago</i>	Jarden	Pinnacle Bancshares	Unum Group
Bryn Mawr Bank	<i>Fed'l Home Loan Bank-Dallas</i>	JER Investors Trust	Pinnacle Bankshares	Valley National Bancorp
Bsquare	<i>Fed'l Home Loan Bank-Pittsburgh</i>	Keycorp	Piper Jaffray Companies	Veri-Tek Int'l
Bunge	<i>Fed'l Home Loan Bank-San Francisco</i>	<i>KKR Fin'l Holdings</i>	PNC Fin'l Services Group	Vision Sciences
Camelot Entertainment Group	<i>Fed'l Home Loan Bank-Topeka</i>	Kulicic & Soffa Industries	Popular	Visteon
Canandaigua National	Fieldstone Investment	Kurrant Food Enterprises	Powersecure Int'l	Waccamaw Bankshares
Canyon Bancorp	Fin'l Industries	LandAmerica Fin'l Group	PPL	Wachovia
Capital One Fin'l	First Bancorp	Landmark Bancorp	PPL Energy Supply	Washington Mutual
Capitalsource	First Capital Bancorp	Laporte Bancorp	Princeton Acquisitions	Watts Water Technologies
Capitalsouth Bancorp	First Charter	Lattice	Principal Fin'l Group	Wells Fargo
Carey W P & Lic	First Chester County	Lehman Brothers Holdings	Procentury	<i>West Suburban Bancorp</i>
Carlisle	First Fed'l Bancshares-Arkansas	Liberator Medical Holdings	Protective Life	White Mountains Ins. Group
Catcher Holdings	First Fin'l Holdings	Liberty Global	Prudential Bancorp-PA	Wilshire Bancorp
CBRE Realty Finance	First Horizon National	Liberty Media	Pulte Homes	Wintrust Fin'l
Cel Sci	First Keystone Fin'l	Lincoln Educational Services	Quanta Capital Holdings	World Fuel Services
Celgene	First Mariner Bancorp	Lincoln National	Radian Group	Zenith National Ins.
Center Bancorp	First Mercury Fin'l	Little Squaw Gold Mining	Rainier Pacific Fin'l Group	
Center Fin'l	First Midwest Bancorp	M&T Bank *	RAIT Fin'l Trust	

* R.G. Associates, Inc. holding. See note on back page.
Firms with italicized names have no publicly-traded equity.

Another fair value pronouncement, Statement 156, “Accounting for Servicing of Financial Assets,” also widened the use of fair value reporting. Again, because the fair value provisions provided relief from tedious work required by another accounting standard, you didn’t hear much corporate griping about fair value reporting ruining Western civilization. In this case, Statement 156 provided relief for the parts of Statement 140, “Accounting for Transfers of Financial Assets” that had a nasty standard interaction with Statement 133. Servicing rights² were required to be accounted for on a historical cost basis after they’d been recognized and evaluated on the basis of lower of cost or market. At the same time, firms would hedge such rights as mortgage servicing rights with derivative instruments that Statement 133 required them to carry on a fair value basis. Income statements could be volatile simply because of the mismatched attributes of the items being hedged (servicing rights, on a historical cost basis) and the hedging instruments (derivatives, on a fair value basis). Statement 156 required servicing assets and liabilities to be measured at fair value initially, and gave firms the choice of reporting them on a fair value basis subsequently or simply amortizing them, as had been the practice. The fair value option was simpler, and also relieved them from some of Statement 133’s least-loved requirements: proving the effectiveness of a hedge at each reporting date.

Firms adopted Statement 156 without complaint. Below, 221 firms found that adopted Statement 156.

Statement 156 Adopters

AAB National	Citigroup	A Flagstar Bancorp	Madison Gas & Electric	Saul (B.F.) REIT
ACA Capital Holdings	Citizens Republic Bancorp	Florida Community Banks	Marriott International	Seneca-Cayuga Bancorp
Alfa	Citizens South Banking	FNB	Medallion Financial	A SI Financial Group
AMB Financial	City National Bancshares	Franklin Bank	A Merrill Lynch	Sky Financial Group
Amcore Financial	Cobiz Financial	Frederick County Bancorp	Metlife	A SLM
Amer. Community Bancshares	A Colonial Bancgroup	General Motors	Metlife Insurance Co of CT	A Southcrest Financial Group
American Express	Community Bancorp	Global Cash Access Hlgs	Metlife Life & Annuity Co of CT	Southeastern Banking
American Home Mortg. Invmt.	Community Shores Bank	GMAC	Morgan Stanley	Southern Community Financial
American Patriot Fin'l Grp.	Conns	Goldman Sachs Group	Nara Bancorp	A Sovereign Bancorp
Ampal-American Israel	Countrywide Financial	Greater Atlantic Financial	National Bank Of Indianapolis	State National Bancshares
A Anchor Bancorp Wisconsin	A DCB Financial	Green Energy Group	A National City	Student Loan
A Associated Banc-Corp	Deere & Co	Green Energy Holding	A Nat'l Consum. Cooperative Bank	Sun Bancorp
A Astoria Financial	Deere John Capital	Greene County Bancorp	National Health Realty	A Suntrust Banks
Aurelio Resource	Delta Financial	A Greenville Federal Fin'l	National Penn Bancshares	Sussex Bancorp
BancorpSouth	DSA Financial	A H&R Block	Nationwide Financial Services	Synovus Financial
A Bank Mutual	Dynex Capital	A Hancock Holding Co	Nationwide Life Insurance	Temecula Valley Bancorp
Bank Of America	A East West Bancorp	Hanmi Financial	Naugatuck Valley Financial	Textron Financial
Bank Of Granite	Epic Bancorp	Hanover Insurance Grp.	Newstar Financial	A TFS Financial
Bank Of Hawaii	Evergreenbancorp	Hawaiian Electric Co	A Newtek Business Services	A Third Century Bancorp
Baylake	A Fannie Mae	A Hawthorn Bancshares	North Central Bancshares	A Thornburg Mortgage
BB&T	Fed'l Home Loan Bank-Cincinnati	A Heartland Fin'l USA	A Northwest Indiana Bancorp	A Tierone
Bear Stearns	Fed'l Home Loan Bank-Pittsburgh	A HMN Financial	Norwood Financial	A Timberland Bancorp
Benjamin Franklin Bancorp	Fieldstone Investment	Home Federal Bancorp	A Novastar Financial	TMSF Holdings
Berkshire Bancorp	Financial Industries	Homebank	A Oak Hill Financial	Tompkins Trustco
Beverly Hills Bancorp	First Bancorp	Hopfed Bancorp	A Old Second Bancorp	Toyota Motor Credit
BFC Financial	First Busey	HSBC USA	Opteum	A UCBH Holdings
Blackrock	First Capital Bancorp	A Huntington Bancshares	Oriental Financial Group	Umpqua Holdings
A BNCCORP	A First Charter	IBT Bancorp	A Origen Financial	Union Bankshares
BOK Financial	First Chester County	A Independent Bank	PHH	A United Bancorp
Broadway Financial	First Defiance Financial	Indymac Bancorp	Phoenix Companies	United Bancshares
A Bryn Mawr Bank	First Fed'l Bancshares- Arkansas	Int'l Business Machines	Pinnacle Bancshares	US Bancorp
A Canandaigua National	First Federal Bankshares	Interwest Bancshares	Pinnacle Bankshares	A Valley National Bancorp
Canyon Bancorp	A First Fed'l Of Nthn. MI Bancorp	A Irwin Financial	Piper Jaffray Companies	A Wachovia
Capital One Financial	First Financial Bancorp	Istar Financial	A PNC Financial Services Grp.	Washington Mutual
Capitalsource	First Financial Holdings	IT Group Holdings	A Popular	Wayne Savings Bancshares
Capitalsouth Bancorp	First Franklin	J P Morgan Chase & Co	Princeton Acquisitions	A Wells Fargo
A Center Bancorp	First Horizon National	A Keycorp	A Principal Financial Grp.	Wesco International
Center Financial	First Indiana	Lakeland Bancorp	Provident Financial Services	A West Suburban Bancorp
A Centerline Holding Co	First Keystone Financial	Lakeland Financial	Prudential Bancorp Of PA	Wilshire Bancorp
A Central Pacific Financial	First Mariner Bancorp	Landmark Bancorp	A PSB Holdings	Wintrust Financial
Chancellor Group	First Midwest Bancorp	A Laporte Bancorp	Pulte Homes	Yadkin Valley Fin'l
Chandler USA	A First Mutual Bancshares	Leesport Financial	Rainier Pacific Financial Grp.	
A Cheviot Financial	First Robinson Financial	A Legacy Bancorp	Rurban Financial	
Cincinnati Financial	First South Bancorp	Lehman Brothers	A S&T Bancorp	
Citi Investor Services	A Firstcity Financial	A LNB Bancorp	Sandy Spring Bancorp	

A- firm chose to amortize servicing rights rather than subsequently recognize changes in their fair value after Statement 156 adoption.

² Servicing rights can be servicing assets: a contract to service financial assets with estimated future revenues from contractually specified fees and other revenues expected to more than adequately compensate the servicer for performing the servicing duties. Common example: mortgage servicing rights. Servicing rights may also be liabilities, when the estimated future revenues are not expected to adequately compensate the servicer.

II. The Unloved Fair Value Standards

Statement 156 wasn't much of a standard in that it didn't require companies to do things consistently in comparison to each other - the entire point of standardization. It required firms to initially measure servicing rights at fair value - if practicable - and they could choose to continue recognizing changes in the value of those rights through earnings on either a fair value basis or an amortized cost basis. That created opportunities for different accounting bases for the same kind of things on just one company's balance sheet; never mind the comparability lost among the income reporting for different companies. Maybe that's a reason companies never complained about the fair value issue: there just wasn't much "standard" to the standard and it afforded them an opportunity to paint the kind of earnings they wanted after its adoption.

On to the big enchilada, Statement 157. Issued in late 2006, the standard was originally intended to go into effect in years beginning after November 15, 2007, companies could adopt the standard early - and many of them did. (As it turns out, the FASB may well delay the required implementation of parts of the standard. See sidebar, next page.) Below, 100 companies that adopted Statement 157 early; 12 of them were non-public with filed financial statements or were part of a public firm. Sixty-eight of them went the Statement 159 route and elected the fair value option for parts of the balance sheet.³

Statement 157 (& Statement 159) Adopters

X Abbott Laboratories *	Delta Air Lines	KBW	Regal One
X Alliance Bankshares	X Deluxe	X <i>KKR Financial Holdings</i>	<i>San Diego Gas & Electric Co</i>
X American Home Mortgage Investment American Surgical Holdings	X Devon Energy	X Leesport Financial	X Seacoast Banking Of Florida
<i>Art Design</i>	X Discover Financial Services	X Lehman Brothers Holdings	Seacor Holdings
X Bank Holdings	X Everest Re Group	X LNB Bancorp	<i>Security Capital</i>
X Bank Of America	X First Bancorp	<i>Main Place Funding</i>	Sempra Energy
X Bank Of Marin Bancorp	X First Community	X Massbank	X Seneca-Cayuga Bancorp
X Banner	X First Federal Of Northern Michigan Bancorp	X MBT Financial	X Shenandoah Telecom
Bear Stearns	X First Mariner Bancorp	X Merrill Lynch	Solitario Resources
Bentley Pharmaceuticals	X First Mutual Bancshares	<i>Merrill Lynch Life Insurance Co</i>	X Student Loan
Blackstone Group	X First Security Group	<i>ML Life Insurance Co Of New York</i>	X Suntrust Banks
BOK Financial	X Flagstone Reinsurance Holdings	X Monogram Biosciences	X Sussex Bancorp
X Britton & Koontz Capital	X Flushing Financial	X Montpelier Re Holdings	Tenfold
X Cadence Financial	X Gateway Financial Holdings	X Morgan Stanley	Tofutti Brands
X Cascade Financial	Genco Shipping & Trading	MSGI Security Solutions	X Tompkins Trustco
Chancellor Group	Golden Cycle Gold	X National Penn Bancshares	X Trustco Bank
X Citigroup	X Goldman Sachs Group	Northwest Airlines	X Umpqua Holdings
X Citizens Bancshares	Green Energy Holding	X Novastar Financial	X United Security Bancshares
X Comforce	X <i>HSBC Finance</i>	X Oak Ridge Financial Services	X Validus Holdings
X Community Banks	X IBT Bancorp	<i>Pacific Enterprises</i>	X Valley National Bancorp
X Community Central Bank	Icahn Enterprises	X Peoples Bancrust	X <i>Venture Financial Group</i>
Complete Production Services	IParty	X <i>PMA Capital</i>	X Wells Fargo
X Conns	X IPC Holdings	Powersecure International	X Western Alliance Bancorporation
Dataram	X J.P. Morgan Chase & Co	<i>Princeton Acquisitions</i>	X White River Capital
	X Jefferies Group	X Quanta Capital Holdings	X Xstream Beverage Network
X - Adopted Statement 159. * R.G. Associates, Inc. holding. See note on back page. Firms with <i>italicized</i> names have no publicly-traded equity.			

Most of the early adopters in the table were financial firms, as one might expect. When you consider that nearly 80% of those 157-adopters were also Statement 159-adopters, it seems entirely possible that the real intention of these firms was to do an early adoption of Statement 159. To get that fair value option, they had to adopt Statement 157 as well.

As the press reports wave after wave of writedowns tied to the fair value of scummy financial assets at monolithic banking firms, the investing public starts to believe that only gigantic firms have the interest or resources to implement Statement 157. That's an impression that firms have encouraged as they've asked the FASB to delay Statement 157's effective date.⁴ In fact, that impression is even present in the handout materials at the November 14 FASB meeting⁵ where the partial delay was discussed. The materials mention the preparer view that "the early adopters are primarily **large** financial institutions that have significantly more experience and dedicated resources in valuing financial instruments." (Emphasis retained.)

³For more in-depth discussion of Statement 159 and its adopters, see Volume 16, No. 4, "Fair Value Free-For-All: Statement 159 Arrives" and Volume 16, No. 7, "The Good, The Bad, And The Ugly Of Statement 159."

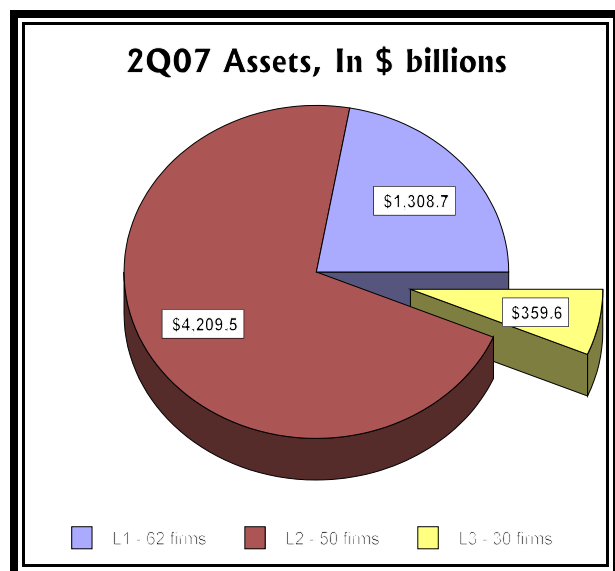
⁴For instance, see the letter submitted to the FASB by the Financial Executives Institute on October 1, 2007 at: <http://www.financialexecutives.org/eweb/upload/FEI/FAS%20157%20101107.pdf>

⁵Handout materials available for downloading at http://fasb.org/board_handouts/11-14-07.pdf

Large Financial Institutions Are *Not* The Only 157 Adopters

(Market capitalization in \$ millions)			
Bank Of America	\$214,211.2	Valley National Bancorp	\$2,456.8
Citigroup	208,708.0	Seacor Holdings	2,189.9
J P Morgan Chase & Co	157,863.6	Deluxe	2,102.8
Wells Fargo	113,090.9	Montpelier Re Holdings	1,836.9
Goldman Sachs Group	98,560.8	Genco Shipping & Trading	1,834.3
Abbott Laboratories*	84,402.8	IPC Holdings	1,814.3
Morgan Stanley	71,460.5	Validus Holdings	1,514.7
Merrill Lynch	56,737.3	Complete Production Services	1,434.7
Devon Energy	41,563.0	Flagstone Reinsurance Holdings	1,119.1
Lehman Brothers Holdings	33,535.0	Umpqua Holdings	1,013.5
Suntrust Banks	25,270.2	KBW	886.6
Sempra Energy	16,054.1	National Penn Bancshares	828.7
Bear Stearns	13,105.4	Trustco Bank	790.7
Discover Financial Services	9,212.4	Community Banks	753.7
Icahn Enterprises	8,220.7	First Bancorp	731.8
Blackstone Group	6,616.2	Western Alliance Bancorporation	681.8
Everest Re Group	6,424.4	Conns	600.0
Delta Air Lines	5,005.9	Shenandoah Telecom	558.5
BOK Financial	3,657.6	Banner	508.9
Northwest Airlines	3,620.8	Tompkins Trustco	396.6
Jefferies Group	3,361.0	Flushing Financial	361.5
Student Loan	3,321.6	Bentley Pharmaceuticals	309.0
Seacoast Banking FL	\$279.9	Powersecure International	204.5
Novastar Financial	\$50.0	Monogram Biosciences	202.6
First Mariner Bancorp	47.6	United Security Bancshares	196.6
Alliance Bankshares	46.1	Cadence Financial	192.9
Sussex Bancorp	37.7	Cascade Financial	186.0
Comforce	37.6	Quanta Capital Holdings	185.8
Britton & Koontz Capital	37.2	Gateway Fin' Holdings	185.7
Dataram	28.2	First Mutual Bancshares	178.6
Community Central Bank	27.9	First Security Group	172.9
First Federal Of Northern MI Bancorp	21.8	Solitario Resources	168.2
Citizens Bancshares	21.2	MBT Financial	165.2
Seneca-Cayuga Bancorp	19.6	Bank Of Marin Bancorp	161.8
Oak Ridge Financial Services	17.8	Massbank	154.5
Tofutti Brands	16.4	Peoples Bancrust	138.4
Tenfold	14.3	IBT Bancorp	108.6
MSGI Security Solutions	11.3	Leesport Financial	108.2
American Surgical Holdings	9.9	LNB Bancorp	104.1
IParty	9.1	Golden Cycle Gold	90.8
Chancellor Group	5.2	White River Capital	73.0
American Home Mtg. Investment	4.3	Bank Holdings	62.3
Regal One	0.4	First Community	51.0
Green Energy Holding	0.3	Xstream Beverage Network	0.1

* R.G. Associates, Inc. holding. See note on back page.



Nothing could be further from the truth, as the above table showing the recent market caps⁶ of the early adopters shows. The biggest firms are the ones in the headlines for sure, but they're definitely in the minority. The median market capitalization is \$294 million, hardly making Statement 157 the province of only "large financial institutions."

The best thing about Statement 157 is that it lets investors know the quality of the figures presented at fair value through its hierarchy of fair values. In brief, fair values based on Level 1 inputs are of the highest quality: they're objective figures because they come from quoted prices in observable markets. Level 2 fair values are a step down in quality because, while there aren't observable fair values for the reported assets or liabilities, they can be imputed or derived from observable prices of other items. Level 3 fair values are the most suspect - though they could be completely valid - because there are no observable inputs for the estimation of fair values.⁷ The chart at left shows the hierarchy for the assets of the early Statement 157 adopters.

Where 157 Will Probably Be Deferred

The FASB will propose that Statement 157 will be deferred for one year, for all nonfinancial assets and nonfinancial liabilities, except for those items that are recognized or disclosed at fair value in the financial statements on a recurring basis. That scope leaves financial instruments unaffected by the deferral. Examples of items getting the deferral:

- Non-financial assets and non-financial liabilities that are measured at fair value in a business combination or other new basis event, but not re-measured at fair value in later periods
- Reporting units measured at fair value as part of a first step in goodwill impairment testing
- Non-financial assets and nonfinancial liabilities measured at fair value in a goodwill impairment test
- Indefinite-lived intangible assets
- Long-lived asset groups measured at fair value in an impairment test
- Asset retirement obligations that are measured at fair value at initial recognition, but are not measured at fair value later
- Liabilities for exit or disposal activities that are measured at fair value at initial recognition, but not measured at fair value later

⁶Source: S&P Research Insight data as of 11/8/2007.

⁷For more on the hierarchy of fair values, see Volume 15, No. 14, "Statement 157: Making Fair Value Reporting Work."

While much is made in the press of the perils of “mark-to-myth” Level 3 assets, it’s a surprisingly minor amount of the total assets carried at fair value for the Statement 157 adopters - a bit more than 6% of total assets. (More on the misconceptions surrounding fair value accounting later.) Below, a list of the companies adopting Statement 157 where the Level 3 assets were 1% or more of the total assets.

Where Level 3 Assets Live: Ranked By Asset Exposure

(\$ in millions)	Total 157-Applied Assets	Level 1 Assets %	Level 2 Assets %	Level 3 Assets %	Level 3 % of Total Assets
Blackstone Group	\$10,779.0	9%	0%	91%	52%
Conn’s	166	NA	NA	100%	42%
KBW	498	32%	53%	15%	8%
Discover Financial Services	2,475	0%	1%	99%	7%
Goldman Sachs Group	584,863	22%	69%	9%	6%
White River Capital	10	NA	NA	100%	5%
Morgan Stanley	760,821	18%	73%	9%	5%
Novastar Financial	558	NA	60%	40%	4%
Bear Stearns	219,960	18%	74%	8%	4%
Wells Fargo	129,107	47%	36%	16%	4%
Citigroup	1,242,399	26%	67%	7%	4%
Lehman Brothers Holdings	269,794	35%	57%	8%	4%
Student Loan	773	NA	1%	99%	3%
J P Morgan Chase & Co	1,257,328	24%	73%	3%	3%
Sempra Energy	6,644	24%	68%	8%	2%
Merrill Lynch	581,487	16%	81%	3%	1%
National Penn Bancshares	1,304	2%	92%	6%	1%
Bank Of America	694,588	9%	88%	3%	1%
Jefferies Group	7,101	50%	45%	5%	1%
First Bancorp	1,748	23%	66%	11%	1%

Sure, you expected **Blackstone Group** to be near the top of the list - but **Conn’s**? The retailer had securitized receivables balances and retained a large interest in them, which is its only Level 3 asset. Below, the Statement 157 adopters with Level 3 assets worth more than 1% of stockholders’ equity, ranked by stockholders’ equity exposure.

Where Level 3 Assets Live: Ranked by Equity Exposure

(\$ in millions)	Total 157-Applied Assets	Level 1 Assets %	Level 2 Assets %	Level 3 Assets %	Level 3 % of Equity
Blackstone Group	\$10,779	9%	0%	91%	215%
Morgan Stanley	760,821	18%	73%	9%	171%
Goldman Sachs Group	584,863	22%	69%	9%	153%
Bear Stearns	219,960	18%	74%	8%	139%
Lehman Brothers Holdings	269,794	35%	57%	8%	110%
Citigroup	1,242,399	26%	67%	7%	68%
Conns	166	NA	NA	100%	54%
Student Loan Corp.	773	NA	1%	99%	48%
Novastar Financial	558	NA	60%	40%	46%
Wells Fargo	129,107	47%	36%	16%	45%
Merrill Lynch	581,487	16%	81%	3%	43%
Discover Financial Services	2,475	0%	1%	99%	42%
J P Morgan Chase & Co	1,257,328	24%	73%	3%	32%
First Bancorp	1,748	23%	66%	11%	25%
Jefferies Group	7,101	50%	45%	5%	19%
KBW	498	32%	53%	15%	17%
Bank Of America	694,588	9%	88%	3%	16%
National Penn Bancshares	1,304	2%	92%	6%	15%
White River Capital	10	NA	NA	100%	9%
Sempra Energy	6,644	24%	68%	8%	6%
Suntrust Banks	34,548	22%	75%	2%	5%
BOK Financial	5,543	1%	98%	1%	4%
First Community	155	1%	98%	1%	2%
United Security Bancshares	104	88%	11%	1%	2%
Tompkins Trustco	664	90%	10%	0%	1%
Western Alliance Bancorporation	679	NA	99%	1%	1%

It’s easy to know what the Level 3 assets are worth relative to equity; it’s hard to know if those values are trustworthy. Right or wrong, markets are saying they’re not worth much - and that will probably change the behavior of companies going forward. Either they’ll forgo dicey investments in securities that don’t have observable values - or they’ll try to make Level 3 assets look like Level 2 assets.

Statement 159, “The Fair Value Option for Financial Assets and Financial Liabilities,” has come in for almost as much press-bashing as Statement 157 - mostly due to the fact that the standard permits electing firms to measure debt at fair value. The strange consequence: a firm can see the value of its debt slide in the marketplace due to credit concerns, and it will then record a gain. Coupled with the potential for Level 3 valuation mischief, Statement 159 adopters have generated vast suspicion among investors, whether or not it’s deserved. Intuitively, it’s hard for investors to get used to the idea that a deterioration in credit (subliminal message: *punishment*) should result in an income statement gain (subliminal message: *reward*).

A search for companies adopting Statement 159 yielded the 68 firms listed below. Notice that 31 of them applied Statement 159 to debt issues or other liabilities.

Where Statement 159 Lives: Through 2007’s First Half

(\$ in millions)	Total Gains/ (Losses)	Liability Gains/ (Losses)	Pretax Income	Total G/L %	Debt G/L%	Total Gains/ (Losses)	Liability Gains/ (Losses)	Pretax Income	Total G/L %	Debt G/L%	
Abbott Laboratories*	--	--	\$2,093.3	--	--	Jefferies Group	--	--	\$231.9	--	--
Alliance Bankshares	(\$0.5)	0.0	1.7	-29%	-2%	KKR Financial Holdings	(14.1)	--	102.3	-14%	--
American Home Mtg. Investment	--	--	--	--	--	Leesport Financial	0.0	0.0	3.4	-1%	-1%
Bank Holdings	(0.1)	--	2.0	-4%	--	Lehman Brothers Holdings**	--	--	3,578.0	--	--
Bank Of America	(207.0)	29.0	16,483.0	-1%	0%	LNB Bancorp	0.3	--	2.9	9%	--
Bank Of Marin Bancorp	0.7	--	9.5	7%	--	Massbank ¹	0.5	--	5.3	8%	--
Banner	(0.7)	(0.2)	21.8	-3%	-1%	MBT Financial	--	--	10.0	--	--
Britton & Koontz Capital	(0.4)	--	1.2	-30%	--	Merrill Lynch	1,133.0	855.0	6,028.0	19%	14%
Cadence Financial	--	--	4.6	--	--	Monogram Biosciences **	(0.8)	--	(17.7)	5%	--
Cascade Financial	0.7	0.2	11.7	6%	2%	Montpelier Re Holdings	15.6	--	145.9	11%	--
Citigroup	703.0	181.0	15,979.0	4%	1%	Morgan Stanley	12.0	(307.0)	6,934.0	0%	-4%
Citizens Bancshares	0.1	0.1	1.5	7%	7%	National Penn Bancshares	0.0	0.0	40.5	0%	0%
Comforce	--	--	3.5	--	--	Novastar Financial	63.5	63.5	(193.5)	-33%	-33%
Community Banks	0.0	--	22.6	0%	--	Oak Ridge Fin'l Services	0.1	--	0.5	24%	--
Community Central Bank	0.2	0.2	1.4	11%	11%	Peoples Bancrust	(1.5)	--	3.2	-47%	--
Conns	(0.4)	--	34.3	-1%	--	PMA Capital ¹	(0.5)	--	6.1	-8%	--
Deluxe	--	--	111.6	--	--	Quanta Capital Holdings ¹	(5.9)	--	(3.4)	171%	--
Devon Energy	152.0	--	1,992.0	8%	--	Seacoast Banking Of Florida	--	--	11.5	--	--
Discover Fin'l Services	--	--	704.0	--	--	Seneca-Cayuga Bancorp	--	--	--	--	--
Everest Re Group	109.8	--	710.8	15%	--	Shenandoah Telecom	--	--	16.9	--	--
First Bancorp	(56.6)	(56.6)	59.0	-96%	-96%	Student Loan	(1.9)	--	185.4	-1%	--
First Community	0.0	--	2.3	1%	--	Suntrust Banks	158.9	120.5	1,745.1	9%	7%
First Fed'l Of Northern MI Bancorp	0.2	0.1	0.2	78%	74%	Sussex Bancorp	0.0	--	1.4	-0%	--
First Mariner Bancorp	(0.1)	0.7	(6.2)	1%	-12%	Tompkins Trustco**	(0.2)	--	17.9	-1%	--
First Mutual Bancshares	0.7	0.4	6.8	10%	6%	Trustco Bank	0.6	--	30.2	2%	--
First Security Group	0.0	--	8.5	-0%	--	Umpqua Holdings	0.6	0.6	63.1	1%	1%
Flagstone Reinsurance Holdings	8.0	--	64.4	12%	--	United Security Bancshares	0.1	0.1	11.0	1%	1%
Flushing Financial	0.2	1.2	16.0	1%	7%	Validus Holdings	(4.5)	--	127.5	-4%	--
Gateway Fin'l Holdings	(0.2)	0.1	7.0	-3%	1%	Valley National Bancorp	7.9	1.3	123.3	6%	1%
Goldman Sachs Group	(1,137.0)	(1,208.0)	8,290.0	-14%	-15%	Venture Fin'l Group	0.2	0.2	9.1	2%	2%
HSBC Finance	14.0	14.0	949.0	1%	1%	Wells Fargo	142.0	--	6,644.0	2%	--
IBT Bancorp	0.0	--	4.3	1%	--	Western Alliance Bancorp.	(2.4)	0.7	29.2	-8%	2%
IPC Holdings	9.7	--	105.2	9%	--	White River Capital	0.2	0.2	13.6	1%	1%
J P Morgan Chase & Co	(258.0)	(1,407.0)	13,683.0	-2%	-10%	Xstream Beverage Network	(11.7)	NA	NA	--	--

* R.G. Associates Inc. holding. See back page.

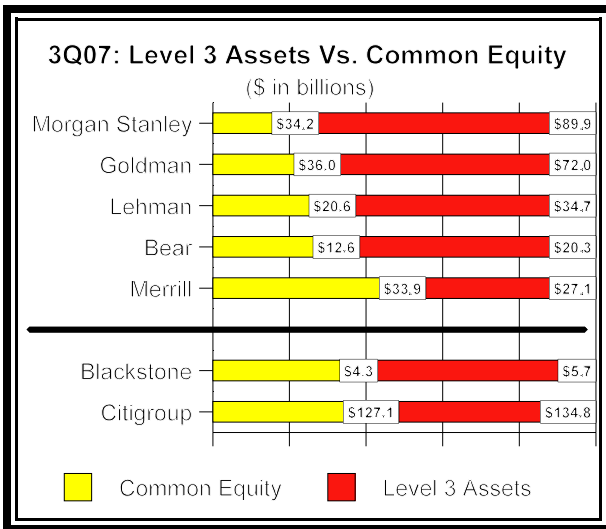
** No gains/losses disclosed for 159-applied debt; however, firm discloses that it applies Statement 159 to debt.

Italicized firm names indicate no publicly traded equity.

¹ Firm disclosed only net-of-tax amounts.

Source: Company 10-Q filings, except for pretax income data sourced from S&P Research Insight database.

Slight irony: in the first half of 2007, the firms with the largest impacts on pretax income from Statement 159 fair value changes were *not* the companies now in the news for making lousy decisions on the merits of investing in subprime mortgages or collateralized debt obligations. The 159 effects for firms like **Merrill Lynch**, **Citigroup** and **Morgan Stanley** were minimal compared to the rest of the bunch. Notable exception: **Novastar Financial**. Notice that the firm reaped some large gains from revaluation of debt and still had some serious losses. At the time of this writing, the firm teeters on insolvency. Looking for gains like those should stimulate critical thinking on the part of investors.



The chart at left captures the recent angst over fair value reporting: now that everyone knows what “Level 3” means, they use it as a measure of firm riskiness. The thinking goes like this: if all Level 3 assets are more likely worth zero, what would it mean to equity? As the graph and table show, there’s not much good that would come to equity for the five SEC-monitored “consolidated supervised entities” at the top of the page. Nor would it be cheerful a prospect for two other Statement 157 poster children, **Blackstone Group** and **Citigroup**.

L3 Assets/Equity

CSEs:

Morgan Stanley	263%
Goldman Sachs ¹	200%
Lehman Brothers	168%
Bear Stearns	160%
Merrill Lynch	80%

Others:

Blackstone Group	131%
Citigroup	106%

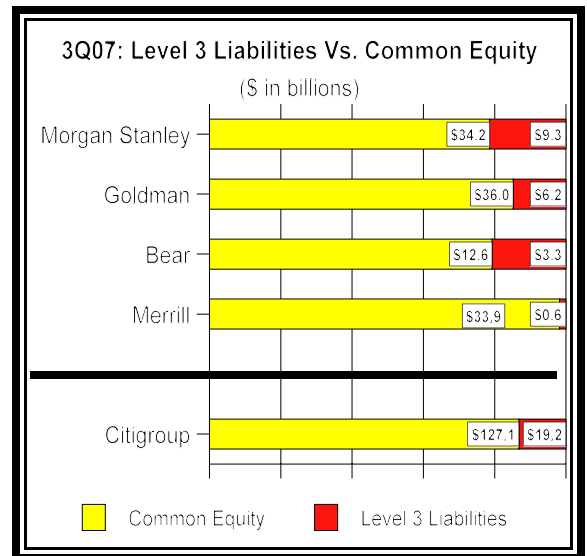
¹Includes \$21.1 billion of Level 3 assets on GS balance sheet for which it has no economic exposure.

The problem with that thinking is that it *automatically* presumes the right answer is zero, or that asset values have to be “juiced.” Neither presumption is necessarily correct. Why not extend such thinking to Level 3 liabilities as well? Is a Level 3 asset the *only* Level 3 value that should automatically be judged worthless? Or is a Level 3 liability presumed automatically to be understated?

If Level 3 liabilities are really worth zero, then there should be some boosts to equity, too. The chart at right shows the third quarter Level 3 liabilities for the same companies in the above chart. (Exceptions: **Lehman Brothers** and **Blackstone Group** had no Level 3 liabilities reported at the end of the third quarter.) The Level 3 liabilities aren’t much of an offset to Level 3 assets, but the real point is that thinking needs to be extended to more than just looking at one figure in a footnote.

That sums up the thinking about fair value reporting right now: in getting used to it, observers will look only at a part of the equation without asking more. It’s encouraging to see that they’re getting used to the idea of a hierarchy of fair values, but there’s more to it than that.

Firms compound the problem by going for “minimalist” disclosures. Level 3 values might look a lot less threatening if more was discussed about how they came to be, why there’s no market for them, how they relate to other items on the balance sheet (or not on the balance sheet), and more dissection of how values were determined. On the other hand, maybe they’d look even more threatening.



III. Fair Value Myths & Misconceptions

Where does one begin? Nobody seems to have much to say about Statements 155 or 156, so it's hard to tell whether folks get them or not. Not the case with Statements 157 and 159, however; there's plenty of fear and loathing of fair value right now. Let's begin with the most overarching misconception, and move on from there.

1. Statement 157 will greatly expand the use of fair value accounting.

Wrong. It would be absolutely correct to say that Statement 157 will greatly expand the disclosures related to the use of fair value accounting. That would be something to cheer about. Instead, commentators are panicking over the stories told by the disclosures - which shows that at least people are reading them.

Statement 157's most important effect on accounting: it brought order to the hodge-podge of accounting standards dealing with fair value before its issuance. It created more rigorous requirements for the estimation of fair values when estimation is necessary. It created a uniform way of expressing the quality and reliability of reported fair value amounts - the Level 1, 2, and 3 hierarchy.

Wall Street and the financial press have taken to understanding that hierarchy rather quickly, considering the limited application of the standard so far. The problem is that the disclosures tell uncomfortable truths about the reported fair values - facts that always existed but went unreported. "Level 3" assets have always existed in balance sheets, and their valuations could have helped managers make earnings targets - but investors were never in a good place to evaluate them. Now they have the ability to evaluate balance sheets and earnings veracity - but can they handle it? Or will they simply blame the messenger for the news they don't like?

So far, the relationship between Statement 157 reporting and investors can be summed up in the famous line from Jack Nicholson's character in the movie *A Few Good Men*: "You want the truth? You can't *handle* the truth!"

2. Statement 157 will cause massive asset writedowns once it's implemented.

Stupid lending and investing causes massive writedowns. Accounting standards only tell the story of stupidity, and only when they're allowed to. Statement 157 just provides a framework for companies to communicate their involvement with assets and liabilities carried at fair value. Now that firms will have to be more responsible for communicating what assets and liabilities are worth, they may take a sharper pencil to calculated fair values. If more writedowns occur because of Statement 157, it's not because it changed valuation principles; it will be due to more care being taken because of the sunlight the standard will create.

An analogy to stock option reporting might help. When firms only disclosed the pro forma effects of stock option compensation in the footnotes, the calculations of options' estimated fair value were sometimes sloppily performed. Once the expense figures moved into the income statement, many firms tightened up on valuation assumptions. Some might have been gamed, but some changes may have been the result of increased precision because firms were finally taking the standard seriously.

So it is with fair values: firms might have been finessing Level 3 valuations for years and produced whatever kind of numbers they wanted to show. Now that they have to provide visibility into those valuations, they might be getting serious about how they're calculated.

3. Statement 157 creates artificially valued assets and liabilities because of its Level 3 requirements.

Statement 157 doesn't create Level 3 assets. (Or liabilities, either.) To repeat: anything that is reported as a Level 3 asset or liability may have been a purely estimated figure for many years past. It's just that the nature of the items was never discussed. Now we have global paranoia about the scale of Level 3 assets compared to capital.

Maybe firms will sober up about the investment activities that lead to these kinds of critters instead of rushing pell-mell after growth at all costs.

4. The fair value numbers produced by Statement 157 will be inherently unreliable and "fictional." The accounting was just fine before.

What was in place before Statement 157 - wholesale sanctification of historical cost? No. If an asset was impaired, it had to be written down to what it was worth, period. And as mentioned before, Statement 157 doesn't make firms produce more fair value numbers than before: it just makes them talk about it more.

This gripe is often leveled at Statement 157 in general, but it only comes close to making sense in the case of Level 3 assets and liabilities. In the case of impaired assets, it might help to think of their carrying value as a range. At one end of the range is zero: you throw your hands up, say it's impossible to value the asset and you'll never get another penny out of it again. At the other end of the range is the original amount paid for it. Unless the asset is truly worthless, neither end of the

range is right. Before Statement 157, firms couldn't simply pick one or the other end of the range and run with it; they always were required to carry the asset at what it's worth, and that's somewhere in the infinite middle of the range. Statement 157 doesn't change that one iota.

The unique situation with Statement 157 is that it arrives at a time when markets for collateralized debt obligations and other esoteric financial instruments have dried up and Level 1 or 2 values are unavailable. Should firms report zero or original cost in those cases? Neither answer is right; in fact, both are probably exactly wrong. (Again, unless the assets in question are genuinely worthless.) The estimated value in between the two endpoints is vaguely right - a better place to be, and the disclosures about the estimated values should be the investors' friend in judging how much truth they can handle.

5. Firms are making up earnings by marking down their liabilities under Statement 159.

No doubt about it: it's just plain counter-intuitive for firms to reap gains from seeing the value of their debt decrease - especially when the cause of the decrease is due to a deterioration of credit status. Pundits have probably had more fun with this aspect of Statements 157/159 than any other.

Put aside knee-jerk reflexes for a few moments and consider some things you don't hear about those gains.

- *Other gains go through the income statement and get stripped out of earnings by investors.* In fact, just about any decrease in a liability improving earnings is viewed with suspicion by investors; debt forgiveness is just not a sustainable source of earnings. For that matter, neither are gains on assets sales. You don't usually see investment arguments recommending that earnings containing these kinds of things be capitalized by investors.

Analysts and investors are used to plucking non-operating items out of earnings. These should be no different.

- *If a liability-devaluation gain occurs due to credit deterioration, analysts and investors shouldn't stop at just plucking the gain out of the earnings stream.* There are some serious questions that need to be asked:

- Was there an impaired asset or group of assets on the other side of the balance sheet that caused the credit deterioration? If so, how do the conditions leading to that writedown affect the outlook for the firm?

- If there was no asset impairment recognized at the same time as the gain, should there be one? What has changed in the company's environment that makes credit-paying ability a real problem, but doesn't pose a harsher reality for the value of assets? Does it have to do with an unrecognized asset - or is it another looming liability not yet recorded?

- *Devalued debt could spell balance sheet management opportunities.* Suppose a firm realizes liability-devaluation gains as the result of interest rate changes. That shows shareholders that the firm's managers have an opportunity to buy back bonds more cheaply. Even if the devaluation gains come from, say, a slight ratings agency downgrade, there could still be a treasury bond opportunity: there might be sufficient assets for buying in bonds, perhaps even from assets that contain unrecognized appreciation like real estate.

6. Liabilities are contractual obligations. Why show them at fair value? Shareholders can't spend those gains.

Liabilities called "bonds" are assets on a firm's balance sheet, when they've been issued by another firm. They're contractual obligations, too. When they decline in value because of interest rates or dubious credit-paying ability, should they *not* be written down to what they're worth just because they're contractual obligations? It's not an argument to be made with a straight face.

When bonds held as assets increase in value, that increase in value can go into earnings, if the company elects such treatment. (That's not new; that's the way it's been since the issuance of Statement 115 in 1992.) Shareholders don't get showered with dividends from those gains, either. In substance, a gain from a devalued liability is no different from unrealized appreciation on an asset.

7. Firms will try to move as much as possible into Level 3 valuations because they can manipulate them.

Anyone making this argument has to be really stretching for a reason to dislike Statement 157. So far, neither the markets nor the press have not taken a shine to companies showing Level 3 valuations. They're financial lepers, so it's a little hard to believe that firms would want to show more Level 3 valuations than they must. If anything, you'd have to believe that they'll try to somehow rationalize their Level 3 valuations as Level 2 to escape the incremental disclosures and shellacking.

Those are the chief myths and misconceptions noted thus far by this observer. No doubt there will be more once fair value reporting becomes prevalent in 2008. If you find more, you're welcome to send them along.

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