

FAIR VALUE AND CORPORATE GOVERNANCE

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Abstract

Recently two discussion papers on a new paradigm for the International Accounting Standards (IAS) have attracted much controversy. In the new proposed paradigm the definition of fair value used in the US standard SFAS 157 for financial instruments and acquisitions is extended to all the IAS and stewardship is abolished as a separate objective of financial reporting. In this work, we revise the reasons behind these proposals and the criticisms they are attracting. In the light of this analysis and especially focusing on the corporate governance concerns, we discuss the opportunity for the IASB to retrace their steps back and to avoid pushing the fair value approach too far.

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In November 2006 the IASB published a discussion paper (DP) "Fair Value Measurements" in which it proposed a new definition of fair value. This last decision is part of a process in which both the accounting standards setting bodies, IASB and FASB, are changing the accounting paradigm since, within traditional accounting, financial statements seem to have lost part of their relevance over time (Francis and Schipper, 1999).

According to the current definition (IAS 16,6), "fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction". These measures are used in accounting for financial instruments (IAS 39) and in agriculture (IAS 41). With the introduction of fair value measures for some assets, we observe in the balance sheet a coexistence of different measurement attributes (historical costs, entity-specific values, fair values) for different assets as a result of conventions and differences in practice that have evolved over time.

Moreover, also the fair value measure is not unique; in fact the above definition of fair value is consistent with different current market value measures such as entry value, exit value or net realisable value. According to Barth (2006): "these differences generate financial statements that are internally inconsistent" and complicate the interpretation of accounting summary amounts.

To solve this problem the IASB in the DP of November 2006 propose adopting the definition of fair value used for financial instruments and acquisitions in the US standard SFAS 157 (2006) and extending it to all of IAS. According to SFAS 157 fair value is an exit value, it is non entity specific and transaction costs are not included.

The decision of IASB is being criticized for two main reasons: the definition of fair value as an exit

value and the introduction of a bigger degree of subjectivity within the new fair value accounting.

The IASB seems to think that exit values are the best indicators of future cash flows for all the assets. Notwithstanding, according to the European Financial Reporting Advisory Group (EFRAG) this definition is too restrictive⁷. They do not believe that there can be one concise definition of fair value. The mixed measurement system is justified on the basis that in different circumstances different measures will better reflect the future cash-flows. For instance, where assets are not held for disposal, replacement costs may be better (Page and Whittington 2007). EFRAG question also the idea that exit values should always be non-entity specific. If this is correct for financial instruments where deep and liquid markets exist, this is not appropriate for assets where there are no active markets. In these cases it is not clear why fair value based on a hypothetical transaction using non-observable inputs should be more objective rather than an entity settlement value. Moreover, as regards transaction costs, the inclusion should depend on the specific nature of the transaction cost involved. For example, the cash-flow receivable from the sale of an asset will be the sale price less the selling costs.⁸

The second issue related with the new fair value accounting is that it will increase the degree of subjectivity of financial statements in case it is extended to non-financial assets and liabilities.

⁷ Comment letter on the discussion paper Fair Value Measurement, april 2007 www.efrag.org

⁸ According to Benston (2008), a balance sheet with all the assets and liabilities measured at exit value will be useful only to some creditors and shareholders of companies that face likely liquidation. Moreover this measure of liquidation value will also be incomplete because of the non inclusion of transaction costs.

According to SFAS 157 entities should use inputs for measuring fair value according to a three level hierarchy. In Level 1 inputs are quoted prices in active markets. In Level 2 observable inputs are “quoted prices for similar assets or liabilities in active markets,” or “quoted prices for identical or similar assets or liabilities in markets that are not active”. In level 3, where there are no markets for comparable assets, valuations must be based largely on the estimations and judgements of the valuing entity itself.

Only for financial instruments there are deep and liquid markets but when we move to non financial assets and liabilities we are forced to go down through the hierarchy (Walton 2006). This translates in a bigger relying upon managers’ estimates. Benston (2008) strongly criticizes the eventuality of extending SFAS 157, within GAAP, to assets and liabilities different from financial instruments. In his view, dishonest and opportunistic managers are going to be facilitated in their efforts to manipulate reported net income. External auditors are just designed to uncover and prevent such frauds, but, with fair-value accounting, they will be faced additionally with the task of attempting to verify and attest managers’ determinations of the amounts for which assets could be sold and liabilities assumed. This is also confirmed by the case study-based examination conducted by Gwilliam and Jackson (2008) on the use of fair value accounting by Enron in the years immediately preceding its collapse. In the 90s Enron lobbied the SEC and obtained to use mark to market accounting for its gas trading business. A significant proportion of the assets shown at fair value were valued not on the basis of market prices but on the basis either of management estimates or third party valuations. Enron employed a range of third parties to provide mark to market valuations including Andersen, KPMG Consulting, PricewaterhouseCooper. These valuations, which were normally provided for significant fees, were frequently highly optimistic, and, in some cases not independent. Also Benston (2006) claims that Enron’s use of fair-value accounting was substantially responsible for its demise.

Behind this debate regarding the eventuality to extend fair value measure a la SFAS 157 also to non-financial asset and liabilities, there is the broader question on what is the objective of financial reporting. It does not come as a surprise that in the same year (2006) of the DP on the fair value measurement, the IASB together with FASB proposed in the DP *Preliminary Views on an improved Conceptual Framework for Financial Reporting* that the converged framework should specify in a new fashion the objective of financial reporting. Traditionally, the objective of financial reporting is the “decision usefulness” and then there are two sub-objectives “valuation usefulness” and “stewardship usefulness” (Gassen, 2008). In their current joint project IASB and FASB identify only one objective

of financial accounting, that of providing information that is useful to users in making investment, credit and similar resource allocation decisions (decision usefulness). They further state that decision-useful information should help investors to assess the entity’s future cash flows (valuation usefulness). Thereby the Boards appear to be implicitly narrowing the focus of decision usefulness on valuation usefulness. Moreover, arguing that information relevant to assessing stewardship will be encompassed in the objective of decision usefulness, they no longer view stewardship and valuation usefulness as alternative sub-objectives.

Two IASB Board members disagreed with this and argued in the Alternative View in the DP that stewardship should be identified as a separate objective. This view is supported also by the 78% of the respondents on the comment letters the IASB and FASB received about the DP⁹.

Stewardship is inherently linked to agency theory. If owners assign stewardship of their company to the management, they wish to have the ability to oversee management behaviour to ensure that it is aligned to the owners’ objectives and no misappropriation of the company assets takes place. In order to do this they need information that enables them to review the company’s performance.

Stewardship was originally the primary objective of financial reporting and this constitutes the basis for the legal requirements of audited financial reports. It was only after the development of capital markets that a further focus for financial reporting on cash flow generation developed to support the decisions of investors.

In a comment supportive of the Alternative view, Hermes¹⁰ claims that ordinary shareholders should be considered the primary users of financial reporting. The information needed by shareholders for their decision whether to keep their resources in the hands of the current management requires considerations of the potential returns from a reshaping of the business and from its being run more effectively. It requires backward-looking information to highlight the performance of the investment history of current management.

On the same issue, EFRAG and other European standard-setters published a paper to express the European point of view on the objective of financial reporting (see footnote 4). They demonstrate that valuation and stewardship are alternative objectives giving some practical examples. One of these regards specifically the asset valuation. If stewardship is an objective, operational assets should receive a current entity-specific valuation expressed by value-in-use

⁹ “Stewardship/accountability as an objective of financial reporting: A comment on the IASB/FASB conceptual framework project” written by EFRAG and other European countries standard setters, www.frc.org.uk

¹⁰ Hermes is one of the largest pension funds in the City of London

and current replacement cost in order to convey the potential contribution to productivity a company is able to derive from the assets. By contrast, the valuation objective requires the exit value. This approach assumes that investors are only interested in how market participants would value such an asset rather than the potential benefits the company derives from the use of the asset in its business.

The suggestion that valuation usefulness and stewardship are alternative objectives is also confirmed empirically. Gassen (2008) documents that the valuation usefulness of financial accounting information is consistently negatively related to its stewardship orientation.

It has been conventional to contrast historical cost valuations which are seen to be reliable (necessary for stewardship) but may not be considered relevant (necessary for valuation of investors), with current or market valuations which may be seen as more relevant but less reliable. An important aspect of the current IASB Framework is the explicit reference to the possibility of a trade-off between relevance and reliability and in the accounting practice this is frequently invoked as a reason for not using fair value measurements. On the other hand, in chapter 2 of the DP of the new framework, consistently with the restatement of the objective in Chapter 1, this trade-off is removed. Relevance should be considered first because it is essential and the *faithful representation* (the new word used to express reliability) should be considered next.

Conclusions

We find that the decisions of the IASB to give one concise definition of fair value as an exit value and to abolish stewardship as a separate objective of financial reporting are intimately correlated. In this way the IASB aims to obtain increased coherence of measurements methods within the balance sheet, increased relevance of financial statements and convergence with the US GAAP.

However, we believe that it is not convenient to have a single preferred measurement method. The definition of exit value is appropriate for financial instruments where markets are active and liquid but it does not seem not be valid for non-financial assets and liabilities. Moreover, the increased reliance on management estimates linked to the measurement hierarchy will offer management both the scope and the temptation to manipulate reported net income. Furthermore, we support the idea that stewardship should be a distinct function of financial reporting. We believe that financial reporting should provide information that is useful input to investors' valuation models, rather than direct valuation of future cash flows (Whittington 2007). It is important here to recall the famous remark of Clemenceau that war is too important to be left to the generals.

In conclusion, our view is that the IASB should retrace their steps back. The Board should place more emphasis on the stewardship orientation of financial statements and have a less ideological approach to the definition of fair value.

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