Fair values in global accounting - ideal way or wrong track?

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'Mirror, mirror, on the wall, which is the fairest value of all?' [With apologies to Jacob and Wilhelm Grimm.]

Dear President, Dean, Ladies, Gentlemen, Professors, Doctors, Assistants and Students,

Thank you very much for inviting me to be your Ludwig-Erhard-Foundation Professor at Bayreuth University for 2004. I am greatly honoured, and glad to be here again to see old friends and make new ones. I am here for two weeks to participate in a seminar on international accounting with the advanced undergraduate accounting students; to give this lecture; and to lecture on 'issues in global accounting'.

'Global accounting' is my reason for being here - the real prospect that at least all the listed companies of the major countries of the world will prepare their accounts using the same rules. A spectacular step towards this goal was the EU's decision in 2002 that all its listed groups must prepare their consolidated accounts using International Accounting Standards or International Financial Reporting Standards (IAS or IFRS). Following the EU's decision, Australia, New Zealand, Russia and China, agreed to implement IAS/IFRS. By 2005, 91 countries will either allow or require IAS, and it looks likely that the US will join, allowing companies listed there to use IAS/IFRS without reconciliation to US GAAP from 2007. We used to talk about 'international accounting', but this is *global* accounting!

I have followed this historic development (that began in earnest the 1970s) through my teaching and research for the last 15 years or so. Now, against all the expert predictions, we are on the way to global accounting - at least, that is the destination. To get there will require continued agreement by many countries, based on mutual understanding. This is the main reason I am here today. I have come to meet German scholars and others interested in discussing the direction of IAS/IFRS as Germany makes major changes to its well-established system of accounting and taxation; to offer a critique of the type of 'Anglo-Saxon' global accounting that is emerging under US (and UK) influence; and to encourage you to join me in developing this critique!

I should first explain something about the title of the lecture; the rest will become clear. Eighteenth century British merchants, industrial entrepreneurs and authors of accounting books often talked of accounting as the 'mirror' that reflected reality and allowed them to control their enterprises. Today, our image of accounting is not so clear and, as Enron has reminded us, the images it provides users may not reflect economic reality. Accounting is a large and complex subject, and is getting larger and more complex by the day as the global economy and global society develops apace. To face the challenges, we must go back to basics. Nothing is more basic in accounting than what we mean by 'value', particularly the idea of 'fair value' accounting. US accounting scholars (such as William Paton and Andrew Littleton) used this phrase in debates of the 1930s and 40s, and resurrected it in the 1960s in US utility rate-setting cases. Today 'fair value accounting' it is on the lips of everyone with a specialist interest in the subject. (Some evidence of this is that a Google search produced about 5,360 hits on 'historical cost accounting', but 11,900 for 'fair value accounting'.)

'Fair value accounting' is the topic of my lecture today. I shall explain what 'fair

value' is; why the International Accounting Standards Board's (IASB) predecessor (the International Accounting Standards Committee (IASC)) made increasing use of them; and why, many believe, the IASB wants a comprehensive fair value system. Finally, I shall explain my view that the IASB's approach to fair value accounting is the wrong track to the future of global accounting.

I will try to convince you that 'fair value accounting' is not an arcane subject, fit only for accounting professionals and academics, but raises important issues for all those affected by the measurement of business performance (investors, government, workers, customers, creditors) - in short, everyone. I will argue that the IASB's approach to fair value accounting redefines what we mean by 'value' in accounting and, hence, what we mean by business success – what we mean by 'profit' – that should be the subject of public discussion. My intention today is to provide non-accountants with an introduction to some of the major issues.

At its broadest, 'fair value' simply means the market price - the value placed on a product or service in a 'fair' market. However, as in reality there are potentially many market prices, to decide which price is *the* 'fair value' we first need to be clear about the fundamental aim of financial reporting to shareholders, creditors and other outsiders. I will then ask what we mean by 'fair values', and show that aim we give accounting determines which of the many 'fair values' we could use is (or are) the 'fairest of them all'. Finally, I will draw some conclusions.

The primary aim of financial reporting: accountability or decision-relevance?

In the modern Anglo-Saxon world, large corporations relying heavily on equity capital from large numbers of widely-diversified shareholders, and relatively little on debt finance from banks, dominate economic activity. Strongly influenced by the works of economists Irving Fisher and John Canning, during the late 1960s the US accounting authorities concluded that, within the context of well-developed capital markets, the aim of financial reporting should be to help equity investors decide whether to buy, sell or hold shares. They called this aim 'decision–relevance', and concluded that traditional aim of 'accountability' (explained below) was no longer relevant.

We can challenge the historical premise of the FASB's conclusion that growth in the importance of stock markets justified changing the aim of accounting. Stock markets have been important for much longer in the Anglo-Saxon world than the spectacular flowering of the capital markets system in the US since the end of World War II might suggest. Joint stock companies became the driving force of industrial development in Britain from the end of the eighteenth century, and were supreme from around 1850. Widely held joint stock companies became the dominant force in North America only at the end of the nineteenth century, and they grew to spectacular proportions during the early twentieth century. Well before then, however, British judges, businessmen and accountants had forged the traditional principles that still underlie the bulk of financial reporting practice, including US practice. There is, in short, nothing in the history of capital markets to justify changing the aim of accounting.

Throughout the history of capital markets, outside investors have demanded accounts to make management 'accountable' to them for their capital and its profitable employment – to give them ultimate control of management. How does accountability do this? What we mean by 'accountability' in accounting comes from the two meanings of the English word 'account'. One meaning is the demand of a principal that a subordinate agent produce an 'account' or *reckoning* of his or her performance. The other meaning is that the principal then *judges* the account against a target and

punishes or rewards the subordinate accordingly. In modern management control theory, we call accountability 'results control'. Accounting therefore gives the principal control of the agent by making him or her accountable for target results, for example, a required return on capital. (The alternative is 'action control' - telling managers what to do - but this is not possible for ill-informed outsiders.) Managers know that the principal will judge an objective measure of their performance against a target, and that the principal will punish or reward them on the outcome. This motivates them to engage in what modern management control theory calls 'feedforward control', that is, planning ahead and taking corrective actions to achieve targets (just as the prospect of examinations should motivate our students to work!).

I have said that the aim we choose for accounting will determine what we think is a 'fair value'. My next questions, therefore, are: what is 'fair value', and how do the different aims lead to different fair values? Finally, I will ask which aim is the most

6

important, and which, of the many alternative fair values that could stare back at the users from the mirror of accounting, is the 'fairest value of all'?

What are 'fair' values?

The English word 'fair', like many other English words, has two main meanings. It either means 'beautiful', or it means 'unbiased'. The meanings are quite distinct.

In Medieval English (Latin/Old French) a 'fair' was a periodical gathering of buyers and sellers (usually on a holiday) where rules from a charter, statute or custom governed the trading. The prices from such are market were 'fair' or unbiased because they came from the application of agreed rules. In modern English, use of the word 'fair' often means unbiased ('just', 'middling', 'average').

By contrast, in Old English (Scandinavian/Gothic), 'fair' meant 'beautiful to the eye', as it still does in modern English when we use it to mean 'free from fault'; 'favourable'; or to describe blond skin or hair.

These two English meanings of 'fair' are clearly different. It is one of the joys (and, perhaps, one of the curses) of the English language, that we quite often have the same word spelt in the same way having different meanings. (Other examples are, 'right' meaning legal or moral power, and 'right' meaning the opposite to left; 'fine' meaning good or alright, and 'fine' meaning a financial penalty; and, of course, the word 'account' itself).

It certainly a curse on students of accounting that we now, in effect, have the two meanings of the word 'fair' to describe accounting values - unbiased and beautiful – that, we shall see, the authorities do not clearly distinguish!

To understand the meaning of English words such as 'fair' we must (as in every language) understand the context of its use. In accounting in Britain, the traditional (and legal) context for using the word 'fair' has, since the seventeenth century, always been 'true' (or something that meant this, e.g., 'proper'). Accounts must be 'true *and* fair' - both together, and in the financial statements themselves, not in the supporting notes. By contrast, as we shall see, the IASB only wants accounts to be 'fair', to be 'beautiful' as well as unbiased! The question for us is whether, in its obsessive search for theoretical beauty, the IASB has lost touch with reality?

In the remainder of the lecture I will argue that accounting should not seek the IASB's theoretically beautiful ideal. That, indeed, accounting has its beauty, but it is the practical beauty of a well-oiled, excellently designed machine, based on the best that engineering science can offer. (The images it conjures up for me are of powerful locomotives, steel plants, and German motor cars, not English roses or the Mona Lisa!)

The IASB has made no official statement to this effect, but it is clear that it wants to use more 'fair values' because it believes them to be the most theoretically perfect, most beautiful, measures of value. Fair value is important in IASs 16, 18, 20, 21, and IFRS 1, and is central to IASs 32, 39, 40 and 41 and IFRS 2, 3 and 4. The IASB defines 'fair value' as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction" [Glossary].

This definition does not help us very much. Knowledgeable, willing and otherwise unrelated parties ('at arm's length') *could* exchange an asset or settle a liability at a variety of 'market prices'. The question is which market prices are 'fair', that is, what knowledge should a party to a transaction have to willingly exchange money for an asset or a liability?

Consider the logical possibilities that exist in valuing a partly finished product (or a service) for exchange at that point. (The possibilities are fewer for initial inputs or finished products, but the issues are the same. We can think of a fixed asset as a partly finished commodity; as a partly finished component of the final product). Its value may vary along three dimensions: (i) *when* we value the product, (ii) the *form* in which we value the product, and (iii) the *market* in which we value the product.

The values we can put on any product can refer to its past prices, to its current price, or to its future price. The prices may depend on which market we are dealing with - whether we are buying, when 'entry' prices are relevant, or selling when 'exit' prices are relevant. Prices may also depend on whether we are valuing the initial inputs, the asset in its current form, or the asset in its finished form less the costs to completion. The value may also depend on whether we intend to sell the finished product, or to use it. Leaving aside questions of using the initial inputs and the part-finished commodity, or selling the initial inputs, we have 24 possible market values, although we can easily dismiss the historical values as obviously 'unfair':

Possible market values for a part-finished commodity

Form of asset

Value date, Market

Initial inputs

Present Form

Ultimate form

Disposal

Use

Past, entry

Historical costs of the inputs.

The past cost for which the part- complete product could have been bought.

The past cost at which the finished product could have been bought, less the past costs to completion.

The past cost at which the stream of net benefits from a finished product could have been bought less the past costs to completion.

Past, exit

Past selling prices of the inputs.

Past selling prices of the part- complete product.

Past selling prices at which the product could have been sold in its finished form, less the past costs to completion.

Past selling prices of the stream of net benefits from the product in its finished form, less the past costs of completion.

Current, entry

Current prices of buying the inputs.

Current price of buying a part- complete product.

Current price of buying the finished product, less the current costs to completion.

Current price of buying the stream of net benefits from the product in its finished form less the current cost to completion.

Current, exit

Current prices from selling the inputs.
Current prices from selling a part-complete product.
Current price from selling the finished product, less the current costs to completion.
Current price from selling the stream of net benefits from the finished product, less the current cost to completion.

Future, entry

Expected buying prices of the inputs.
Expected buying prices for a part- complete product.
Expected cost of buying the finished product, less the expected costs to completion
Expected cost of buying the stream of net benefits, less the expected costs to completion.

Future, exit

Expected selling prices of the inputs
Expected selling prices of a part- complete product.
Expected prices of selling the finished product, less the expected costs to completion.
Expected prices of selling the stream of net benefits from the finished product, less the expected costs to completion

Historical cost is *the* fair value at the time of exchange because the buyer and seller agreed this price. At that moment, the historical price is the current price. From that moment onwards, however, the historical prices in the table are obviously unfair because (except by chance) they are not prices at which knowledgeable and willing parties would exchange now.

Most people would accept that to be 'fair' the value of a product should be the current or future market price. Few would consider an offer to buy or sell at the past cost of the inputs, or the past cost of buying or selling a part-finished commodity, or the past cost of a finished commodity, a 'fair' basis for exchange. Few would consider past selling prices 'fair' either, for whatever form of the commodity.

However, in theory, all the other prices in the table are 'fair' values at which informed and willing buyers and sellers could exchange. In fact, if we follow the normal economic assumptions about well-functioning markets, they should all produce exactly the same price. (I leave aside the issues of the bid-ask spread, and whether we should deduct transactions costs).

Assume that everyone earns the normal rate of profit, say, 25% on the cost of production and distribution, that initial inputs include labour, and that the 'costs to completion' include the normal rate of profit. Thus, in the above table, the current costs and exit prices of the initial inputs should equal the cost of a part-completed product. Valuing the part-completed product by reference to the final entry or exit prices less the current costs to completion should give the same answer. Thus, for example, assume that the selling price of a finished product to the consumer is £15, the cost of production is £8, and the cost of distribution is £4, giving an overall profit of £3. If the producer sold the finished product to a distributor the buying price would be £10 (including £2 profit) and the distributor would expend a further £4 making a profit of £1 by selling at £15. If the initial producer sold the commodity half-finished when he or she has incurred costs of £4, the price to the buyer will be £5 including £1 profit. To this the second producer adds a further £4 costs to complete the product and £1 for profit and sells it for £10 to a distributor, or spends another £4 on distribution making another profit by selling at £15. In short:

Current exit and entry prices in the part-complete, wholesale and retail markets in well-functioning markets

Exit price for finished @ retail
Exit/entry prices for finished @ wholesale
Exit/entry prices for part-complete £5
cost of production =
£15
£10

profit = £1
cost of distribution =
£4
profit = £1
cost of production =
£4
profit = £1
£4 Time 0123

With appropriate changes to reflect expectations, future prices should in theory equal current prices in all markets with appropriate adjustments for risk and time preferences.

In short, according to economic theory we can only exclude historical values as obviously 'unfair'. From the remaining values we must choose which are 'fair' and which are not (the table below indicates the traditional choice and the IASB's choice, which we explain later):

POSSIBLE 'FAIR' VALUES FOR A PART-FINISHED COMMODITY

Value date/ Market
Past/entry
Past/exit
Current/entry
Current/exit
Future/entry
Future/exit
Form of asset
Present form
Unfair
Unfair
Initial inputs
Unfair
Unfair
Current reproduction cost **replacement cost**
Ultimate form
Use
Unfair
Unfair
Current economic value
Current selling price **market value** **economic value**
Disposal
Unfair
Unfair
Current market value
Current
Opportunity cost
Expected reproduction cost
Expected opportunity cost
Current
Current
Expected replacement cost
Expected market value
Expected economic value
Expected selling Price **market value** **economic value**
Expected
Expected
= Traditional fair values
= IASB fair values
= Both

In reality, the prices in these different markets may be, and often are, very different. For example, US experience in the used equipment market is that the exit market

prices plus transportation and installation costs do not equal the 'cost of reproduction new less depreciation', the currently standard measure for US valuers (see, for example, Alfred M. King, 'New Rules for Fair Value', *Valuation Strategies*, September/October, 2004, p.45.)

So, assuming for the present that prices exist in all these markets, and that they are unbiased (but not necessarily the same), to choose between the alternatives we must bring to bear our view of the primary aim of financial reporting. Do we want accounting to hold managers accountable for the value of the capital they control, or do we want it to help investors value their shares? What aim we choose will determine which of the values in the table above we think is (or are) the 'fairest value(s) of all'.

Fair values for accountability

Following the traditional road, our overriding aim is to choose fair values that make management's accountable for the 'capital' they control, 'the most important money' that cycles around a business - sometimes for use; sometimes for disposal. The accountant's job is to make the cycles of capital visible to outsiders so they can hold management accountable for the results. The figure below gives an outline of the total cycle of capital through its different phases, during which it exists either in the form of money or a claim to money (mainly as cash or debtors), or as useful things for the business such as buildings, machines, inventories, etc., that is, as 'non-monetary' assets:

The enterprise operating cycle m

This figure says that outsiders put money (the capital) into a business (M) that management spend on commodities (C), labour (L) and the means of production (mp) that it puts into a production process (P). Out from production comes different commodities (C') that management, to continue in business, must sell for more money

Floating Capital
M′
Start here
C′ M
Productive
Capital **L**
PC
mp

than they cost to produce (M'). If management makes a profit (m) it can distribute this to investors, government, workers, etc., or invest it to expand the size of the capital employed in the business.

The cycle of capital has two main phases, and here I shall use the old-fashioned terminology to highlight the difference between them. In the first and last parts of the cycle, accountants used to say that capital 'floats' on the market – either as capital coming into a business (as cash or debtors) or as finished commodities coming out of production or other assets available for sale. In between, capital goes through production, is 'productive'. To keep production going, management must replace the non-monetary assets it consumes, and recover its monetary assets before it can distribute any money as profit. The general rules in traditional accounting are, therefore, that the fair value of non-monetary capital is its current replacement (reproduction) cost (RC), and the fair value of monetary capital is its historical cost (HC).

If special circumstances mean that the current replacement cost (buying price) of a

non-monetary asset is less than the current cost of identical assets in normal circumstances, management must write down this asset to its 'recoverable amount', the current replacement price given the special restrictions. Examples of special restrictions requiring a write down to recoverable amount are state regulation of production to below planned capacity, and loss of a major customer for a dedicated, special-purpose plant. By definition, such write-downs should be rare events. Similarly, if special circumstances or conditions prevent management from recovering the historical cost of productive monetary assets, it must write these down to their 'recoverable amount', the amount of the original cost that management can recover under the special circumstances (e.g., bankruptcy of a long-term debtor). For the same reason - accountability for the capital management actually controls - traditional accountants will choose current exit prices as the fair value if this is less than the current replacement cost of a non-monetary asset, and less than historical costs of floating monetary assets. In other words, they use the very old 'lower of cost or market rule'. The table below summarizes the traditional fair value rules, and gives some common examples of each category (explaining how the rules apply to items such as investments in shares and financial instruments such as options and derivatives, is beyond the scope of this lecture):

Traditional fair values

Monetary	Lower of	•Fixed assets • Loans • Leases • Mortgages
Monetary	Lower of Historical Cost or Recoverable Amount.	• Finished • Debtors
Non-monetary	Lower of	•Raw materials stocks •Assets for sale •Work-in- progress
Non-monetary	Lower of Historical Cost or Market (selling price).	
Replacement Cost or Recoverable Amount.	Replacement Cost or Market (selling price).	

Replacement markets do not exist for some part-finished (or used), non-monetary assets, or market imperfections may mean that the prices are biased. Nevertheless, the primary markets for their inputs (labour and materials) do exist, and we can reasonably assume that their prices are unbiased.

Economists see asymmetry in the traditional lower-of-cost-or-market rule that writes current assets down to the market price when less than cost, but not up to market price

when this is greater than cost. Traditional accountants, however, see perfect symmetry in accountability for capital controlled: when the market evidence is that management has lost capital under its control, a write down holds them accountable. When the market price rises above cost, traditional accountants disregard this because management has yet to control (that is, to realise) this increase and so cannot take credit for it in the accounts.

The lower of cost or market rule

EXIT PRICE
COST EXIT PRICE
UNREALISED GAIN ≠ CONTROLLED CAPITAL
LOSS OF CONTROLLED CAPITAL
RECOVERABLE CAPITAL

To hold management accountable, accounts must not only be 'fair' (unbiased), but '*true* and fair' - that is, objective and unbiased. For decision making, by contrast, accounts need only be 'fair', and this is why, I think, it sends us down completely the wrong track.

Fair values for decision-usefulness

If we follow the IASB's decision-usefulness objective for accounting, we will ideally choose as the fairest (most beautiful) of 'fair values' the current or expected selling price, or the expected market value or economic value. The reason is that all are measures of the expected present value of the product which, according to the FASB and its supporters, is the value with 100% relevance to investment decision-making. Alternatively, we can limit the choice of fair values to current exit prices, current economic value, or current market value. Current economic values and current market values constrain estimates of the present value to the seller to current prices and costs (ruling out management's use of expected prices and costs).

The IASB does not give any general guidance about selecting fair values, only specific rules in specific standards. The nearest to its current thinking is probably current exit prices and expected economic value using exit prices, as it is for the FASB and for Sir David Tweedie whose theoretical preferences derive in part from the works of Raymond Chambers, a well-known advocate of exit values for financial reporting. The FASB recently published draft rules on *Fair Value Measurement* where it makes its preference for market prices clear by insisting that only if unbiased market prices do not exist can valuers even think of using the equally important cost or income approaches to valuation.

Level
Fair value

Market I
Quoted prices for identical assets or liabilities in reference markets whenever that information is available.

Market II
Quoted prices for similar assets or liabilities in active markets, adjusted, as appropriate for differences, whenever that information is available.

Multiple Valuation Techniques
If quoted prices...are not available, or if differences ...are not objectively determinable, fair value shall be estimated using... the market approach, income approach, and cost approach whenever the information necessary...is available without undue cost and effort'

Although quoted prices are objective, requiring management to use 'adjusted' prices of 'similar' assets, or the 'income approach' (that forecasts and capitalises cash flows) if it thinks the expense of gathering the information is not 'undue', shows that the FASB's definitions leave the door wide open to subjectivity.

Furthermore, whereas current costs are objective because they measure the value of inputs *actually consumed* at current prices, although *current exit prices* are objective, they are not objective measures of *management's performance* as only by chance do they measure the exit price at the date of sale. Market or economic values based on current or future exit prices add further subjectivity as we do not objectively know the *future costs* to completion. As the FASB admits in its exposure draft,

"The objective of fair value measurement is to estimate an exchange price for the asset or liability being measured *in the absence of an actual transaction* for that asset or liability. Thus, the estimate is determined by reference to a current *hypothetical transaction* between willing parties" (Proposed Statement of Financial Reporting Standards, *Fair Value Measurements,* September 2004, para.5, emphases added).

Exit prices are necessary for decision 'relevance' or economic 'beauty', but they are 'hypothetical' and, therefore, inherently subjective as measures of management's performance. Where active markets do not exist (and sometimes when they do), management can bias prices (as Enron has reminded us).

Accountants usually call expected exit value 'net realisable value' (NRV). Net realisable value is subjective because it asks management to estimate *future* inputs at current prices. By contrast, to construct a replacement cost from the initial inputs we only ask management to put current prices on *past* (or established, technically improved) inputs. (For example, whereas there is no market for the used wiring and piping in a chemical plant - often a large part of the total value - we know the current prices of replacing it new, and can estimate how much economic life it has left.)

If we believe that the aim of financial reporting should be decision-relevance, we will report all increases or decreases in the market prices of all assets and liabilities as profits or losses. That is, we will account for increases in market values as a surplus that the government could tax (and account for decrease as a deficiency that could relieve tax), be divided (or restrict dividends) or reinvested (or restrict investment). However, many (if not most) of these prices changes may be temporary fluctuations, and management has realised none of them.

In contrast to the IASB's approach to fair value accounting, traditional accountants account for all increases and decreases in current replacement cost of non-monetary assets as capital maintenance adjustments (CMA). That is, adjustments to changes in the recoverable value of the entity's capital that are beyond management's control.

We can see the potentially dramatic different results from the traditional and decision-relevance approaches to accounting for profit and loss in the following diagram:

Traditional versus decision-relevance fair value accounting for profits and losses

Prices
HC = RC = NRV
NRV RC RC
Exit price
NRV
0123 N Time
Profit?
CMA+Loss
CMA or
Profit?
Loss
Loss?

The diagram shows that we bought an asset at time 0 at which time the price equalled the RC and NRV. During the time 0-1 the replacement cost increases above HC and the NRV even more. At the end of the first period traditional accountants write up the asset to its RC as a capital maintenance adjustment (CMA), whereas decision-relevant

accountants write the asset up to NRV and book a profit (NRV – HC). At the end of period 1 (beginning of period 2) the RC increases again, stays there until the end of 2 when the exit price falls, and the NRV even more. The traditional accountant first writes up the asset by a CMA for the increase in RC and, at the end of period 2, books a loss for the fall in exit price to below RC. The decision-relevant accountant, by contrast, writes down the asset to its lower NRV, booking a bigger loss. From this simple illustration, where the decision-relevant profit and loss exaggerates the swings in traditional profit and loss, we can easily appreciate the often stated fear that the IASB's fair value accounting will cause increased volatility in profit that is completely spurious from the accountability viewpoint.

The IASB claims that decision-relevance subsumes 'accountability'. That investors can hold management accountable by selling shares (punishing it by increasing the cost of capital) or firing people if the share price (or 'fair value' of the firm in the accounts, for the IASB, an approximation for market value) falls, or buying shares and acceding to higher salaries and pensions, etc., if it (or the 'fair value') rises. This view, however, overlooks that we cannot objectively attribute fluctuations in share prices solely to management actions because many of them reflect events (e.g., interest rate changes, technical changes) beyond its control, or result from speculations about future events. The same is true for decision-relevant profits and losses, fluctuations in the 'fair value' of the firm, as we have seen.

Going for decision-relevance inevitably means subjectivity, and this means giving up accountability because it means managers taking the credit for unrealised gains and being punished for unrealised losses, that will never arise. It is easy to understand why, therefore, British, American, German, French, Japanese (etc.) accountants and commentators have heavily criticised the subjectivity of decision-usefulness accounting, and they continue to complain. Several commentators have noted that none of Enron's tricks with special purpose entities would have been possible if US GAAP had forbidden mark-to-market accounting.

In response to early vociferous concerns by British accountants about subjectivity, proponents of current value accounting (notably, Sir David Tweedie, who wrote the ASB's *Statement of Principles*) have often (somewhat reluctantly) limited management's choice of fair values with the 'value-to-the-owner', or 'deprival value' rules, first developed for insurance companies:

Deprival values as fair values

If fire, for example, deprived the owner of his or her factory, an insurance company would compensate the owner by replacing the factory because the owner can then use the factory to earn whatever economic value it has. If the economic value of the

Deprival value
Lower of
Replacement cost
Recoverable amount
Higher of
Net realisable
value
Economic value

factory is less than its replacement cost, the owner would either sell it, or use it and not replace it, and would be compensated for loss by the higher of these values.

Deprival value rules are part of the British *Statement of Principles* and are implicit in *IAS 36: Impairment of Assets*, and the IASB will probably include them when it revises its conceptual framework.

Deprival value rules puts replacement cost as the highest fair value, just like traditional accounting, but the other rules are very different. Compared to traditional

fair values, deprival value rules introduce subjectivity by requiring write downs of current assets to NRV rather than to exit price, and by requiring assets to be written down to economic value rather than the traditional measure of 'recoverable amount' (that is, to restricted replacement cost).

Deprival value rules also introduce subjectivity by requiring entities to carry *all* assets and liabilities at current market or economic values, including its long-term debt. As David Damant, a leading advocate of decision-usefulness accounting, rightly says, "the revaluation of an enterprise's own long-term debt is something which the large majority of users of the traditional accounts find very difficult to accept" (*Financial Times*, 20 June 2002, emphasis added).

Many preparers and users of accounts find the prospect of valuing debt at fair value unacceptable because the consequences are paradoxical. The IASB admitted that one of the concerns of bankers, securities regulators and insurers over IAS39 (the rules for financial instruments, such as derivatives) was that "if an entity applied the fair value option to financial liabilities, it might result in the entity recognising gains or losses in profit or loss for the changes in its own credit-worthiness" (*International Accounting Standard IAS 39, Financial Instruments: Recognition and Measurement* (London: IASB, revised 2003, Background, para.3(c)). This absurd result may "explain…why it has proved so difficult to produce rules that more than a handful of theoreticians will accept" (Robert Bruce, *Financial* Times, 20th June 2002).

We can, of course, explain how much of the 'profit' is down to falling credit-worthiness - "the amount of the change in the fair value that is not attributable to changes in a benchmark interest rate" (IASB, 2003, para.BC4). However, this does not explain why any fall in the current value of debt is 'profit' in the first place. We can, of course, argue that there is no profit if we write down the assets to offset it, but there can be no automatic need to write off assets because the market value of a firm's debt falls, and we would still have to explain the 'profit' to equity, albeit one offset by a loss.

If we use fair value accounting and management uses derivatives or otherwise hedges assets and liabilities to eliminate risks, we get spurious volatility in the *components* of earnings that cancel out in the profit and loss account with no net effect. However, if we do not mark both sides of a hedge to market – do not use comprehensive fair values for all financial instruments - we will also get spurious volatility in *total* earnings (or in equity for some hedges according to the rules of IAS39).

A paradoxical example of spurious volatility is the issue of fairly valuing a bank's demand deposits. Is the fair value of a liability repayable on demand its face value (as a traditional accountant would argue), or is it their present value, that is, the deposit less the returns on it the banker expects before the customer withdraws it? One would think the IASB would naturally choose the latter, but the unacceptable consequence would be the recognition of a profit from merely acquiring a deposit!

Imagine, then, the frustration of the European (particularly French) banks in being unable to use fair value hedge accounting (and account for offsetting gains and losses on the derivative and the hedged item) for their hedges of the interest rate risk on demand deposits. Instead, the IASB insists the banks must account for demand deposits at their historical proceeds which, according to the rules of IAS39, means they must account for the derivative at fluctuating fair market values in their equity accounts as a 'cash flow hedge'. This could induce spurious volatility in the banks' equity, with potentially serious consequences (for example, they could need to raise extra equity to protect bond covenants) in addition to confusing shareholders and others!

In the face of this nonsense, on the 1st October the EU decided to give member countries the option of limiting the application of IAS39's hedging rules. On 1st October the Accounting Regulatory Committee of the European Commission voted to remove the IAS fair value option as it applies to liabilities, and to facilitate the use of fair value hedge accounting for interest rate hedges of core deposits!
Furthermore, in practice (and contrary to common belief), many companies have their derivative financial instruments custom-made for their particular circumstances. By definition, 'active' and 'homogenous' markets do not exist for these derivatives. Therefore, management must value them using *models* that are sensitive to small changes in assumptions. We cannot, therefore, assume that these valuations are unbiased.
To sum up:
Partial use of fair values partially undermines management's accountability for capital. Even if we apply fair values to only those assets and liabilities for which unbiased market prices exist, fair value accounting remains subjective and it increases the reported volatility of earnings.
Full use of the IASB's fair values will seriously undermine management's accountability. If we apply fair values fully, we open the door wide to subjectivity and may well introduce bias. A comprehensive fair value accounting system would allow management to 'mark-to-market' or 'mark-to-model' all of its assets and liabilities. This would allow it to take credit for unrealised gains, and require asset 'impairments' to be written down to economic value as losses (and reversals as profits). When we value debt at market value we get a result that is counter-intuitive.

Is compromise possible?
Many broadminded accounting scholars (and those tired of war) think that we need not choose between accountability and decision-relevance - that we can have both the tiresome 'beast' of accountability and the 'beauty' of decision-relevance (to mix my fairy tale metaphors!).
In my view, we can have both, but not in the same financial statement. My fear is that if we mix decision-relevant fair values with fair values for accountability, we risk confusing the users and undermining accounting's distinct accountability function. We cannot trade-off a bit less accountability for a bit more decision-relevance because they are mutually exclusive systems with mutually exclusive functions.
We can, of course, ask management for a separate 'valuation statement' (its estimate of the net present value of the firm), but we must not mix this with 'the accounts', whose accountability function is distinct, and must be kept distinct. The IASB says it believes in the rationality of markets. Why not, therefore, produce two reports and let the market of users and commentators decide which is most important?
Apart from the expense, it seems very unlikely that the IASB would ever agree to two statements as it would mean recognising objective accountability as a primary aim of accounting. This would mean a wholesale revision of its US-inspired conceptual framework, in which many of its incumbents have invested their intellectual lives. Robert H. Hertz, for example, chairman of the FASB, educated at the University of Manchester, still considers himself a Hicksian economist and, therefore, believes that accounting should define "income as changes in wealth" which Sir John Hicks famously argued we should define as expected present value. Robert H. Hertz, not surprisingly, fervently believes that "fair value is the most relevant measurement attribute" *CFO Magazine*, February 01, 2003). Trapped in a lover's trance, "the FASB's...cavalier approach to verifiability is troubling" (Ross L. Watts,

'Conservatism in Accounting Part I: Explanations and Implications', *Accounting Horizons*, Vol. 17, No.3, 2003, pp.207-221), but wholly understandable.
True believers such as Hertz do not even recognise the aim of accountability. To wake them from their sleep, we must confront them with the choice they are implicitly making for us in trying to live out their dream of accounting in an ideal economic world. We must tell them that this dream is becoming a nightmare; that although their aim of decision-relevance offers a beautiful theoretical perspective, in the cold light of day it is often ugly as unbiased markets for assets and liabilities do not exist, and the 'prices' that emerge from valuation models may be biased. To rouse them from their dreams, we must convince the true believers that the real world demands the practical beauty of accountability – that, in reality, economic 'fair value' is not the 'fairest of them all'. In short, the real choice is not between historical cost and economic fair value accounting. In reality, we must choose between decision-relevant accounting that is ugly in practice, and practically beautiful traditional accounting. Here is the real choice as I see it:

'MIRROR, MIRROR...': THE REAL CHOICE

Conclusions

My overall conclusion is clearly that the IASB's approach to fair value accounting is the wrong track for global accounting because it undermines accountability. The IASB's approach could, therefore, impede the development of capital markets, or even weaken them by undermining investors' confidence, and it could impede or weaken business accountability to government and labour.
The EU and the member governments on continental Europe have worked hard over the last 25 years or so years to create an enduring 'equity culture'. The IASB's fair value accounting could seriously undermine this effort. I agree with Sir David Tweedie that
"After the Enron and WorldCom scandals...people realised how important accounting really is. Accounting is the bedrock of capitalist society, because if you can't trust the numbers, people won't invest" (*Accountancy*, January 2004, p.56).

OBJECTIVE
Theoretically ugly historical cost accounting
Practically beautiful
traditional accounting
SUBJECTIVE
Theoretically beautiful decision-usefulness accounting
Practically ugly decision-
usefulness accounting

It is also true that if government and workers do not trust the numbers, they will not invest in businesses – whether through tax relief for losses, or restraining wage demands.
However, I disagree profoundly with Sir David's view that to 'tell-it-as-it-is', "the market is where reality is and that is why a lot of people don't like it" (*Accountancy*, January 2004, p.56). I agree that 'the market is where [one] reality is', but which market is an important question (he means exit prices), and management and its accountability is also 'where reality is'.
I think that what would really make investors lose confidence in investing is if they believe that management is not fully accountable for their capital that it controls.

If we believe that the IASB should not ignore accountability, what can we do? Before we get too depressed about the formidable momentum behind the decision-relevance paradigm, we should remember that securing the full co-operation of the EU is essential to the survival and success of the IASB. Germany is a powerful member of the EU that rightly takes its accounting seriously because, I think, it recognises that logical rules for business are essential elements in the beneficial regulation of social life. Fair value accounting threatens German accounting and, therefore, the German way of life with its traditional emphasis on social accountability.

Before we also get too depressed about the apparent hegemony of a US that does not listen, we should also note that, after a 30 year trend towards 'fair value' accounting, 'Enronitis' has caused Americans to seriously question their often self-confidently asserted belief that 'US accounts are the best'. As Watts says,

"the Enron case demonstrates...[that] the FASB appears to favor mark-to- market accounting without insuring verifiability of the market estimates.... The FASB can ill afford more scandals of the Enron variety in which 'generally accepted' unverifiable values played a role" (op cit, p.218).

The same is true for the IASB which is following the FASB "down a path that many before them have feared to tread, and with good reason" (op cit, p.219). I agree with Watts that this path leads to a world where "net asset values and earnings are subject to more manipulation and, accordingly are poorer measures of worth and performance" (ibid) – to a world with less accountability.

Given its strong intellectual traditions in accounting, Germany ought to play a leading role in conducting an effective European critique of the US and IASB's 'fair value' accounting typified by IAS39. It was, therefore, somewhat disappointing that Germany abstained in the June 2004 Accounting Regulation Committee vote on IAS39!

I hope this short lecture has helped you to understand some of the issues involved in an important *public* debate about 'fair values' in accounting that should be taking place, but is not. Encouraging an effective European critique of the IASB's approach is an important reason for my visit, and for enthusiastically accepting your gracious offer of the Ludwig-Erhard-Foundation-Professorship for this semester. Thank you for listening.