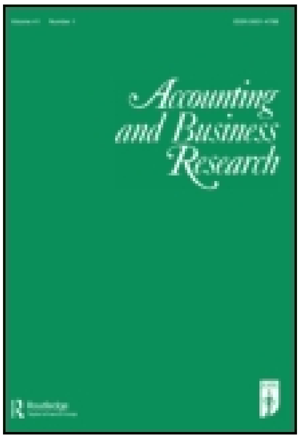

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Philip Broadley [a b]

[a] Prudential plc

[b] Hundred Group of Finance Directors, E-mail:

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Discussion of 'Financial reporting quality: is fair value a plus or a minus?'

Philip Broadley*

I have been asked to give a preparer's perspective as to whether fair value helps or hinders the quality of financial reporting, in response to Stephen Penman's paper. I do so with some trepidation, even more so now that I have actually heard his paper. I would not describe myself as a technical specialist in financial reporting, and I do not often accept invitations to speak on this subject.

When I accepted the invitation, I did not know what Professor Penman was going to say, but now that I have both read the longer paper and had the chance to hear his remarks, I found myself agreeing with it almost entirely, which makes the difficulty of finding anything new to say even harder.

However, as chairman of the Hundred Group of Finance Directors, I have at least a perspective on the views of those who prepare financial statements. Although I speak today in that capacity, I am finance director of an insurance company, and therefore do have some practical experience of grappling with the task of reporting on close to £130bn worth of long-tail liabilities, which provide an opportunity to reflect on some of the philosophical questions of fair value on a regular basis.

It is 20 years this year [2006] since I qualified as a chartered accountant, and in that first flush of youth I contributed to a book (now probably a collector's item) called *Accounting for Treasury Products* by one John Tiner who, some of you based in the UK will know, went on to other things and is currently chief executive of the Financial Services Authority. Fair value then was exciting, and so I was an ardent convert to fair value accounting. Now, as a finance director, I would say I have matured and do not disparage the mixed attribute historic model as something that someone's great grandfather did once; I recognise that it still has some practical relevance.

I would like to speak a little about the preparer's perspective and move on to discuss some of the challenges with fair value approaches. I will give a couple of examples around accounting for pension liabilities and conclude with some comments about how fair value approaches might help corporate communication or otherwise.

First, let us consider the preparer's perspective. The Hundred Group has recently endorsed a Position Statement that sets out its views on financial reporting (see Appendix). I think it is the first public document setting out the views of leading UK preparers on a vision for financial reporting. Within it we have set out the objectives of financial reporting as, among other things, to provide relevant, reliable, comparable and understandable information to a wide range of users, to assist them in making rational economic decisions, and also to provide a basis for assessment of the results of management's stewardship of the resources entrusted to it. This means reporting what are we actually doing in converting the assets that have been entrusted to us; not the cash or the Treasury bills, but the assets where the business model is doing some sort of conversion.

Within the transaction-based framework of performance reporting, the Hundred Group supports the application of fair value as a basis of measurement where the Level 1 criterion of a reliable market can be derived and where fair value is not searching for a hypothetical value – really where Stephen's one-to-one criterion, as I now know it, is passed.

It is sometimes said that preparers are not themselves users of financial reporting. I have heard that view more than once this year. I disagree; I think preparers – by which I mean companies, their boards and management – take an intense interest in the deliverables that constitute financial reporting. Indeed, one would hope that the financial reporting reflects the way in which businesses are managed and provides a way, as we have described it within our statement, of seeing the business through the eyes of its management, or its board.

It is our view that external reporting, in both its narrative and prescriptive statement form, should provide that insight. We do want to keep the connection between the information that management use day-to-day and the information that is prepared and used in communication with shareholders.

As a finance director, I meet extensively with shareholders and debt-holders and probably hold

*The author is finance director of Prudential plc and also chairman of the Hundred Group of Finance Directors. The views expressed are his own. The Position Statement of the Hundred Group, published in November 2006, is appended to the Discussion. E-mail: philip.broadley@prudential.co.uk

between 150–200 meetings with them annually, depending on the year and the particular circumstances. Over time, I would suggest these meetings do give one some insight into the interests and needs of users. I do not seek to set out to speak for financial statement users; they can and must do so for themselves. My observation is that institutional shareholder interaction with company management involves investors gaining an insight into what we think, challenging that thinking and hopefully becoming comfortable with it. I believe the current transactional model described in the paper serves those discussions well.

Regarding some of the issues of contention: we have heard some of the challenges of definition today, and so I suppose what I am really thinking about here is the mooted paradigm change that Stephen discussed.

It does seem reasonable to me that the measurement of fair value should be predicated on the availability of some sort of observable price. Where I have difficulty is when we move on to the use of internal models because my fear here – evident in my own industry – is that internal models are assumed to have a degree of accuracy and to provide a consistency across reporting companies that may be illusory.

At the Hundred Group, we support the need to simplify accounting standards where possible to reduce cost and complexity for preparers; to increase usefulness and understandability for both internal and external users; and to avoid the problems that can arise due to lack of clarity, comparability and transparency. I suggest it is contentious whether these criteria will be met if market prices are not observable.

The existence of liquid markets is, then, fundamental to the credibility of fair values, and I would question how often deep and liquid markets do exist for many of the transactions reported on, on a fair value basis. Consider pension accounting – it is a fashionable subject to criticise, admittedly, but it is one about which I have some practical experience. In encouraging companies now to provide a buy-out valuation of their pension fund, I would suggest, thinking about a UK context, that if the pension fund has more than about £2bn worth of assets in it, the most sensible and accurate disclosure would be that no buy-out of a scheme of this size has been achieved, and therefore no value is disclosed because that cannot be provided with any degree of certainty. I do not think that is 'copping out'; rather it is providing an insight as to what management would find if they were to investigate a buy-out valuation.

There is much discussion about the appropriateness of the discount rate used to value pension liabilities: some question the determination of the discount rate and whether it should be made independently of the asset mix of the fund. I do not quarrel with that notion.

What I do find more difficult is the idea that in 10 days' time from now [31 December 2006] several hundred billion pounds' worth of pension fund liabilities for UK companies will be valued by reference to a relatively small amount of index-linked gilts in issue being traded on a particular day – the bubble notion that Stephen referred to earlier. One only has to look at how rates have moved around periodically to get some sense of that.

In making these comments, I am not denying that there is a problem in recognising pension liabilities, or that that information must be provided to enable investors to make an informed choice. I simply suggest that a single valuation implies a degree of certainty about an outcome that I do not think is helpful; on the contrary, it adds volatility in results as one is attempting to pinpoint precisely a distant outcome.

My analogy to this is that in my spare time I pilot light aircraft around the south of England – so you have been warned, if you live anywhere in that area. If you have ever done any navigation, whether by air or sea, you will probably have learned the 1-in-60 rule: the idea that if your heading is one degree off your true course then after 60 nautical miles you will be one mile away from where you should be. If you can keep within one degree of your true course in a light aircraft, being buffeted around in a strong wind, you are doing very well! On a day of low cloud it is hard work, but the error could result in your straying into controlled airspace and endangering not only yourself but many other people. However, I still think that is easier than plotting the course for pension liabilities over many decades. At least I have come back from my flying, so far.

As to the final question: will fair values provide better market information? Again, I find myself in violent agreement with the ICAEW's paper. I would also observe that while we have heard where the models could be improved, if fundamentally models that have become comfortable and become a feature of life for a long time are not broken – or not apparently so – then it requires some very thorough cost-benefit analysis to suggest that we need to move to some alternative.

Fair values can provide better information for the markets in cases where observable market prices exist and the tests of depth and liquidity can be passed – and I think meeting the one-to-one test as well, as we heard in the paper. But without that connection to reality, one is in danger of moving into the area where management is voicing opinions rather than providing information. I would suggest it is information that investors are really seeking.

Appendix

Position statement of the Hundred Group on Financial Reporting
27 November 2006
http://www.100groupfd.co.uk/fdgroup/?t=reports

1. **Objectives of Financial Statements**
The Hundred Group supports the following objectives of financial reporting for a business entity:
   - to provide relevant, reliable, comparable and understandable information to a wide range of users to assist them to make rational economic decisions about the reporting entity;
   - to provide a basis for assessment of the results of the stewardship of the management of the reporting entity of the resources entrusted to it.

2. **Conceptual framework for financial reporting**
The Hundred Group supports a conceptual framework for financial reporting which is business driven and which ensures financial information reported to investors is closely aligned to the performance information used internally so that existing and potential investors are able to view the business through the eyes of management.
The conceptual framework should encompass information about the financial position, economic and financial performance and changes in financial position of a business.

3. **Accounting standards**
The Hundred Group supports accounting standards which are principles-based and which are understandable by the non-technical user.
Accounting standards should reflect economic reality and focus on cash flow as the source of value creation. They should not be based on untested theoretical concepts. Accounting standards should not give rise to behaviour which drives business decisions that are not in the economic interests of the business entity.
The Hundred Group supports the need to simplify existing accounting standards:
   - to reduce the cost and complexity for preparers;
   - to increase the usefulness and understandability for all internal and external users of financial reports; and
   - to avoid abuse that might arise due to lack of clarity, comparability and transparency.

4. **Convergence**
The Hundred Group supports the global convergence of accounting standards:
   - to provide a common platform of financial information for existing and potential investors in increasingly global capital markets; and
   - to ensure consistency of reporting over time of the business entity and between entities.

5. **Performance reporting**
The Hundred Group supports the use of a transactional-based framework to report financial performance and to ensure:
   - financial performance from operations can be reported separately from value adjustments;
   - differentiation of the results of operations from financing activities; and
   - proper reconciliation of profits and cash flows.
The principles of realisation and matching are critical for financial performance measurement and reporting.
To properly reflect the measurement of performance and assist users of accounts, recycling of items within the financial statements may be necessary.

6. **Basis of measurement**
Within the transaction based framework of performance reporting, the Hundred Group supports the use of values in addition to historic cost as a basis of measurement for assets and liabilities in the balance sheet where practicable. The use of such values would be appropriate where there is a reliable basis for assessing value and where the value reflects economic reality. The application of 'fair value' as a basis of measurement is supported only where there is a reliable market from which fair value can be derived and fair value is not a hypothetical value.

7. **Narrative reporting and supplemental information**
The Hundred Group supports the development of supplementary narrative reporting which is complementary to financial reporting and provides relevant and reliable information about the performance, financial position and prospects of the business enterprise.

The Hundred Group supports the publication of information to supplement financial reporting. Supplementary information might encompass the use of qualitative and quantitative information, financial and non-financial information and projected and historic information to the extent it is considered reliable and relevant to an assessment of the economic performance and prospects of a business as a whole.

8. **Forward looking information**
The Hundred Group supports the continued development of reporting relating to forward-looking information to the extent it provides reliable information relevant to an understanding of the future prospects of a business. To encourage the development of forward looking information, the Hundred Group supports the use of safe harbour provisions relating to any forward-looking statements.