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Response to ‘Fair value accounting, financial economics and the transformation of reliability’

Patricia McConnell*

As a very new member of the IASB that comes not from public accounting or academe but from the investment community, I am often asked two questions: ‘Do investors want fair value information?’ and ‘Why is fair value information useful to investors?’

The short answer to the first question is that investing is all about fair value. Very simply, a decision about whether to purchase, sell or hold an investment generally is based on its fair value and expectations about future changes in its fair value relative to other investment opportunities.

Typically, the answer to the second question is that fair value impounds the most current and complete assessment about the value of an item because it impounds all the available information about the amount, time and uncertainty of the net cash flows generated by an item. That is a very nice theoretical statement and, while it is true, I think those who ask me that question are often looking for a more practical answer. The most practical use of fair value information by investors is in financial statement analysis. The underlying objective of financial statement analysis is the comparative measure of risk and return, but general purpose financial statements do not provide the data necessary for this comparative assessment without significant adjustment.

Skilled chartered accountants may be wondering why anyone would want to adjust the financial statements that they have so painstakingly prepared and audited; but the reason should be obvious to them. The historic cost financial statements do not produce information useful for comparative analysis. Many assets and liabilities are recorded at price levels that existed when they were acquired and, further, accounting choices such as depreciation methods, inventory methods, etc., detract from the

comparison. These are only some of the deficiencies.

So financial statement adjustments made in financial analysis include adjustments to reflect accounting differences, adjustments for off-balance-sheet financing, adjustments to restate assets to current values, and adjustments to reflect the capital structure at current value.

I use the term ‘current value’ rather than ‘fair value’ to describe the adjustments to an entity’s assets and capital structure because ‘fair value’ now has a precise meaning in accounting literature. The values available to analysts for use in adjusting financial statements rarely meet that definition at the moment. However, the objective is the same. So it has been common practice for many years – longer than I have been a practising analyst, which is a very long time – for investors to use all the information at their disposal to adjust balance sheets to current value. Some of these adjustments are straightforward and others are complicated. Some are just a whim.

For example, financial reporting standards increasingly require recognition or disclosure of the fair value of financial instruments. This has facilitated the investor’s balance sheet adjustments for these items. Another common adjustment, at least in the US, is adjusting inventory balances from last in, first out (LIFO) to first in, first out (FIFO). Currently, the FIFO balance of inventory would not meet the accounting definition of fair value, but it is a measure of current value when inflation is low and it is the best estimate available today to an investor. However, it is more difficult to substitute a current value or fair value for other non-financial assets like real estate, timberland and mineral properties, but there are methods to do this. Estimating the current value of an operating facility such as a factory is more problematical. For intangibles like brand names, customer relationships and technology, it is difficult, if not impractical, for an outside investor to place a current value on them. A popular

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American textbook on financial statement analysis suggests over 30 balance sheet adjustments, and provides suggestions for doing them.

The adjusted values of the assets less the adjusted value of the liabilities gives the new adjusted book value of the entity. This adjusted book value is used for calculating ratios such as book value per share and the debt-to-equity ratio. The adjusted value of assets is used to calculate such ratios as return on asset and asset turnover, and the adjusted value of debt is used to calculate the weighted average cost of capital in addition to the debt-equity ratio. Since the calculations are made using adjusted information, companies being considered for investment can be more easily and fairly compared. So it is no surprise then that 74% of chartered financial analysts (CFAs) responding to a survey from the CFA Institute responded that fair value was either very important or important to their work.

I have to ask myself, therefore: Why then has the IASB's extensive outreach to the investment community for its financial instruments, classification and measurement project produced such mixed results? I can really only speculate. The CFA Institute survey was asking analysts about the usefulness of fair value information in general. It did not get into the details of where investors might like to see the information. That is, whether they wanted it in the footnotes or in the financial statements themselves, in the balance sheet only, or did they want full fair value through profit and loss (P&L)? In contrast, the current IASB outreach is focused on very specific recommendations for financial instruments.

My personal interpretation of what I have been hearing from the investment community regarding the proposed revisions of IAS 39 is as follows. There is more support for fair value information in North America than in other parts of the world, but there are also more investors and at least more dollars to invest in North America as well.

Even in North America the support for fair value has waned since the financial crisis. There are even those who do not think that fair value should be prominently displayed, for example, on the face of the balance sheet. They seem to fear that other investors and market participants are not as smart as they are, and that they will misinterpret changing fair values, which in turn will cause procyclicality. They also seem to worry that potential differences between reported generally accepted accounting principles (GAAP) capital and regulatory capital will lead to a loss of confidence, not just in particular financial institutions, but in the financial system as a whole.

However, in North America there are a few, those that I would characterise as the 'thought leaders', who support full fair value through P&L for all financial instruments. They believe that fair value is a more meaningful measure than historic or amortised cost for financial instruments. They believe that measuring instruments at fair value will be much simpler and easier to understand than IAS39 even when factoring in the complexity of valuing complex, thinly traded or non-traded instruments. They also believe that accounting for all financial instruments at fair value through P&L will minimise the growing trend towards earnings management, and, of course, they firmly believe that it will enhance inter-company comparability.

I am not discouraged, even though the feedback has been mixed. I believe that accounting changes need to be evolutionary and not revolutionary and I believe that investor perceptions regarding fair value information have been evolving.

In the late 1990s when the old International Accounting Standards Committee (IASC), on which I was privileged to represent investors, circulated a proposal for full fair value through P&L for all financial instruments there was almost universal disagreement, even in the investment community. In the early years of this century, after the collapse of Enron and the role that fair value accounting played in that debacle, I thought that fair value accounting would languish for another generation. But support has continued to grow, albeit slowly. The financial crisis has resulted in another setback to its popularity, but I believe that the more it is discussed, both the pros and the cons, the better its relative strengths and weaknesses will become evident and the support for it will continue to grow.

This was my experience with accounting on employee stock compensation. In the early 1990s, when the Financial Accounting Standards Board (FASB) first proposed expensing the value of employee stock options using an option pricing model to estimate the value, there was almost no support in the investment community. Opponents made the following arguments against it: the value was unreliable; it would be double-counting because employee stock options are included in the denominator of earnings per share; they have no cash flow impact; and it is not a big problem!

The story is well known. The FASB backed off from its proposal in 1994 and instead proposed footnote disclosure of what income and earnings per share would have been if the options had been expensed. During the technology and internet boom of the 1990s the use of employee stock options

grew meteorically. Footnote disclosure allowed investors to see the impact employee stock options were having on the value of their investments. By the turn of this century many investors were clamouring for the actual recognition of employee stock option expense, although there were still those that fought against it, largely technology or internet analysts.

I think the lesson from this experience for standard-setters is clear: change must be gradual. Preparers, auditors, investors and regulators all need time to digest and understand the change and to adjust to it. However, in my mind the trend towards general acceptance of fair value accounting for financial instruments is meeting with growing acceptance in the investment community.