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# Fair Value and the IASB/FASB Conceptual Framework Project: An Alternative View

This paper analyses various controversial issues arising from the current project of the IASB and FASB to develop a joint conceptual framework for financial reporting standards. It discusses their possible implications for measurement and, in particular, for the use of fair value as the preferred measurement basis. Two competing world views are identified as underlying the debate: a Fair Value View, implicit in the IASB's public pronouncements, and an Alternative View implicit in publicly expressed criticisms of the IASB's pronouncements. The Fair Value View assumes that markets are relatively perfect and complete and that, in such a setting, financial reports should meet the needs of passive investors and creditors by reporting fair values derived from current market prices. The Alternative View assumes that markets are relatively imperfect and incomplete and that, in such a market setting, financial reports should also meet the monitoring requirements of current shareholders (stewardship) by reporting past transactions and events using entity-specific measurements that reflect the opportunities actually available to the reporting entity. The different implications of the two views are illustrated by reference to specific issues in recent accounting standards. Finally, the theoretical support for the two views is discussed. It is concluded that, in a realistic market setting, the search for a universal measurement method may be fruitless and a more appropriate approach to the measurement problem might be to define a clear measurement objective and to select the measurement method that best meets that objective in the particular circumstances that exist in relation to each item in the accounts. An example of such an approach is deprival value, which is not, at present, under consideration by the IASB.

**Key words:** Conceptual framework; Fair value; Financial reporting; International accounting standards; Measurement.

The project by the IASB and FASB to develop a joint conceptual framework, derived from their existing frameworks, is likely to influence the development of accounting standards for many years to come. It is therefore not surprising that

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the first discussion papers resulting from the project have attracted much fiercer criticism than the standard setters seem to have anticipated, or that much of this criticism has come from within the European Union, which is committed to adopting the International Financial Reporting Standards (IFRS) of the IASB.

The issue that seems likely to attract most controversy is that of measurement, which has not yet reached discussion paper stage within the conceptual framework project. In particular, the IASB's perceived preference for fair value as a measurement objective is likely, if expressed in the conceptual framework discussions, to be strongly contested. This issue has already been raised by an earlier discussion paper issued (but not endorsed) by the IASB, and authored by staff of the Canadian Accounting Standards Board (2005), which praised the positive properties of fair value.[1] Controversy has been stirred further by the IASB's publication, as a discussion paper (November 2006), of the FASB's SFAS 157 (2006), which attempts to prescribe the interpretation of fair value within FASB standards as being a current market sale price, ignoring transaction costs and free of entity specific assumptions. Many critics feel that the adoption of this within IASB standards would change present practice significantly and adversely, because IFRS apply fair value more widely to non-financial assets than do FASB standards. Sale prices are seen as less relevant and less reliable in the case of non-financial rather than financial assets.

Although fair value is a focus for much of the recent criticism of the IASB's standards and is also likely to be so for its conceptual framework project, the reasons for the criticism lie in other elements of the framework. Critics of fair value are, in fact, offering an alternative world view of financial reporting, although this view is usually not well articulated. Nor, for that matter, is the fair value world view well articulated: the argument is usually conducted on the basis of accepting a few simple assumptions that make fair value seem to be an obvious choice, whereas the assumptions themselves should be under discussion.

The objective of this paper is to make some progress towards identifying these alternative world views and therefore to clarify the nature of the dispute about the conceptual framework in general and fair value in particular. The perspective is that of the IASB, of which the author was a member from 2001 to 2006, rather than the FASB, which is its partner in the project. The author's own experiences in writing a number of alternative views to IASB drafts and standards inform the discussion.[2] These were written piecemeal, but gradually a more coherent pattern began to be apparent, which expressed a different set of assumptions, or world

[1] The paper discusses specifically measurement on initial recognition, but the discussion has wider application.

[2] An alternative view is a note explaining the view of a Board member who did not vote in favour of issuing a particular exposure draft or standard (in the latter case, it is described as a 'dissenting view'). The Alternative View developed in this paper is consistent with a number of such views but also draws on the views of external critics of the IASB: it therefore has no claim to be an expression of the views of particular members of the IASB, and it is a 'world view' rather than a comment on a particular draft or standard.

view, described here as the Alternative View. This is in contrast with the view that is implicit in many of the IASB's pronouncements, described here as the Fair Value View. This account is likely to be subjective and incomplete, and there are likely to be many other world views. However, when there is such a fierce debate between supporters and opponents of a view, it must surely help understanding to identify the main sources of disagreement. It must also be acknowledged that some of the contentious issues arise within the existing conceptual frameworks, but, as the frameworks are being revised, it is appropriate to question them.

The paper proceeds as follows. First, a description is given of the current project to develop a joint conceptual framework for the IASB and FASB, including its motivation and objectives. Next, there is a discussion of the controversial aspects of the first two draft chapters of the new framework, on the purpose of financial reporting and the desirable properties of accounting information, which have already been issued in discussion paper form. This is followed by a discussion of the issues raised by the subsequent chapters of the new framework that are currently in various stages of development, including definition of the elements of accounts, recognition and measurement. An attempt is then made to identify the two competing world views represented by opposing sides of the arguments on specific issues. We then consider how these competing views have been reflected in past IASB pronouncements, and in alternative views expressed on them. We conclude by considering the theoretical support for the Alternative View.

## THE IASB/FASB CONCEPTUAL FRAMEWORK PROJECT

Both the FASB and the IASB already have conceptual frameworks. The FASB's was the first, dating mainly from the 1970s, and consists of seven substantial concepts statements, each published separately.[3] The IASB's *Framework for the Preparation and Presentation of Financial Statements* (1989) is a much briefer single document of 110 paragraphs, dating from 1989. Its content shows a strong affinity with the FASB's earlier work, although there are important differences of detail. One important similarity is that, like the FASB framework, it lacks a treatment of measurement and is therefore incomplete. This is a legacy of the fierce and unresolved debates that took place particularly in the 1970s, when standard setters struggled unsuccessfully to achieve a solution to the inflation accounting problem that would be accepted by both users and preparers of accounts. Another legacy of the pressures and controversies of that period is that both frameworks emphasize decision usefulness, particularly to investors in capital markets, as the primary focus of general purpose financial statements. This was a bold step at the time, sweeping away the traditionalist view that accounting is primarily for legal and stewardship purposes, with decision usefulness as a useful

[3] A valuable 'insider' account of the development of the FASB Conceptual Framework is given by Storey and Storey (1998). An authoritative account of the development of the IASC Framework is in Camfferman and Zeff (2007, Chapter 9).

Table 1

CONCEPTUAL FRAMEWORK REVISION TIMETABLE, 30 SEPTEMBER 2007

| Phase | Already published | Publication planned in | | |
|---|---|---|---|---|
| | | 2007 | 2008 | Undecided |
| A: Objectives and Qualitative Characteristics | DP | ED | | |
| B: Elements and Recognition | | | DP | |
| C: Measurement | | | | DP |
| D: Reporting Entity | | DP | | |
| E: Presentation and Disclosure | | | | DP |
| F: Purpose and Status | | | | DP |
| G: Application to Not-for-Profit Entities | | | | DP |
| H: Remaining Issues | | | | TBD |

*Abbreviations*: DP = Discussion Paper, ED = Exposure Draft, TBD = Yet to be determined.
*Source*: Abstracted from the IASB Work Plan—Projected Timetable, published on the IASB web site: iasb.org.uk. The full IASB Work Plan is available at http://www.iasb.org/Current+Projects/IASB+Projects/IASB+Work+Plan.htm (accessed, 20 February 2008).

possible additional benefit. It is argued later that this change of focus may be carried too far by the current revision of the frameworks.

A primary motivation for the joint project is to *converge* the frameworks of the two boards in order to provide a consistent intellectual foundation for the convergence of the two sets of standards, to which both boards committed themselves in the Norwalk Agreement of 2002. Convergence is not, however, the only motivation: *improvement* is equally important.[4] There are two aspects to improvement: filling gaps to achieve *completeness*, and removing internal contradictions to improve *consistency*. The most obvious gap that needs to be filled is to develop guidance on measurement. There are many aspects of the coherence of the IASB's framework that need improvement. An area that has given particular difficulty recently is the definition of a liability and especially the distinction between a liability and equity.

The joint project started in 2005. Its planned sequence of topics and current achievements is listed in Table 1. The working papers for the project are developed by a joint IASB/FASB staff team, there being a different staff team for each stage. FASB's greater staff resources mean that they are usually in the majority, although staff from the Canadian standard-setting body are currently developing the proposals on elements and recognition. Each paper is discussed by both boards, usually separately but sometimes in joint meetings. Thus, the project is truly a joint one, although the greater bulk of the FASB's existing framework and

[4] Bullen and Crook (2005) provide a staff overview of the objectives.

its strong staff input mean that the starting point tends to be the FASB's existing document rather than the IASB's. In most aspects, there is little difference between the current IASB and FASB frameworks, so that the FASB's distinct influence is seen mainly in the bulk and style of exposition and argument (which may be politely described as 'thorough') in the two draft chapters and working papers that have appeared to date. The present paper is, however, written from the IASB perspective, and this means that some matters which look like changes from that perspective are the result of converging with the FASB's existing position.

## OBJECTIVES AND QUALITATIVE CHARACTERISTICS

The first stage of the revision project (Phase A in Table 1) was initially considered to be so uncontroversial that it was intended that the first publication would be an exposure draft, which would be the only public consultation. However, wiser counsel prevailed and it was decided that the first stage would be (as with all subsequent stages of the revision) a discussion paper, which would be followed later by an exposure draft. This Preliminary Views paper, entitled *The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information*, was published in July 2006, with the comment period ending on 3 November. The comments received have demonstrated that the proposals are controversial and have justified the decision to issue a discussion paper, allowing further consultation on the subsequent exposure draft. They were originally conceived as being uncontroversial because they substantially reiterate much of the material that is in the existing frameworks. However, they do contain some significant reconstruction of the form and argument, certainly relative to the IASB's currently slender document, and these contain the seeds of controversy.[5] Moreover, the retention of some of the concepts in the existing framework is also controversial, particularly in those countries that are recent adopters of IFRS and that were not involved in the original development of the framework.

### *The Objective of Financial Reporting*

Chapter 1 of the Discussion Paper, on the objective of financial reporting, is fundamental to the remainder of the Framework. It reiterates the existing concern to produce *general purpose financial statements*, that is, ones that meet the needs of all external users who do not have privileged access to the entity's internal information. It also continues the present policy of selecting *investors and creditors* as the focus group for establishing needs. This includes potential as well as present investors and lenders as well as equity investors. The needs of investors are assumed to be to make *resource allocation decisions*, which will be served by providing '*information to help present and potential investors and creditors and others to*

[5] The first two chapters of the Discussion Paper (including the Basis for Conclusions), covering objectives and qualitative characteristics, are more than twice as long as the entire existing IASB Framework.

*assess the amounts, timing and uncertainty of the entity's future cash inflows and outflows*' (para. OB3).

This is consistent with the previous Framework, but to newcomers to IFRS it may seem to understate the special role of present shareholders as the existing proprietors of the entity. There is certainly a wide range of users of 'general purpose' financial statements, and they have many needs in common, but some might feel that additionally fulfilling the legitimate needs of present shareholders in their special role as proprietors is a *necessary* requirement, whereas other users have a less compelling claim. This view is expressly rejected, in the Basis for Conclusions (BC1.8–1.13), on the ground that a broad '*entity perspective*' is more inclusive than a narrow '*proprietary perspective*'. This stylization of the proprietary perspective as being narrow and exclusive is contentious: as the Discussion Paper admits, all investors have substantial common interests, so the proprietary approach does not inevitably entail excluding assets and transactions of a group that may be seen as belonging to outsiders, for example, in the manner of proportional consolidation, but rather might entail more detailed information to existing shareholders on how their share of the total had changed.

The problem of accommodating the specific needs of present shareholders was brought into sharp focus by the issue of *stewardship*, which attracted an alternative view from two IASB members (AV1.1–1.7) and a substantial volume of adverse comment subsequently, from the respondents to the public consultation. The Discussion Paper (OB27–28) acknowledged management's stewardship obligation to present owners but claimed that its reporting requirements could be subsumed within the general objective of decision usefulness, served by providing information relevant to future cash flows (OB3, quoted above). Thus, it was not deemed necessary to specify stewardship as a distinct objective of financial reports. The reasoning behind this decision is elaborated in BC1.32–1.41. This does not mark a significant change from the current IASB Framework, which places the assessment of stewardship second in a list of uses of financial reports ((b) in the Preface), but asserts that all of the uses are 'economic decisions' which will be aided by similar information. However, the extensive examination of the issue in the Discussion Paper drew attention to it, and this sidelining of the stewardship objective was clearly unacceptable to many from countries that were recent adopters of IFRS and inherited a loftier view of stewardship's role. The Statement of Principles of the U.K. ASB, for example, although adopting a broad 'decision usefulness for investors' objective, explicitly states that the objective includes 'assessing the stewardship of management' (1.6). It is notable that both of the authors of the alternative view were former members of the ASB.

The objection to the subsuming of stewardship into the decision usefulness objective is, as expressed in the alternative view put forward by IASB members, that accountability entails more than the prediction of future cash flows. Its stewardship dimension is concerned with monitoring the past as well as predicting the future and is sometimes as much concerned with the integrity of management as with its economic performance (e.g., with respect to management remuneration and related party transactions). It is therefore concerned more with the past than is decision-usefulness, although the needs of the two typically overlap: information about the past conduct of management may be relevant to predicting future cash flows and the proper assessment of stewardship will entail estimating future prospects in order to evaluate the consequences of management's past policies. The difference between the two objectives is therefore typically one of emphasis rather than mutual exclusiveness, but both objectives need to be recognized if a proper balance is to be attained.[6]

One issue that was not thoroughly aired in their alternative view is that of agency theory. The relationship between management and existing shareholders is a classic example of a principal/agent problem. Management, the agent, has scope for free action, and the shareholder needs to monitor that freedom, using the information in the financial reports. This is why, in many jurisdictions, the financial accounts are presented by management to the annual general meeting of shareholders, and it is the context in which the term 'stewardship' has developed. The object of this process is to enhance the performance of management from the shareholders' perspective, so financial reporting is involved in *determining* future cash flows, not merely *predicting* them.[7]

The popular term for the process of monitoring management, of which the stewardship process is a part, is *corporate governance* and it may, to some, seem extraordinary that the Discussion Paper, after acknowledging the agency relationship (BC1.40), attempts (not entirely convincingly) to reject the relevance of financial reporting to corporate governance (BC1.41). A possible explanation for this lies in the interesting work of Tim Bush (2005), who analyses the different origins and forms of the U.K. and U.S. regulatory systems for financial reporting and concludes that the former is based on company law, whereas the latter is based on market regulation (the Securities Acts). The latter basis leads to an emphasis on markets and market prices, and therefore to information relevant to future cash flows, whereas the former leads to greater emphasis on corporate governance and stewardship. The FASB's Conceptual Framework reflects U.S. institutional arrangements and therefore favours the market basis. It is therefore not surprising that the EU member states which typically have a strong legal tradition of accounting regulation have favoured the company law approach with its emphasis on corporate governance mechanisms, including stewardship.

### *Qualitative Characteristics of Decision-Useful Financial Information*

The title of Chapter 2 of the Discussion Paper, on the qualitative characteristics of decision-useful financial information, indicates the importance of the assumptions made in Chapter 1, and particularly the subsuming of stewardship under the general objective of decision-usefulness.

[6] Some examples of this balancing process in standards are given later under the heading Reliability and Prudence.

[7] This point is elaborated in the ASB's response to the Discussion Paper, which is available on the ASB's website (http://www.frc.org.uk/asb/press/pub1343.html, accessed, 8 March 2008).

This chapter, like Chapter 1, claims to retain substantially the principles adopted in the predecessor frameworks. However, it does make substantial changes in both form and language, and these are likely to affect the interpretation of the underlying principles. The main change in form is the sequential approach to applying the qualitative characteristics, replacing the previous simultaneous approach in which explicit trade-offs were made. The main change of language is the replacement of *reliability* by *faithful representation.* These changes combine to eliminate the possibility of a *trade-off* between *relevance* and *reliability*, which many regarded as an important aspect of the present Framework. This trade-off is frequently invoked as a reason for not using fair value measurements, which are perceived as often being relevant but unreliable.[8]

The sequential approach to applying the characteristics is described in paragraphs QC42–7 and discussed in BC2.59–2.65. It is explained that relevance should be considered first because it is essential, and that faithful representation should be considered next, but that both characteristics are necessary for decision-usefulness, so that 'they work in concert with one another' (QC45). What is absent from this explanation is an acknowledgement that neither relevance nor representational faithfulness is an *absolute* property of accounting information; rather, there are different *levels* of relevance and faithful representation, which opens the possibility of a *trade-off* between them. If this is ignored, as it appears to be, the proposed sequence will involve selecting an accounting method first on the basis of highest relevance and then subjecting this selection to a filter based on some absolute minimum level of representational faithfulness. Above this threshold there will be no question of saying that greater representational faithfulness might compensate for less relevance, even if the latter loss is very small.

The substitution of *faithful representation* for *reliability* has already weakened the possibility of such a trade-off. The IASB's existing definition of reliability is:

> Information has the quality of reliability when it is free from material error and bias and can be depended on by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent. (IASB Framework, para. 31)

The proposed definition of faithful representation in QC16 is:

> To be useful in making investment, credit and similar resource allocation decisions, information must be a *faithful representation* of the real-world economic phenomena that it purports to represent. The phenomena represented in financial reports are economic resources and obligations and the transactions and other events and circumstances that change them. To be a faithful representation of those economic phenomena, information must be *verifiable*, *neutral*, and *complete*. (QC16)

There are significant differences between the two definitions, despite the Discussion Paper's argument that the new definition is consistent with the intentions of the existing Framework. Not only is faithful representation elevated to be the over-riding concept, but now it refers specifically to 'the real-world economic

[8] Walton (2006), a close observer of IASB meetings, notes the possible implications of this change for the future extension of fair value measurement.

phenomena' rather than simply 'that [which] it purports to represent'. Moreover, the Discussion Paper goes on to assert that: 'Information cannot be a faithful representation of an economic phenomenon unless it depicts the economic substance of the underlying transaction or other event' (QC17).

Thus, the essence of the new qualitative characteristic is that it requires judgments about economic substance and real-world economic phenomena, rather than merely the accuracy with which information represents 'that [which] it purports to represent'. Thus, if fair value were deemed to better capture 'economic substance', historical cost might be deemed to be an inappropriate measure, despite the latter possibly being a more accurate representation of what it purports to represent (historical cost). In QC18, the Discussion Paper attempts, rather clumsily, to explain what it means by a 'real-world economic phenomenon'. It asserts that 'deferred charges and deferred credits do not exist in the real world outside financial reporting'. This is, of course, highly controversial: does, for example, purchased goodwill exist outside financial reporting? It goes on to use the easy example of a machine as something that is a real-world economic phenomenon and asserts that original cost is also such an economic phenomenon, but would not be a faithful representation of a three-year-old machine. In this case, depreciated cost would 'better represent the machine as it now exists' and current replacement cost would be 'even better'. Fair value is offered as another alternative but not evaluated. This example illustrates why those who are opposed to the IASB's alleged intention to extend the use of fair value see the proposals of the Discussion Paper as leaning in that direction.

The other important change that is proposed can also be regarded as tilting the criteria in favour of fair value. This is the removal of the phrase 'free from material error and bias', which is in the definition of reliability in the current Framework but absent from the new definition of faithful representation. Many critics of fair value believe that it often involves more estimation and subjectivity (leading to error and bias) than some alternative measures, and the proposed changes reduce the force, within the framework criteria, of this objection.

These measurement error issues are not entirely ignored in the Discussion Paper. It is argued (QC20–2) that absolute certainty and precision are unattainable in financial reporting, but it is not clearly acknowledged that, nevertheless, greater certainty and precision are preferable to less. What is left of 'free from material error' is subsumed in *verifiability*, a component of faithful representation, and 'free from bias' is included in *another* component, *neutrality*.

> *Verifiability* implies that different knowledgeable and independent observers would reach general consensus, although not necessarily complete agreement, either:
> (a) that the information represents the economic phenomena that it purports to represent without material error or bias (by direct verification); or
> (b) that the chosen recognition or measurement method has been applied without material error or bias (by indirect verification). (QC23)

This concept covers part of what is sometimes termed *objectivity*, requiring that independent observers would reach the same (or a very similar) conclusion. However, it does not require accuracy of the estimate in terms of its correspondence with 'that which it . . . purports to represent' which is required by a stricter view of objectivity and is a critical element in the idea of reliability.[9] A brief alternative view to the Discussion Paper (AV2.1–2.2) pointed out that this is unsatisfactory because there is no requirement that the consensus is based on reliable evidence. Furthermore, in the case of (b), indirect verification, there is no requirement that the method used should be one that would yield an estimate that is free from material error or bias.

*Neutrality* is another component of faithful representation and is defined as

> the absence of bias intended to attain a predetermined result or to induce a particular behaviour. Neutrality is an essential aspect of faithful representation because biased financial reporting information cannot faithfully represent economic phenomena. (QC27)

This definition is curiously restricted because it requires *intent* to influence consequences. Other forms of bias in measures or estimates, such as that resulting from the natural optimism of managers when they make acquisitions, would presumably be allowed. This reflects the Discussion Paper's rejection of the concepts of reliability used in econometrics and statistics (BC2.25).

*Neutrality and Prudence*

The present IASB Framework refers favourably to *prudence* but the Discussion Paper explicitly rejects the use of the term because of its inconsistency 'with the desirable quality of neutrality, which encompasses freedom from bias' (BC2.22). The present Framework (37) attempts to reconcile prudence with neutrality by saying that it is 'the inclusion of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated'. It explicitly disallows deliberate under- or over-statement in the cause of prudence.

The U.K. ASB's Statement of Principles (1999), which adopts a similar approach to the Framework, attempts a reconciliation of prudence with neutrality as follows:

> Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making estimates required under conditions of uncertainty, such that gains and assets are not overstated and losses and liabilities are not understated. In particular, under such conditions it requires more confirmatory evidence about the existence of, and a greater reliability of measurement for, assets and gains than is required for liabilities and losses. (3.19)

By introducing explicitly the role of *confirmatory evidence* to relieve *uncertainty*, the ASB goes some way towards clarifying the relationship between 'two aspects of reliability—neutrality and prudence', but it admits that a 'tension' can exist between the two which requires 'finding a balance that ensures that deliberate and systematic understatement of gains and assets and overstatement of losses and liabilities do not occur' (3.36).

[9] Paton and Littleton (1940, pp. 19–20).

The Discussion Paper's position (no prudence) avoids this trade-off, but in doing so it ignores an important aspect of financial reporting, arising from its stewardship role. Much of agency theory is concerned with the problem that the agent has an incentive to exaggerate performance in order to enhance rewards, a problem that is particularly acute when senior executives are rewarded by stock options and stock prices are driven by reported financial performance. There have been a number of recent accounting 'scandals' arising from this scenario. In this context, a 'degree of caution' associated with a requirement for 'more confirmatory evidence' may lead to improved reliability (expressed as confidence by the user in the information) which will adequately compensate for any possible bias.

A specific example of the exercise of prudence which is an important component of the standards of both the IASB and the FASB is the *impairment test* (IAS 36). This *reduces* the carrying amount of an asset to its current recoverable amount, when that is less than the carrying amount. It does not *increase* the carrying amount if the recoverable amount is higher. Hence, it is fundamentally a biased approach to measurement; it is, however, a prudent one.[10] A similar (biased) measure of liabilities results from the *liability adequacy test* used in the IASB's current standard on Insurance (IFRS 4); this test can result in the carrying value of a liability being increased but not reduced. In the case of both of these tests, strict adherence to neutrality would suggest that the adjustment should be symmetrical, that is, in the case of the impairment test, the asset would always be carried at current recoverable amount (which could, in some cases, be Fair Value). The consequences of this for accounting for purchased goodwill, which has only recently (IFRS 3, 2004) adopted the impairment test in place of amortization, would be particularly significant and controversial. It was therefore to be expected that there would be many adverse comments on the proposed removal of prudence from the Framework. The objectors are not simply clinging to past practices; they are concerned with inconsistencies with current practice, some of which has been imposed only recently by the IASB.

## ELEMENTS AND RECOGNITION

Phase B, Elements and Recognition, has hitherto concentrated on the definition of two basic elements, assets and liabilities. The other elements defined in the current IASB Framework, equity, income and expenses, have not yet been addressed, and neither has been the important and potentially contentious issue of recognition, although developments in the IAS 37 (liabilities) revision relate to it.

By starting with the definition of assets and liabilities, the IASB is reaffirming the so-called 'balance sheet' approach that is embedded in its existing Framework and in that of the FASB. This gives what is sometimes called 'conceptual primacy' (Johnson, 2004) to assets and liabilities over flow measures such as income and expense. This approach argues that the accruals resulting from the recognition of flows must meet the definitions of assets and liabilities in order to be recognized

[10] Bromwich (2004) suggests that impairment tests should not be one-sided.

in the financial statements, that is, the elements of the income statement, such as income and expense, must give rise to accrued amounts that are consistent with the elements of the balance sheet. This approach is a means of imposing discipline on the assessment of accruals, avoiding the recognition of what Sprouse (1978) described as 'What-You-May-Call-Its'. This approach does not require the elevation of comprehensive income (total gains measured consistently with changes in the balance sheet) as a central measure of performance, although it might facilitate it.

*The Definition of an Asset*

The current IASB Framework definition of an asset is:

> a resource controlled by an entity as a result of past events and from which future benefits are expected to flow to the entity. (IASB Framework, 49(a))

The current proposed definition is:

> An asset is a present economic resource to which the entity has a present right or other privileged access.

The new definition deletes two significant phrases in the original: 'as a result of past events' and 'from which future benefits may be expected to flow'. Both of these are likely to affect the recognition criteria, which have not yet been discussed in the conceptual framework revision.

The deletion of 'as a result of past events' was justified on the ground that it was superfluous: anything that exists must have come into existence at some time in the past. However, the deletion does reduce the emphasis on the importance of past transactions and events, and supporters of the stewardship perspective may regret this. If the recognition criterion were merely to say that anything which *currently* meets the new definition should be recognized as an asset, this would seem to erode the grounding of recognition in past transactions and events, reducing the *reliability* of financial statements. It is less obvious that it would reduce *representational faithfulness*, with its emphasis on the representation of 'real-world economic phenomena'. Future prospects that have no origin in past transactions might be regarded as real-world economic phenomena, thus allowing the recognition, at fair value, of elements of internally generated goodwill that have not hitherto been regarded as suitable for recognition in financial reports.

The deletion of the reference to *expected* future benefits suggests that there will be a future proposal to remove one of the current recognition criteria from the Framework:

> An item that meets the definition of an element should be recognised if:
> (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and
> (b) the item has a cost or value that can be measured with reliability.
> (IASB Framework, 83)

Clearly, 83(a) will have little relevance if expected future benefits no longer form part of the definition of an asset. The IASB's reason for the deletion is that the phrase has given rise to some confusion, and it must be admitted that this arises, in part, from the explanation of it in the current Framework (85), which confuses *measurement* with *recognition*. Most elements of financial statements will have uncertain outcomes and, if the *existence* of an asset (or liability) is certain, the fact that its associated cash flows are uncertain can be dealt with by measurement. For example, it is usual to impair debtors for *expected* losses due to bad debts, and stocks may be impaired for expected wastage. Impairment tests are a common way of reflecting expected future cash flows in the measurement of assets.

The type of uncertainty that is unique to recognition, rather than measurement, is what the U.K. ASB's Statement of Principles calls *element uncertainty* (ASB, 1999, 5.13–5.15). This is uncertainty as to whether the element exists and meets the definition of an element, and the IASB's criterion of 'probable that any future economic benefit . . . will flow to the entity' can be interpreted as referring to this type of uncertainty. An asset is not an asset of the entity, and therefore not recognized in its accounts, if its benefits do not flow to the entity. Such 'non-assets' of the entity would include assets whose existence cannot be established with an acceptable level of probability, such as internally generated goodwill. This clearly is an existence (recognition) issue rather than a measurement issue, and the proposed amendment to the asset definition appears to ignore it. The IASB is currently wrestling with that same issue in its revision of IAS 37 (liabilities), where it is attempting to define when a constructive obligation should be recognized as a liability.

Measurement also is part of the recognition process (83(b)), but this is in relation to *reliability* of measurement rather than *uncertainty* of outcome. It is in this context that the IASB Framework (85) is potentially confusing, because the example chosen (credit risk on a receivable) appears to relate to measurement of an uncertain outcome with known parameters (an outcome with known risk, which can be priced and therefore dealt with by measurement) rather than to uncertainty as to what those parameters are (unreliability of measurement itself, which prevents the reliable pricing of the outcome).

In summary, the IASB's (and FASB's) tentative proposals on asset definition involve two changes that potentially erode the recognition criteria in the current Framework. The recognition criteria have not yet been addressed as part of Phase B, and a staff proposal to do so was rejected in July 2007 in favour of continuing work on the definition of an asset. Critics of fair value may fear that the removal of 'past transactions and events' from the asset definition, the transfer of uncertainty from recognition to measurement (where fair value might be thought to capture it effectively) and the possible modification or even removal of the present reliability of measurement criterion for recognition will open the way for an extension of the application of fair value measurement.

*Liabilities*

The asset definition has hitherto received most attention in Phase B, for the reason that this will provide the foundation for the other elements in the 'balance sheet' approach. The other element that has received considerable attention is liabilities, where a parallel definition to that of assets has been proposed. The IASB's current Framework definition is:

> A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. (IASB Framework, 49(c))

The current proposed definition is:

> A liability is a present economic burden for which the entity has a present economic obligation.

Just as the liability definition mirrors that of assets, so do the changes in the definition. As in the case of assets, the reference to past events is deleted, as also is the reference to expectation of future flows. Thus, the same implications arise for assets as for liabilities, particularly with regard to recognition criteria.

As already indicated, the IASB is already confronting recognition criteria in its revision of IAS 37. It proposes to abolish the concept of *provisions*, classifying all former provisions as liabilities. Provisions were liabilities 'of uncertain timing or amount' (IAS 37, para.10) and the IASB's current thinking is that many liabilities are subject to a degree of uncertainty that is reflected in their measurement, so that a sub-category of provisions is unhelpful, despite the fact that it may convey information about the relative predictability of the respective categories. With regard to the recognition of liabilities, the IASB has focused on the question of whether an obligation exists. It has identified a *stand-ready* obligation, as in a guarantee or insurance contract, as giving rise to a liability, the uncertainty of future outflows being reflected in measurement. It is currently exploring the difficult problem of establishing the circumstances in which a constructive liability should be recognized when there is no contractual obligation. This is an element uncertainty issue, but the IASB's current preference (*IASB Update*, July 2007) is to draw up a list of indicators rather than confronting directly the probabilistic nature of the decision by defining a probability threshold for recognition, such as 'more likely than not'. These developments are likely to reinforce the possibility that the IASB, by removing uncertainty criteria from recognition and requiring that uncertainty should, instead, be reflected in measurement, is moving towards a position of requiring that the recognition criterion be the existence of a fair value. Essentially, any expected future cash flow to the entity, however speculative, could be reflected in a fair value that might be said to meet the new element definition and therefore be recognized.

*Equity*

The definition of *equity* and the difficult problem of defining the distinction between liabilities and equity is another elements issue that will have to be dealt with in Phase B, but which has not yet been addressed directly, although the FASB does have a project on the liability/equity distinction, which is being 'shadowed' by the IASB. This difficulty arises partly because equity is a residual category in the current Framework:

> Equity is the residual interest in the assets of the entity after deducting all liabilities. (IASB Framework, 49(c))

This leads to a wide variety of financial instruments, such as options on equity, being classified as equity, thus confusing the simple picture that would be given if there were only one category of equity instruments, issued shares in the holding company. It also has led to considerable ambiguity at the margin with liabilities: essentially anything that is not a present obligation to part with economic resources is equity. This has led the IASB to breach the Framework in one instance (a promise to settle in shares to the value of a fixed monetary amount is classified as a liability) and it has issued an exposure draft that proposes to create another breach (*Financial Instruments Puttable at Fair Value*, October 2006) by treating as equity some instruments that have a right to cash settlement and seem therefore to meet the current definition of a liability.

One of the possible solutions recently explored in this project is the *claims* approach, which regards all credits in the balance sheet as 'claims', making no debt/equity distinction. This solves the problem by abolishing it, and is unlikely to be adopted. However, little enthusiasm has been expressed for moving in the alternative direction of having *two-tier equity*, the lowest tier being the claims of existing shareholders, and the other tier including other equity instruments such as warrants, options on equity and (in group accounts) minority interests. Such an approach would accommodate the needs of those who regard present shareholders as having a special role as the proprietors to whom the directors owe a special duty of accountability and who are the ultimate controllers of the entity. The 'entity' perspective currently favoured by both FASB and IASB makes no concessions to this group and can lead to accounting that makes it quite difficult for them to establish the gain or loss on their interest in a period.

*Other Elements of Financial Statements*

Other elements have not yet been discussed in Phase B, and it is not yet clear whether all of the elements in the current Framework will be retained. The two elements defined in the existing framework that have not yet been mentioned in Phase B are *Income* (which includes both *revenue* and *gains*) and *Expenses* (which includes *losses*). In view of the 'balance sheet' approach, it seems likely that these will not be discussed as elements but will instead be discussed as part of the performance statement in Phase E of the Framework revision, Presentation and Disclosure. The IASB and FASB already have a joint project on performance reporting, which originally arose from the problem of income statement presentation. This has attracted a large amount of critical comment. Opponents of the IASB's preferred single comprehensive income statement, many of whom are preparers of accounts, are afraid that comprehensive income, possibly based substantially on fair value measurement, will become the central figure for performance evaluation.[11] They regard fair values and comprehensive income as

[11] For a further discussion of comprehensive income in this journal, see Cauwenberge and De Beedle (2007, pp. 1–26).

volatile measures that mask operating profit, which they would regard as a better indicator of the entity's underlying potential for generating future cash flows. The IASB is still exploring the obvious solution, which is to allow sub-totals such as operating profit (roughly, revenue less expenses, in the current Framework's terms). The difficulty is to define such sub-totals in a way which is based on sound principles, practical in application, and acceptable to users and preparers of financial statements.

## THE REPORTING ENTITY

Phase D of the conceptual framework deals with the reporting entity and has made more progress than the measurement phase (C), possibly because it is less controversial. A discussion paper on reporting entity issues is expected to be published in 2008. This is not to say that the subject is not important or that it is without controversy (Walker, 2007).

One source of criticism is likely to stem from the rather rigid view currently favoured by the IASB that only one set of general purpose financial statements is appropriate for a group entity. The rejection of the importance of separate holding company accounts is a symptom of the rejection of a proprietary perspective in favour of an entity perspective, leading to the view that the interests of those financing the holding company, and particularly the equity shareholders, should not be given special consideration in financial reporting. The group accounts would be important under either perspective, but a proprietary view would regard the holding company accounts as adding useful information from the perspective of the holding company, for example, showing the extent of its direct control of assets and legal obligation for liabilities.

## MEASUREMENT

Work on Phase C, Measurement, has already started, and it is likely to be a lengthy process, because of the importance of the subject and its contentious nature, which caused the predecessor conceptual frameworks to avoid addressing the issue directly, discussing desirable properties of measurements rather than recommending a single preferred measurement objective.

The controversial nature of the subject was partly a result of the inflation accounting debate that raged in the 1960s and 1970s, when the FASB was also developing its conceptual framework which provided a model for successor frameworks such as that of the IASB. The debate at that time was about whether price changes should be reflected in accounts. In other words, it was about historical cost versus some form of current value. It was then easy to stylize the debate as being between 'old-fashioned' advocates of historical cost, justified by a narrow view of stewardship, and 'modern' advocates of current value who believed in decision-useful information. However, at the time, it was accepted by many, and acknowledged in the frameworks of the FASB and the IASB, that decision usefulness and stewardship are not necessarily competing objectives and that the needs of stewardship require timely information about performance which would, ideally, be captured by current values.

Since that time, the debate has moved on. Although comprehensive price change accounting did not prove to be successful, recent years have seen an increasing adoption of current values in accounting standards, particularly in accounting for financial instruments (IAS 39), but also in areas such as agriculture (IAS 41).[12] In these new applications, discussion has been concerned with the question of *which current value* should be used. The failed attempts to introduce price change accounting were based on *current cost* which is supported by *deprival value* reasoning. More recently, standard setters have preferred to use the term *fair value*, meaning a *current market value*:

> Fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. (IAS 16, 6)

This definition is consistent with either an entry value (such as current cost) or an exit value (such as selling price), and it does not define a treatment of transaction costs, so that, for example, it is consistent with net realizable value (selling price less selling costs being the *amount* that the seller would receive). These ambiguities are removed by the recent IASB Discussion Paper based on SFAS 157 (FASB, 2006):

> Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (SFAS157, 5)

Thus, fair value is an *exit* value (the price received to sell an asset) and *transaction costs* are *not* included (hence the substitution of 'price' for 'amount'). Moreover, the reference to a *market* rather than a transaction between parties emphasizes the requirement that the measure be *non entity specific*, that is, it should be based on a hypothetical best market price rather than the price actually paid or that would be actually obtained by the reporting entity.

The Discussion Paper based on SFAS157 is supposed to be merely a 'how to do it' proposal for existing uses of fair value, rather than extending that use, but the result of its new definition is to draw the lines clearly between different views of the appropriate measurement basis. The difference is not now between historical cost and current value but between *entry* (cost-based) values and *exit* (sale) values, and between those who wish to measure the opportunities available to the *specific entity* and those who prefer to use hypothetical *market prices*.

The Discussion Paper is not strictly part of Phase C of the Framework revision, although its progress to date is likely to have more impact than that of the Phase C work. The latter has taken the form of drawing up an inventory of valuation bases and developing a conceptual approach to measurement that will enable those methods to be evaluated.

[12] Tweedie and Whittington (1984) provide an account of the development of price change accounting standards, and Tweedie and Whittington (1997) describes their rejection (mainly by preparers of accounts) and subsequent withdrawal.

The nine candidate valuation bases selected for analysis in Phase C do not include deprival value, once the favourite of standard setters, on the ground that it is a hybrid measure, derived from a comparison of other measures (current entry value, current exit value and value in use). This ignores the fact that deprival value is a coherent valuation *objective*. Concentrating on the intrinsic properties of specific measures at the expense of considering how objectives might be achieved seems to miss the point of accounting, which is to inform users in an imperfect and uncertain world.[13] It seems possible that this type of analysis will lead to a long and ultimately fruitless debate.

This impression is borne out by the papers on measurement submitted to the IASB's July 2007 meeting. After a careful analysis of measurement theory, a revision of the IASB's definition of measurement is proposed. The current definition is:

> Measurement is the process of determining the monetary amounts at which the elements of financial statements are to be recognized and carried in the balance sheet and income statement. (IASB Framework, 99)

The proposed new definition is:

> Financial statement measurement is the numerical ordering or comparison of an asset or liability (or a change in an asset or liability) to other assets or liabilities (or changes in other assets or liabilities) with respect to a preconceived and defined basis in terms of a monetary unit that relates to that same basis, with the result that the asset or liability is properly placed in a monetary ratio scale. (*IASB Information for Observers*, Board Paper 2B, July 2007, 69)

This may be rigorously grounded in measurement theory, but it seems unlikely to have as good an intuitive appeal as the present definition, from the perspective of preparers and users of financial statements.

Ultimately, the IASB and FASB will have to stop analysing the internal consistency of definitions and turn to the *utility* of accounting measures. In evaluating that, it will be necessary to have agreement on the *purpose* of financial statements and the *environment* in which they are used. This is a much wider issue than measurement, or, specifically, whether fair value is judged to be a good measure by certain criteria. It is concerned with what was earlier described as a world view. More precisely, this is a model of the purpose of financial accounting and the context in which it operates.

## COMPETING WORLD VIEWS

In the earlier discussion of the framework review, it is possible to discern two broad schools of thought or world views. They are not well articulated because

[13] This is not to say that specific measures cannot be associated with a particular objective. An obvious example is Chambers (1966), who justified the need for exit value measures in terms of an objective of measuring financial adaptability. However, it is notable that Chambers' 'current cash equivalent' measure was not the same as fair value: notably, he came to the view that non-vendible durable assets should be measured at zero value (because there was no cash equivalent available) rather than a hypothetical exit value (Chambers, 1970). If there exists a fungible arm's length price for a comparable asset he would use it to report the item. And, Chambers advocated valuing bonds at face values rather than current market prices. For a summary see Chambers (1974).

the argument usually focuses on a particular aspect of the framework rather than the whole system. There is also a variety of individual views within each broad school of thought, so that a degree of stylization is necessary. However, it may clarify the debate if the views of the parties are articulated in a holistic manner, identifying the common ground within each world view and the difference between that and the competing view.

The two competing models identified here are the Fair Value View and the Alternative View.[14] The latter title is justified because many of its ideas are supported by *alternative views* attached to IASB pronouncements. Another reason for using this rather bland description is that many of the attributes of that view are too easily associated with consequences that do not necessarily follow from them. For example, if it were described as 'a stewardship view' there could be an inappropriate belief that this necessarily implied a preference for historical cost measurement.

*The Fair Value View*

This is a view that is apparent in many of the proposed revisions of the Framework. Some of its features are also in the existing Framework. This broad view would be supported by a significant number (but not necessarily a majority) of members of the FASB and the IASB, and possibly by a majority of the staff who have worked or are working on the frameworks of the two boards.[15] Because of its articulation by professional standard setters (albeit with individual differences of view on some aspects) this has been more clearly expressed in a 'joined up' systematic way than has the Alternative View.

The main features of the Fair Value View are:

- *Usefulness for economic decisions* is the sole objective of financial reporting.
- *Current and prospective investors and creditors* are the reference users for general purpose financial statements.
- *Forecasting future cash flows*, preferably as directly as possible, is the principal need of those users.[16]
- *Relevance* is the primary characteristic required in financial statements.
- *Reliability* is less important and is better replaced by *representational faithfulness*, which implies a greater concern for capturing economic substance, and less with statistical accuracy.

[14] A similar (but not identical) identification of two schools of thought is made at the end of Andrew Lennard's very interesting and insightful paper on 'Liabilities and How to Account for Them' (2002).

[15] Staff opinions are not expressed in public, but staff recommendations are expressed to the boards, although only on issues that are referred to them. However, staff do author published papers and their views are sometimes expressed quite forcefully there (e.g., Johnson, 2005).

[16] Directly' means that the measure summarizes expected future cash flows, as in a discounted present value.

- Accounting information needs ideally to reflect the *future*,[17] not the past, so past transactions and events are only peripherally relevant.
- Market prices should give an informed, *non entity specific* estimate of cash flow potential, and *markets* are generally sufficiently complete and efficient to provide evidence for representationally faithful measurement on this basis.

The implications of the Fair Value View are:

- *Stewardship is not a distinct objective* of financial statements, although its needs may be met incidentally to others.
- *Present shareholders have no special status* amongst investors as users of financial statements.
- *Past transactions and events* are relevant only insofar as they can assist in predicting future cash flows.
- *Prudence* is a distortion of accounting measurement, violating *faithful representation.*
- *Cost* (entry value) is an inappropriate measurement basis because it relates to a *past* event (acquisition) whereas future cash flow will result from future exit, measured by *fair value*.
- *Fair value*, defined as market selling (exit) price, as in SFAS 157(FASB, 2006), should be the measurement objective.
- *The balance sheet* is the fundamental financial statement, especially if it is fair valued.
- *Comprehensive income* is an essential element of the income statement: it is consistent with changes in net assets reported in the balance sheet.

*The Alternative View*

As indicated above, the Alternative View is more difficult to articulate than the Fair Value View because it is drawn from a diverse range of constituents of the standard-setting process who are typically commenting on particular issues from a practical perspective, rather than attempting to develop a coherent model of financial statement presentation in the manner of the authors of the Framework. However, this does not mean that an alternative systematic view of the world does not exist and would not attract wide support as an alternative to the Framework, although it does mean that there are probably a number of variations that would be favoured by different constituencies. Below is an attempt to articulate what might be termed an 'enlightened' Alternative View. This would be supported by somebody who did acknowledge the merit of setting accounting standards based on a systematic set of principles and who did recognize the necessity for accounting practice to change in order to meet the needs of users of accounts. It

[17] Mary Barth (2006), an IASB Board member, provides a useful discussion of the orientation of accounting information towards the future, making clear the distinction between recognition (only present rights and obligations should be recognized) and measurement (expected cash flows from those rights and obligations may affect their measurement). She views measurement from a fair value perspective. Michael Bromwich (2004) provides a discussion of future-oriented information from an alternative, deprival value perspective. See also Rosenfield's discussion in this journal of the way to report 'prospects' data within a fair value reporting system (2008, pp. 48–60).

therefore precludes the totally reactionary views (not uncommon among busy people who are preoccupied with the daily problems of running their business) that nothing in current practice needs to be changed, that financial reporting standards are an unnecessary interference in business, and that thinking conceptually about accounting is an academic, ivory-tower activity of no relevance to the real world.[18]

The main features of the Alternative View are:

- *Stewardship*, defined as accountability to present shareholders, is a distinct objective, ranking equally with decision usefulness.
- *Present shareholders* of the holding company have a special status as users of financial statements.
- *Future cash flows* may be *endogenous*: feedback from shareholders (and markets) in response to accounting reports may influence management decisions.
- Financial reporting relieves *information asymmetry* in an uncertain world, so *reliability* is an essential characteristic.
- *Past transactions and events* are important both for stewardship and as *inputs* to the prediction of future cash flows (as indirect rather than direct measurement).
- The economic environment is one of *imperfect and incomplete markets* in which market opportunities will be *entity-specific*.

The implications of the Alternative View are:

- The information needs of *present shareholders*, including *stewardship* requirements must be met.
- *Past transactions and events* are *relevant* information and, together with *reliability of measurement* and *probability of existence,* are critical requirements for the *recognition* of elements of accounts, in order to achieve *reliability*.
- *Prudence*, as explained in the current IASB Framework and in the ASB's Statement of Principles, can enhance *reliability.*
- *Cost* (historic or current) can be a *relevant* measurement basis, for example as an input to the prediction of future cash flows, as well as for stewardship purposes.
- The financial statements should reflect the financial performance and position of a specific entity, and *entity specific* assumptions should be made when these reflect the real opportunities available to the entity.
- *Performance* statements and *earnings* measures can be more important than balance sheets in some circumstances (but there should be arithmetic consistency—articulation—between flow statements and balance sheets).

[18] A feature of standard-setting has been the constructive engagement of the academic and business communities. Standard-setting bodies have always been well stocked with experienced practitioners, but there have also been notable academic inputs. For example, David Solomons was a member of the Wheat Committee that devised the FASB and Robert Sprouse was one of FASB's first members. Robert Sterling and Paul Rosenfield were also early members on the FASB. In the U.K., both the Chairman (David Tweedie) and Vice-Chairman (Brian Carsberg) of the ASB, at its inception, started their careers as full-time academics.

*A Summary of the Two Perspectives*

The Fair Value View emphasizes the role of financial reporting in serving investors in capital markets. It seeks accounting information that has a forward-looking content, impounding future cash flows from a non entity specific market perspective. It is most likely to achieve this when the reference markets are complete and competitive; ideally, perfect markets would be accessible.

The Alternative View also seeks to serve investors, broadly defined, but it gives priority to existing shareholders and regards stewardship as an important and distinct function of financial reporting. It too seeks accounting information that is relevant to forecasting future cash flows, but it assumes that this will often be achieved by providing information that is useful input to investors' valuation models, rather than direct valuation of future cash flows. Such information may be entity specific. This approach assumes that information asymmetry and imperfect and incomplete markets are common.

Possible conflicts between these two competing world views have been apparent in a number of recent IASB pronouncements, and are discussed below.

## SOME IASB PROPOSALS WHERE THE ALTERNATIVE VIEW SUPPORTS CRITICISMS

A number of the IASB's proposals (in discussion papers, exposure drafts and standards) have been subject to strong criticism from constituents and, in some cases, alternative views from within the Board. The following list is by no means complete, but it illustrates instances in which criticisms reflect the Alternative View. The view expressed by the IASB and its partner, the FASB, usually is consistent with the Fair Value View. This is not surprising because the conceptual frameworks of the two boards, which guide their work, are also consistent with that view.

*The 'Present Shareholder' Focus*

IFRS 2, *Share-Based Payment*, adopts the *grant date* approach to measuring stock options. As soon as the grant is made, the option is an equity instrument and subsequent gains or losses in value are treated as transfers within equity rather than gains or losses. From the perspective of present shareholders, these gains and losses are real and should be reported transparently as such until the exercise date, when they are realized. A significant number of critics of this standard advocated *exercise date* measurement, reflecting a 'present shareholder' perspective.

The IASB Exposure Draft, *Proposed Amendments to IFRS 3* (2005), proposes to amend the existing treatment (under IAS 27) of gains and losses on non-controlling equity investments in subsidiary companies (minority interests). This new treatment is based on the economic entity view, which regards non-controlling (minority) interests as equity of the group. Gains and losses on trading in minority shares are therefore treated merely as transfers between equity holders and reported in the statement of changes in equity rather than the income statement. However, such transactions are gains and losses from the perspective of the shareholders of the holding company. An alternative view by three Board members (AV8–10) amplifies this argument. A similar alternative view is attached to the Proposed Amendment to IAS 27, *Consolidated and Separate Financial Statements* (June 2005, paras.AV1–3).

The current version of IAS 27 was revised in 2004, when minority interests (now described as non-controlling interests) were classified as equity for presentation purposes. The standard contains a dissenting opinion (DO1–3) by one member who foresaw the consequences of extending this approach to the recognition and measurement of changes in minority interests.

*Entity Specific Assumptions*

The IASB's current standards do allow entity specific assumptions in some instances. Most notably, IAS 36, *Impairment of Assets*, bases recoverable amount on projected cash flows (when fair value is not an appropriate measure), and these will inevitably be based on entity specific management forecasts. As indicated earlier, impairment testing can be viewed as an application of *prudence*, so that IAS 36 defies the Fair Value View in two respects.

IAS 37, *Provisions*, also allows entity specific assumptions in the estimation of 'the best estimate of the amount to settle an obligation at balance sheet date' (IAS 37, 36). However, the proposed amendment (in the June 2005 IASB Exposure Draft) would narrow, but not eliminate, the scope for entity specific judgement, by moving closer to the FASB's fair value measure (Exposure Draft, IAS 37, Amendments to IAS 37, June 2005, BC77–8). The proposed measure is: 'the amount that it would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date'. Transfer to a third party implies a market transaction, which is a step towards fair value.

The entity specific issue has also arisen in the *revenue recognition* project, where one proposed model advocates that obligations to customers should be measured at fair value, that is, to reflect the costs that a neutral 'market participant' would bear, whereas an alternative would be to reflect the expected costs of the entity holding the obligation. A specific application of this problem arises in the IASB's recent discussion paper on *Insurance Contracts* (2007). The preferred 'exit value' model can be interpreted as a fair value measurement, but fair value would exclude entity specific assumptions, whereas in practice entities are likely to rely substantially on evidence derived from their own business models, so the IASB has reserved its judgment as to whether the approach should be described as fair value.

*The Relevance of Cost*

The use of cost measures is widespread in the standards of the IASB and the ASB, particularly for *initial recognition* of assets and liabilities, but also many assets and liabilities are subsequently carried at historical cost or amortized cost. When items are revalued, this is usually at fair value. We have seen that the SFAS 157 proposals would preclude fair value from being interpreted as replacement cost ('entry' values), although replacement cost might be used as a proxy for fair value in the absence of other measures, at the bottom of the measurement hierarchy. This would change current practice in areas such as IAS 16, *Property, Plant and Equipment*, and IAS 17, *Leases*, where replacement cost may seem to be a more relevant measure of future cash flows for assets that are to be used in the business, and which therefore represent future costs saved rather than future revenues earned.

The rejection of cost in favour of fair value selling price at initial recognition is particularly controversial. This gives rise to 'day 1' profits on financial instruments (IAS 39). Such profits rely on the entity being able to realize the asset at fair value in the future. Therefore, some would argue that the profits are not yet 'earned' at day 1, which is why retailers are usually required to record their stock at cost rather than a higher retail price.[19]

In the exposure draft to revise IFRS 3 on business combinations, the proposal to change from a cost allocation model to one based on the fair value of the whole acquired entity has been very controversial, with extensive alternative views by board members (AV1–20). One of the criticisms made (AV18) is that purchase consideration including acquisition costs (which would be written off under a fair value measurement basis) best captures the economic substance of the acquisition transaction, reflecting the outlay which the acquirer must expect to recover.

*Reliability and Prudence*

The controversy on the proposed IFRS 3 revision raises a number of issues of reliability, particularly with respect to the measurement of 'full goodwill' (including goodwill in the acquired entity that is attributable to minority interests). This depends on there being a reliable measure of the fair value of the acquired entity, rather than merely the portion that was acquired. Five board members proposed an alternative view to this proposal (AV1–7), on grounds of unreliability of measurement.

The existing version of IFRS 3 also attracted a great deal of criticism from constituents, again with particular regard to its treatment of goodwill. Amortization of goodwill, the previous treatment, was abandoned in favour of impairment testing. Critics of IFRS 3 acknowledged that amortization is arbitrary (as is depreciation of tangible assets) but argued that it guaranteed the *accountability* of management for their expenditure on the acquisition, because over its lifetime the full cost of goodwill would be charged to profit. Under the impairment test, there is no guarantee of this, because of the difficulty of separating acquired from internally generated goodwill (IFRS 3, Dissenting opinions, DO16). A related issue is that the impairment test is weaker than it need be because it does not include a subsequent cash flow test like that in the U.K. ASB's original standard (IAS 36, Dissenting Opinions, DO6–10). Such a test might be regarded as an application of prudence, but so is the whole asymmetric principle of impairment testing.

[19] This type of criticism has a long history—see the discussion of the 1930s ideas of George Husband described in this journal (Reinstein *et al.*, 2008, pp. 82–108).

*Recognition Criteria*

The two recognition criteria in the existing IASB Framework are probability that the entity will receive future cash benefits (in the case of an asset) and reliability of measurement. The probability criterion has been eroded by some recent decisions of the IASB.

IFRS 3, *Business Combinations*, and the consequential amendments to IAS 38, *Intangible Assets*, result in the withdrawal of the probability recognition criterion for intangible assets acquired in a business combination, on the ground that their measurement is at fair value, which incorporates assessments of probability. As explained earlier, this ignores element uncertainty, and it is inconsistent with the treatment of other intangible assets. A dissenting view to IFRS 3 (DO7) addresses this issue, as does a dissenting opinion on the revised IAS 38 (DO1–3).

Using the same reasoning, IFRS 3 also removes the probability requirement for contingent liabilities acquired in a business combination because they are measured at fair value, and this too is addressed in DO7.

*Performance and Earnings*

The IASB has a long-running project on reporting financial performance. This has proved to be very controversial, and the project is now part of a joint FASB project, Presentation of Financial Statements. The main original aim of the project was to improve the presentation of the income statement to include a comprehensive income measure, sometimes referred to as 'clean-surplus' income. This might be achieved by having two statements (as in the U.K. ASB's FRS 3 format, and one of the options in the FASB's current standard) or one. Some IASB board members had a strong, publicly expressed preference for a single statement and also an aversion to prescribing sub-totals such as operating income.

This was the main source of opposition, particularly from preparers of accounts, but also from some users, who saw a measure of operating income as an important indicator of management performance and an important input to valuing the entity. It is easy to stylize this attitude as resistance to change or management wanting something below operating profit in which to hide bad news, but there is a more worthy rationale. In many businesses, the operations and margins on operations are drivers of cash flow and, in such cases, it may well be very informative to separate these 'core' activities from other activities such as financing or non-core investments such as property ownership. A vivid illustration of this approach is given in a recent paper by Penman (2007), which uses the example of valuing the Coca-Cola Company to show how cost-based earnings numbers can be used effectively in valuation.[20]

[20] The Penman paper uses historical cost earnings for illustrative purposes. This does not preclude current replacement cost, if it were available, from providing an even more useful measure. This is compatible with the Alternative View expressed in this paper. That view does not deny the potential usefulness of current values (entry or exit) when they can be reliably measured and are relevant to the circumstances of the entity.

## CONCLUDING THOUGHTS: WHO IS RIGHT IN THEORY?

The advocates of fair value, and more broadly the Fair Value View, have a consistent view of the world that appears to have attractive attributes of coherence and simplicity from a theoretical standpoint. It is therefore tempting to dismiss it as 'alright in theory but not in practice'. However, it should be noted that the theoretical underpinnings of the Fair Value View are fairly intuitive and simplistic. Previous advocates of exit value, notably Chambers (1966) and Sterling (1970), developed much more comprehensive theories of business reporting and measurement and would not have been unqualified supporters of the Fair Value View, as outlined above.[21]

The Alternative View, on the other hand, arises from a variety of people with diverse views, commenting on specific issues, often from a practical standpoint. Thus, on the surface at least, it is possible to regard it as somewhat incoherent, pragmatic and lacking in theoretical foundations. Such an approach might be dismissed as 'practical but not alright in theory'. Neither of these conclusions would be correct. As we have seen, the two views are based on different assumptions about the nature of the economic environment, and it is the accuracy of these assumptions that determines the relevance of the respective views to accounting standards.

If we accept that the world is not characterized by perfect and complete markets, the Fair Value View loses much of its attraction, because it does not relate to the real world in which standard setters operate. In this sense, it is not 'alright in theory' because good theory, from the standard setter's perspective, should be relevant, as well as logically coherent.

The Alternative View, on the other hand, does relate to the real world of market imperfection, but it does not offer simple, coherent solutions. The solutions that come out of the Alternative View will have a much greater entity or industry specificity, perhaps even allowing more judgement, which tends to offend the orderly instincts of standard setters. However, the Alternative View does not lack theoretical support. Hicks (1946) is a standard reference for writers on income measurement, and careful readers of his work (of whom there seem to be fewer than those who refer to it) will recall that Hicks confined his analysis of income to static theory (not a realistic view of the business world) and rejected its use in dynamic analysis. In that context, he wrote of Income, Saving and Depreciation:

> In spite of their familiarity, I do not believe that they are suitable tools for any analysis which aims at logical precision. There is far too much equivocation in their meaning, equivocation which cannot be removed by the most painstaking effort. At bottom, they are not logical categories at all: they are rough approximations, used by the business man to steer himself through the bewildering changes of situation which confront him.

[21] Chambers' reservations have been noted earlier (note 13). Sterling was extremely careful to point out that his 'conclusions are restricted to trading assets in a trading firm' (Sterling, 1970, p. 36) and he acknowledged the difficulties caused by market imperfections. Moreover, unlike the advocates of fair value, he advocated the deduction of transaction costs from exit prices in order to establish exit *values* (p. 327). For a summary of Sterling's later ideas, see Lee and Wolnizer (1997).

> For this purpose, strict logical categories are not what is needed; something rougher is actually better. (p. 171).

The Alternative View is compatible with Hicks' 'rough approximations used by the business man' and, although standard setters may hope to smooth out the roughness as much as possible, some will remain.

Theoretical support for the Alternative View can also be found in the classic work of Edwards and Bell (1961), who were also economists by training. Their analysis emphasized income, rather than the balance sheet (although their system did incorporate 'clean surplus' articulation of total gains with the balance sheet), and considered how *ex post* accounting income, based on past transactions and events, could be used to evaluate performance, using current cost measures rather than fair values (which would be included in what they described as 'opportunity costs'). A great deal of subsequent theoretical work by others during the so-called 'golden age' of accounting theory in the 1960s and during the subsequent debate on inflation accounting was in the Edwards and Bell mould and compatible with the Alternative View.

On the level of pure theory, an important paper by Beaver and Demski (1979) demonstrated that income is an ill-defined concept in a world of imperfect and incomplete markets and that, in such a world, accounting has the role of providing useful information rather than definitive measures: a conclusion consistent with that of Hicks. Ironically, in the perfect market conditions in which income *is* a well-defined concept, it is not needed, and neither are financial statements: all of the relevant information is impounded in the present value of the entity, which is its market price in a fully informed market.[22] In the same spirit, when Fischer Black (1993), the pioneer of option pricing theory, came to express his views on how to improve financial reporting, these were very pragmatic and based upon providing information that would help to identify sustainable earnings, rather than offering a Fair Value View.

One reaction to the problem that it is not possible to deduce a general, theoretically 'correct' accounting measure in a world of imperfect and incomplete markets has been for many academics to retreat from theoretical or normative work into empirical studies of how markets react to accounting information, as a test of usefulness. This is unfortunate because such tests can only study what is observable, so that they cannot develop or test new reporting methods: that duty has thus been thrust on the standard setters and on practitioners. A more constructive approach might be to recognize that theories are not likely to offer panaceas such as a universally valid single measurement method and instead to work in a more limited way to solve specific problems. Certainly, this approach has worked well in the related discipline of Economics. Keynes (1930), many years

[22] A recent paper by Hitz (2007) evaluates the decision-usefulness of fair value accounting both from the measurement perspective and from the informational perspective that Beaver and Demski identify as being the appropriate role for financial reporting in a realistic setting of imperfect and incomplete markets. The conclusion of this evaluation is that the case for fair value measurement is supported only when reliable market values are available.

ago, hoped for economists to develop in this way and they have largely achieved this, by developing tools of analysis, such as game theory or agency theory which can be applied to specific problems without claiming to provide universal solutions. Such models are already applied in areas of accounting, such as accounting disclosure.[23] It is suggested that the Alternative View is consistent with this type of theorizing and that it offers more fruitful practical application than the Fair Value View.

One approach to accounting measurement which contains the elements of this approach and is already well-established in the academic literature is *deprival value*,[24] which provides an algorithm for choosing a measurement method (rather than prescribing one universal method) that is grounded in the economics of the firm. It is unfortunate, and perhaps indicative of standard setters' current preferences, that this approach to defining a measurement objective rather than a single technique has been omitted from the current list of measurement candidates being evaluated in the Conceptual Framework revision, on the ground that it is a hybrid approach, allowing for the use of more than one 'pure' measurement method. Therefore, the economists' experience might be relevant to standard setters in their search for a conceptual framework. Perhaps the time has come for them to stop trying to work financial miracles (such as deriving a universal 'best' measurement method from a complex definition grounded in abstract measurement theory) but instead to follow Keynes' advice and 'manage to get themselves thought of as humble, competent people, on a level with dentists'.

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[23] Verrecchia (2004) gives a concise survey of the application of theoretical models to accounting disclosure. Wagenhofer (2004) provides a broader survey of the application of analytical economic models to financial reporting.

[24] The history of the concept and its role in the inflation accounting debate is surveyed in Tweedie and Whittington (1984). Recent examples of work relating deprival value to fair value are Bromwich (2004) and Van Zijl and Whittington (2006). A good example of economic analysis supporting the use of deprival value is Edwards *et al.* (1987).

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