SEC July 9 Roundtable on Fair Value Accounting Standards

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Introduction

The recent credit crisis has provided enough fuel for those who proclaim to be anti-fair value measurement in financial reporting but as remarked in various quarters, the problem is not with the reporting standards themselves but with the economic situation as it is. Indeed, the standard has actually reported the current economic phenomena as it happened!

Even though Malta is a tiny Island in the midst of the Mediterranean, the credit crunch has effected the few listed financial institutions indirectly. Through my research degree at the University of Southampton, I will be identifying what are the perceptions of Maltese auditors, preparers and users (stockbrokers) with respect to the transition in accounting from a historical based model to a fair value one.

I am glad that the SEC will be carrying on the discussions on two distinct levels. One level will address the issue of large financial institutions and the other will seek to address small public companies. I feel there shouldn't be any debate with respect to all quoted companies i.e. they should follow full IFRSs. Yet, however, whilst this will probably highlight certain issues my humble suggestion to the SEC is that the discussion be directed towards giving priority as to what the objective of financial reporting should be. It would be futile to discuss measurement issues if we do not agree what the objective of financial reporting should be.

Setting the scenario

Maltese registered companies are regulated by the Companies Act which came into being on the 1st January 1995. Apart from revamping the whole regulatory framework, an important milestone in the history of accounting in Malta, was to entrench into the said Act, the then existing set of International Accounting Standards as the norm for the preparation of a complete set of financial statements[1]. Henceforth, the same set of standards have to be adhered to irrespective of, whether a company is listed. Listed companies have the additional requirement of complying with the listing rules of the local stock exchange.

[1] Companies Act of 1995 (ACT No.XXV of 1995); Section 2(3)

Historically, Britain was the last foreign ruler of Malta. Referring to the "*suggested classification of accounting 'systems' in some developed Western countries in 1980"* as depicted by Chris Nobes and Robert Parker[2], Malta can be included under the Micro-fair-judgmental-Commercially-driven / Business Practice-Professional Rules-British Origin / **UK influence** accounting system. Indeed, countries like Australia and New Zealand both of which form part of the British Commonwealth are included here. It is noteworthy to point out that the suggested classification puts US influence in contrast to the UK.

This distinction is of significant relevance as even, though, we commonly refer to such accounting systems as falling within the Anglo-Saxon model, there are differences which elucidate the whole fair value debate. Differences stem off from important distinctions within the respective legal systems. A very good account of these differences is presented in a paper written by Tim Bush on behalf of the ICAEW[3]. In the executive summary of that report, he states:-

> *"Because of a constitutional quirk, the US federal reporting model does not address in enforceable law the fundamental capitalist proposition* ***'do the accounts show how efficiently a company is run on its capital resources?'*** *[emphasis added] This proposition requires that internal accounting and external reporting address the intra vires objectives of a company (acting within the powers of the company). Instead the federal model poses a legally very different, and actually far more ambiguous question,* ***'are the accounts consistent in showing what a company might be worth when a share is exchanged?'*** *[emphasis added]"*

This quotation explains the current debate over the recent IASB's Preliminary Views on an improved Conceptual Framework for Financial Reporting – *The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information*. The heated debate centres around whether the objective of financial reporting should be based on 'decision-usefulness' or whether stewardship should be recognised as a separate objective. Relating these two objectives to the above quote it is immediately evident that the concept of 'stewardship' is indeed embedded in UK company law whereas that of 'decision-usefulness' emanates from the US legal framework.

It is certainly relevant at this point to emphasize that this notion of stewardship was also embedded into the Maltese 1995 Companies Act which replaced the previous Commercial Partnerships Ordinance of 1948. Indeed section 163(2) specifically mentions that:

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[2] Christopher Nobes & Robert Parker; Comparative International Accounting; 4th Edition – Prentice Hall publishers; pg.71

[3] Bush Tim; "Divided by common language – Where economics meets the law: US versus non-US financial reporting models"; ICAEW 2005

"….proper accounting records shall be deemed to have been kept with respect to the matters aforesaid if such records are sufficient to show and explain the company's transactions and are such as to –

(a) disclose with reasonable accuracy, at any time, the financial position of the company at that time; and
(b) enable the directors to ensure that any balance sheet and profit and loss account prepared under this Chapter complies with the requirements of this Act."

This issue of stewardship has been expounded on in a paper presented by Andrew Lennard[4] and takes the 'Alternative View' set out by two members of the IASB in underlining that:-

> *"stewardship and decision-usefulness are parallel objectives with different emphasis, that should therefore be defined as separate objectives"*

and continue to argue further that:-

> *"stewardship contributes an important dimension to financial reporting, which should be reflected by specific acknowledgement in the objectives of financial reporting"*

He infers that the concept of stewardship has a direct consequence on the preparation of financial statements based on historical costs and that such information should be complete. He even goes on to say that it would be:-

> *"easier to make a compelling case for this information if a major role for stewardship were identified in the framework, rather than being placed merely in a supporting role"*

Placing emphasis solely on decision-usefulness as an objective of financial reporting has led to

> *"an excessive emphasis on the forecasting of future cash flows* [which is at the heart of fair value accounting]*, and insufficient emphasis on reliability, which seems to be an essential qualitative characteristic of financial statements."*

The following paragraph from the summary of Andrew Lennard's thought-provoking paper says it all

> *"There is no conflict between decision-usefulness and stewardship objectives, since the information required to meet the objective of*

[4] Lennard Andrew; "*Stewardship and the objectives of financial statements*"; Accounting Standards Board Public Meeting – 21st September : Conceptual Framework

> *stewardship is required by decision-usefulness; however, the exclusion of stewardship incurs the risk that those* [like users and preparers in Malta] *who argue for the inclusion of information required for an assessment of stewardship will be placed at a disadvantage."*

The way forward

Both the IASB and FASB have to, initially, settle the objective issue of financial reporting as this has a direct consequence on the eventual measurement base to be adopted within the whole framework for financial reporting. This notion is also supported by Ian Hague[5]

> *"Any examination of the use of a particular measurement characteristic must start with an examination of the purposes for which that characteristic is to be used. Just as an individual planning to purchase an automobile considers whether they want to use it for one person driving in warm, sunny climates (in which case they might select a small convertible) or for a five-person family that regularly takes back-country camping trips (in which case they might select a four-wheel-drive mini-van), the purpose, or objective, of financial reporting must be taken into account in determining whether a measurement characteristic satisfies this objective"*

Moreover, it has been established that we can still use historical cost figures to arrive at a future valuation of a quoted company. This has been very well expounded by Stephen Penman[6] from Columbia University. I myself have adapted his proposed model to one of the quoted companies on the Maltese Stock Exchange and was very close to the stock market price of this entity's share.

Whilst acknowledging the fact that the IASB, alongside the FASB, is promulgating the further use of fair values in the valuation of assets and liabilities within financial statements, attention should be given to this important issue and as the English saying says "the proof of the pudding is in the eating!" Indeed we have and we are now looking for that ingredient to give it a better taste which will keep our customers happy!

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[5] Ian P.N. Hague , 'The case for fair value' in Walton P. (editor), *The Routledge companion to Fair Value and Financial Reporting*, Routledge, Oxon.

[6] Stephen Penman, 'Financial Reporting Quality: Is Fair Value a Plus or a Minus?' ICAEW, *Information for Better Markets Conference*, December 18-19, 2006