Accounting for good governance: the fair value challenge

John Dixon and Yuliya Frolova

John Dixon is based at the College of Social Sciences, Kazakhstan Institute of Management, Economics and Strategic Research, Almaty, Kazakhstan.
Yuliya Frolova is based at the Bang College of Business, Kazakhstan Institute of Management, Economics and Strategic Research, Almaty, Kazakhstan.

Abstract

Purpose – *The purpose of this paper is to describe and analyze the accounting standards reforms that have moved the accounting profession away from rules-based towards principles-based accounting practice and financial reporting, and to explore the implications for boards of directors of fair value estimates of the unknowable contaminating financial statements with financial misstatements.*

Design/methodology/approach – *The paper critically reviews the internationally accepted accounting, auditing and financial reporting standards with respect to fair value accounting and relates them to directors' fiduciary duties – the duties of care, of oversight, and of obedience.*

Findings – *The search for relevance in financial accounting raises daunting challenges for boards of directors tasked with fairly presenting the financial condition of a reporting business entity.*

Research limitations/implications – *The accounting profession has long been epistemologically conservative, judging reliability to be more important than relevance in the compiling of financial statements. With the fair value reforms, relevance has achieved ascendency over reliability. This necessitates an increase in the need for more research in the epistemology and ethics of accounting.*

Practical implications – *Boards of directors need to be well-informed about, and fully engaged with, the assessment of the level of risk of material misstatement associated with the fair value accounting estimates, and with the adequacy of the related mandatory explanatory disclosures.*

Originality/value – *This paper's originality is grounded in its exploration of the epistemology of accounting in the light of the adoption of fair value conventions in the internationally accepted accounting, auditing and financial reporting standards and its drawing out of the implications this has for corporate governance.*

Keywords *Accounting, Corporate governance, Fair value, Ethics, Epistemology of accounting, Accounting ethics*

Paper type *Conceptual paper*

> From an ethical perspective, accounting has a responsibility to require that financial statements ''present fairly'' the financial conditions and operating results of an entity (Seay and Ford, 2010, p. 643).

Introduction

The fair-value reforms to internationally recognized accounting standards[1] have moved accounting from the world of verifiable accounting facts into the world of speculative accounting estimates, a transition that has taken accounting, according to Magnan and Cormier (2005), into ''forecounting''. The resultant financial statements have become factually opaque, with an illusion of mathematical rigor, and a density of mandatory declarations. This paper raises serious questions about what accountants can know as genuine knowledge – the truth – about the financial reality of a reporting business entity by adopting fair value accounting conventions. This, in turn, raises daunting challenges for chief (principal) financial officers, chief executive officers, auditors, and boards of directors, including their constituent audit committees, tasked with compiling, verifying, attesting, and

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certifying that the audited financial statements are free of untrue statements of material facts, because all financial data contained therein are complete, verifiable, unbiased and faithful representations of the phenomenon they purport to represent, and do not omit, misleadingly, any material facts, and thus are free of material misstatements, and so fairly present the financial condition of a reporting business entity[2].

The objectives of this paper are four-fold. The first is to describe the accounting standards reforms that have, over recent decades, moved the accounting profession away from rule-based towards principles-based accounting practice and financial reporting. The second is to describe the accounting principle of fair value, which represents how the generally accepted international accounting standards are guiding accountants in the estimation of the expected market value of a reporting business entity's assets and liabilities at the valuation date. The third is to explain how fair value estimates are externally audited, so as to allow an assessment of the extent to which the audit process ensures that financial statements are not contaminate with material misstatements. The final objective is to explore the implications of the possibility of such contaminating financial misstatements for boards of directors and perhaps their constituent audit committees charged under internationally recognized financial reporting standard with attesting that filed audited financial statements are free of untrue statements of material facts, and do not omit, misleadingly, any material facts, and thus are free of material misstatements, and so fairly present the financial condition of a reporting business entity.

Accounting standards reconceptualization: from historical cost accounting to fair value speculative accounting

The accounting profession has long judged that the dual governing principles of financial accounting (Spiceland *et al.* 2007, p. 24) should be reliability (traditionally, transaction-based accounting facts) and relevance (the utility of those accounting facts), with reliability in the ascendency and relevance informed by probity. Accountants have thus long been epistemologically conservative, being long governed by accounting standards designed to provide them with a set of rules that gave rise to transaction-based accounting methods that are least likely to overstate the values assigned to particular items in financial statements at the valuation date. They thereby produced what could be attested to be fair and consistent financial reporting, which could be readily audited and their truth-value certified. Indeed, accountants prided themselves on being recorders of accounting facts, giving the status of factuality only to financial data the truth-value of which can be established by reference to documented past transactions – the historical cost principle, under which assets are reported and presented at their entry-price value (the cost initially reported on a financial statement) and are only ever adjusted downwards to determine current or carrying-forward values (so reflecting only asset depreciation and ignoring price inflation). The pendulum has, however, shifted over recent decades, as relevance has increasingly achieved ascendency over reliability, with relevance being informed by ''the assumed information needs of users in markets'' (Power, 2010, p. 205). Power (2010) argues, persuasively, that the reliability-relevance debate (see Allen and Carletti, 2008; Song and Thomas, 2010; Hitz, 2007; Ryan, 2008) is grounded in differential epistemological conceptualizations of reliability, and, indeed, its conflation with the concept of relevance (see also Whittington, 2008). Thus, financial reporting is now far less rules-based and far more principles-based with respect to the valuation of a reporting business entity's assets and liabilities (Emerson *et al.*, 2010; see also Jones, 1988). Such a transformation in the logic of financial accounting has its roots in its colonization in recent decades by financial economics, giving rise to the ''financialization of financial accounting'', the ''shadow of financial economics over financial accounting'', and the methodological alignment of financial accounting and financial economics (Power, 2010, p. 203; see also Hopwood, 2009). Thus, it might be said that accountants are being transforming into ''econaccountants'',

Now on the ascendency are mark-to-market or fair-value accounting principles – involving the estimation of the expected market value of assets and liabilities at valuation date, giving

rise to hypothetical exit-price values, i.e. the prices that would have to be received at the valuation date to justify selling an asset or paid to justify transferring a liability (Financial Accounting Standards Board, 2008; but see also Bromwich, 2007), as measured by economic estimation models, making accountants now also the producers of accounting suppositions, the truth-value of which is, to say the least, problematic — for as Power (2010, p. 201) critically comments, such ''values are never real market values but only estimates of market prices which would or could be obtained''. Whether the exit-price value methodology can discern the true and fair financial condition of reporting business entity is, however, a vexed issue.

Fair value accounting

The standard definition of the fair value of an asset or liability is ''the price that *would be received* to sell an asset or liability in an orderly transaction between market participants at the valuation date'' (Financial Accounting Standards Board, 2008: paragraph 5, emphasis added). This gives rise to ''a hypothetical transaction'' (paragraph 7) that permits the estimation of a hypothetical exit price ''based on the assumptions that market participants would use in pricing the asset or liability'' (paragraph 13), on the assumption that the market exchange takes place ''in the most advantageous market'' (paragraph 8), as ''an orderly transaction between market participants'' (paragraph 7), none of whom are ''under duress'' (paragraph 16), and all of whom are ''independent of the reporting identity'', ''knowledgeable, having a reasonable understanding about the asset and liability and the transaction based on all available information'', and ''able'' and ''willing to transact for the asset or liability'' (paragraph 10). In calculating the estimated exit-price valuation of the asset related to its ''highest and best use'' – that which ''would maximize the value of the asset'' (paragraph 13), which must, of course, be ''physically possible, legally permissible, and financially feasible'' (paragraph 12), or the estimated exit price valuation of the liability incorporates any ''nonperformance risk'', i.e. the risk that the sale ''obligations will not be fulfilled'', such as the ''obligation [of the buyer] to deliver cash'' or the ''obligation [of the seller] to deliver goods and services'' (paragraph 15), and the ''terms of credit enhancements related to the liability, if any'' (paragraph 15). So, the fair value of an asset or liability, essentially, can be estimated by its hypothetical exit-price, derived using the assumptions that hypothetical market participants would use to determine the hypothetical price they would have offered at the date of valuation to purchase the asset or liability in a hypothetical best-use market (see Bromwich, 2007).

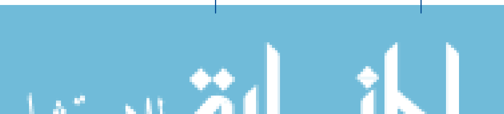
There are three standard sets of fair value estimation techniques that can be used to determine the exit-price value of an asset and liability (Financial Accounting Standards Board, 2008, paragraph 18):

1. the market approach, which ''uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business)'' (paragraph 18, sub-section a);

2. the income approach, which ''uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted)'' (paragraph 18, sub-section b); and

3. the cost approach, which ''is based on the amount that currently would be required to replace the service capacity if an asset (often referred to as current replacement costs)'', and is thus the ''price that would be received by [the seller] for the asset is determined by the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence'' (paragraph 18, sub-section c).

In applying these types of fair value estimation techniques, the ''inputs'' – referring broadly to ''the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk [. . .] inherent in a particular valuation technique [. . .] and/or the risk inherent in the inputs to the valuation technique'' (paragraph 21) – have be categorized as either ''observable'' or ''unobservable'' (paragraph 21). ''Observable inputs are inputs that reflect the assumptions market participants would use in pricing the asset or



liability based on market data obtained from sources independent of the reporting entity'' (paragraph 21, sub-section a). ''Unobservable inputs are inputs that reflect the reporting entity's *own assumptions* about the assumptions market participants would use in pricing the assets or liabilities developed based on the best information available in the circumstances'' (paragraph 21, sub-section a, emphasis added), which means that ''the reporting entity shall not ignore information about market participant assumptions that is *reasonably available* without *undue cost and effort*'' (paragraph 30, emphasis added).

Particularly challenging are financial statement items – such as the market value of the equity in a private company for which there is no publicly listed company equivalent, of derivatives, and of depreciated assets – for the exit-price can only be estimated by reference to inputs that are both unobservable at the valuation date, in the absence of an active and orderly marketplace for the same or similar assets or liabilities, and unknowable ever, because confirming or denying accounting facts cannot be determined at any time in the future, thereby making their verification and thus the attesting and certifying of their correctness or truth value impossible. To be empirically true, an accounting must be both independently (objectively) verifiable by reference to evidence confirming its factuality, a proposition grounded in the verification principle (Hume, 1975; Locke, 2004), and falsifiable, so as to ensure that the accounting value is not just un-falsifiable contention of a self-referential systems of thought, a proposition grounded in the falsification principle (Popper, 2000). On this basis, fair value conventions can give rise to unverifiable and un-falsifiable exit-price asset and liability value estimates on unknowable financial statement items that cannot be warranted as empirical truth. The resultant fair value exit-price generated could well be what a management-oriented estimator thinks it should be, i.e. the highest defensible price; what a conservative estimator thinks it could be, i.e. the most defensible price; or what a risk-aware estimator thinks it might be, i.e. the most likely defensible price. Which of these prevails could well depend on the reporting business entity's risk appetite and tolerance. This makes extremely problematic any assertion that they are true statements of material fact that do not omit, misleadingly, any material facts, and thus also any certification that their inclusion in a financial statement does not constitute instances of material misstatements that would bring into question whether that financial statement fairly presents the financial condition of reporting business entity. This then begs the question, how are fair value estimations audited so as to enable external auditors to judge whether they are, or constitute a risk of being, material misstatements, whether intentional or not? It is to this issue that attention is now turned.

Auditing fair value estimates

International Standard on Auditing 540 (henceforth ISA 540) (International Auditing and Assurance Standards Board, 2008a) acknowledges that there are financial statement items the value of which can only be estimated (ISA 540, paragraph 2) and guides ''the auditor's responsibilities relating to accounting estimates, including *fair values accounting estimates* and related disclosures in an audit of financial statements'' (ISA 540, paragraph 1, emphasis added; see also Grego and Zollo, 2003). An accounting estimate is defined as ''an approximation of a monetary amount in the absence of a precise means of measurement. This item is used for an amount measured at fair value where there is *estimation uncertainty*, as well as for other amounts that require estimation'' (ISA 540, paragraph 7(a), emphasis added). Estimation uncertainty – i.e. the degree of veracity that an accounting estimate – leads to ''the risks of material misstatement of accounting estimates, including their susceptibility to unintentional or intentional management bias'' (ISA 540, paragraph 2). Management bias refers to ''a lack of neutrality by management in the preparation of information'' (ISA 540, paragraph 7(d)). Thus, auditors have to obtain audit evidence about ''*reasonableness* of fair value accounting estimates and *adequacy* of related disclosures in the financial statements in the context of the applicable financial reporting standards or framework'' (ISA 540, paragraph 6, emphasis added). Auditors have thus to obtain sufficient appropriate audit evidence to enable them to include in the audit documentation ''the basis for the auditor's conclusions about the reasonableness of accounting estimates and their

disclosure that give rise to significant risks; and indicators of possible management bias, if any'' (ISA 540, paragraph 23). To this end they are required to undertake a systematic audit process.

First, auditors have to determining whether the fair value estimation of an asset or liability is permitted or required under the applicable financial reporting standards or framework. This may depend on management's intentions to carry out certain actions with respect to particular assets or liabilities (ISA 540, p. 462). Such management intentions include whether an investment is to be held until maturity. Thus, auditors need to understand how management identified the need for fair value accounting estimates. This is done primarily by:

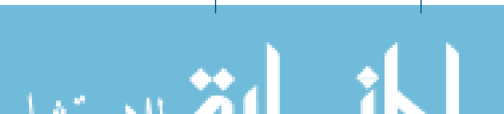
- performing a risk assessment, among other things, directed at the methods and practices management follows to review periodically the circumstances that give rise to fair value accounting estimates (ISA 540, p. A17); and/or
- making inquiries of management, which may include whether the reporting business entity has engaged in new types of transactions or terms of transactions, and whether applicable accounting policies or regulation have changed, all which may give rise for new or revised fair value accounting estimates (ISA 540, p. A19).

This understanding prepares auditors for discussions with management as to how it applied the requirements of the applicable financial reporting standards or framework relevant to particular financial statement item estimates, and to determine whether those requirements have been applied appropriately (ISA 540, p. A13).

Second, the auditors have to understand how management calculated the fair value accounting estimates – the mathematical model chosen and the observable and unobservable inputs used (ISA 540, p. A68), so as to enable the identification of any possible estimation errors that could give rise to material misstatements. This involves them in considering (ISA 540, p. A23):

- whether and how management has used the measurement techniques for making these accounting estimates endorsed by the applicable financial reporting standards or framework;
- whether these accounting estimates were made based on best data available at the reporting date, and
- whether and how management has taken into account new information that subsequently became available.

For some financial statement items, the applicable financial reporting standards or framework requires specific estimation methods to be used, while for other items, alternative methods are permitted. Thus, auditors have to understand the choice of estimation method. This involves consider the nature of the asset or liability being estimated and the methods commonly used to make the particular type of estimate in a particular business, industry, or environment in which the reporting business entity operates (ISA 540, p. A25). Internally developed models and other departures from a method commonly used in a particular environment bear a greater risk of material misstatement (ISA 540, p. A26). Auditors can, in coming to their conclusions on estimation errors, also consider the experience and competence of those who make the fair value accounting estimates (ISA 540, p. A27) and management's use of experts (ISA 540, p. A28) to understand relevant controls. Auditors thus need to understand management's assumptions that underlie the accounting estimates (ISA 540, p. A31) and the extent of subjectivity – the inclusion of unverifiable assumptions – in those assumptions, which influences both the degree of estimation uncertainty and thereby the auditor's assessments of the risks of material misstatement for a particular accounting estimate (ISA 540, p. A36). The auditor can, where applicable, also review prior-period fair value accounting estimates to judge the effectiveness of management's current estimation process on the basis of the effectiveness of the prior-period estimation process (ISA 540, p. A39), and so identify possible management bias (ISA 540, p. A40) and risk of management override of internal controls (ISA 540, p. A41). Those accounting



estimates that were identified during the prior-period audit as having high estimation uncertainty or those that have changed significantly from the prior period involve a greater risk of material misstatement than those accounting estimates that arise from routine and recurring transactions (ISA 540, p. A42). When the risk assessment is finished, the auditor can identify the risks of material misstatement by identifying the sources of estimation uncertainty associated with a fair value accounting estimate, which influence the estimate's susceptibility to bias (ISA 540, p. A45). Fair value accounting estimates for which a highly specialized entity-developed model is used or for which there are no observable inputs represent an example of accounting estimates that may have high estimation uncertainty (ISA 540, p. A47).

Third, auditors then develop a response to the identified sources of estimation uncertainty that may give rise to risks of material misstatement (ISA 540, p. 463). This involves examining how management calculated each fair value accounting estimate, which is done by evaluating:

- the estimation method used (ISA 540, p. A68);
- the appropriateness of the model chosen (ISA 540, p. A74);
- the assumptions used by management, including assumptions about the pricing assumptions that future market participants would make;
- the operating effectiveness of any relevant internal controls; and
- the need to develop a point estimate or range of estimates, or to narrow that range.

However, it is difficult to see how any assessment can be made of any estimation uncertainties of fair values estimates of *unknowable* financial statement items that are based on *unobservable* inputs that ''reflect the reporting entity's *own assumptions* about the *assumptions* market participants would use in pricing the assets or liabilities'' (Financial Accounting Standards Board, 2008, paragraph 21, emphasis added) in the absence of confirming or denying evidence of the veracity of assumptions.

Fourth, auditors must, after determine the risks of material misstatement embedded in each fair value accounting estimate, judge their reasonableness (ISA 540, p. 465), by evaluate their fidelity to fact or even semblance to truth, so as to enable them to make a sound judgment. With respect to unknowable financial statement items, the estimated fair values of which are based on the reporting business entity's own assumptions about the pricing assumptions future market participants would make, it is difficult to see how auditors can make sound judgments on the reasonableness (probable veracity) of those fair value estimates if the nature and extent of the risks of material misstatement cannot be ascertained because the estimation uncertainties are unknowable in the absence of confirming or denying evidence of the veracity of reporting business entity's own assumptions.

Fifth, the auditor evaluates disclosures related to all accounting estimates (ISA 540, p. 465), so as to ensure a full and accurate disclosure of all relevant information related to the calculation of al fair value and other accounting estimates. These required disclosures include (ISA 540, p. A120):

- the method of estimation used;
- the effect of any changes to the method of estimation used from the prior period;
- the reporting business entity's own assumptions used in the pricing particular assets or liabilities; and
- the sources of the estimation uncertainty and their associated risks of material misstatement.

The auditor may conclude that the disclosures are inadequate, even if they are in accordance to applicable financial reporting standards or framework, when they relate to a significant risk of material misstatement (ISA, 540, p. A122).

Finally, auditors ''obtain written representations from management [about] [...] whether they believe significant assumptions used in making [fair value] accounting estimates are reasonable'' (ISA 540, paragraph 22). This permits establishing ''whether there are indicators of possible management bias'' (ISA 540, paragraph 21), such as when the use of an entity's own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions (ISA 540, p. A125), as part of determining whether the financial statements as a whole are free from material misstatement (ISA 540, p. A128). This enables auditors to be satisfied, and thus able to attest, that the fair value estimates of unknowable financial statement items have been calculated:

- in good faith by management;
- in a manner management reasonably believe to be in the best interests of the reporting business entity; and
- using the best information reasonably available to management in the circumstances, with no information being ignored that could have been gathered without undue cost and effort.

Auditors are thus not expected to, cannot, and do not affirm the correctness (truthfulness) of fair value accounting estimates (see also Pannese and DelFavero, 2010). The implications of the accounting profession adopting what Popper (2000) would undoubtedly have regarded as self-referential systems of thought, that generate un-falsifiable accounting estimates, can be seen from the selection of case studies that are the focus of the next section.

Fair value accounting case studies

During the recent global financial crisis, European Union officials requested that the International Accounting and Assurance Standards Board (IAASB) move away from fair value accounting back towards historical cost accounting by changing its financial reporting standards so as to allow banks to reclassify securities held for trading (Pozen, 2009; see also Procházka, 2011). On 13 October The IASB issued 2008 the necessary amendments[3], which made the requested reclassifications possible. As the IASB announced at the time (International Auditing and Assurance Standards Board, 2008b):

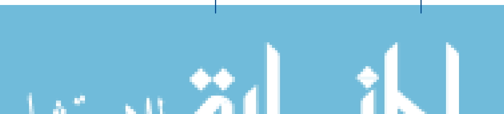
> The deterioration of the world's financial markets that has occurred during the third quarter of this year [2008] is a possible example of rare circumstances cited in these IFRS amendments and therefore justifies its immediate publication. Today's action enables companies reporting according to IFRSs [International Financial Reporting Standards] to use the reclassification amendments, if they so wish, from 1 July 2008.

These amendments allowed, albeit in rare circumstances, the reclassification of securities out of the held-for-trading category if the reporting business entity so chooses. Securities can now be classified as (IAS 39):

- held-for-trading securities, which have to be reported at fair value, with unrealized gains and losses included in the income statement;
- available-for-sale securities, which have to be reported at fair value with unrealized gains and losses excluded from the income statement but reported in the statement of changes in equity; and
- held-to-maturity securities, which have to be reported at their book value (amortized cost).

The consequences of this technical change to the financial reporting standards are insightful.

Deutsche Bank, by reclassifying held-for trading securities as available-for-sale securities, reported a €93m profit under the historical cost principle, instead of a €700m loss for the third quarter of 2008, simply by not recording in its income statement an €800m loss from fair value estimate write-downs that would have been required under the fair value accounting



principle. The management of Deutsche Bank in their report for the third quarter of 2008 (Deutsche Bank, 2008) provided the following justification for their action:

> We identified assets, eligible under the amendments, for which at July 1, 2008, we had a clear change of intent to hold for the foreseeable future rather than to exit or trade in the short term. In these instances, management believes the intrinsic value of the assets exceeds their estimated fair value, which has been significantly adversely impacted by the reduced liquidity in the financial markets. Management believes returns on these assets will be optimized by holding them for the foreseeable future rather than through exit in the short term. The reclassifications align more closely the accounting with the business intent.

ABN AMRO Holding NV reclassified, due to market illiquidity, held-for-trading convertible bonds with a fair value of €509m to being available-for-sale held-for-trading securities. The resultant €38m loss after reclassification was recorded in the available-for-sale reserve (ABN AMRO Holdings, 2008, Note 14) reported in the statement for changes in equity, rather than the income statement.

Barclays plc reclassified certain financial assets originally classified as held-for-trading, which were deemed to be no longer held for the purpose of selling or repurchasing in the near term, out of fair value through profit or loss to loans and receivables, according to IAS 39.46(a), which are measured at amortized cost. If this reclassification had not been made, the Barclays Group's income statement for 2008 would have included unrealized fair value losses on the reclassified trading assets of £1.5m (Barclays, 2008, Note 51).

For Credit Agricole SA, the contribution to 2008 pre-tax income of the reclassified assets amounted to €124m. If assets had been retained in their former category, and thus the subject to fair value estimation, then the 2008 pre-tax income would be a loss of €637m (Credit Agricole, 2008, Note 9).

In general, the IASB's 2008 amendments to its financial reporting standards allowed the European banks to increase profits by almost $29bn in that year (Pozen, 2009). This begs the question, did the financial statements complied and audited under the amended financial reporting standards fairly present the financial condition of a reporting business entity? The relevant management and boards of directors obviously determined that they did. They preferred, when given the option, not to apply fair value accounting principles to measure the value of their securities portfolios in the context of financial markets with reduced liquidity. They judged that an audited financial statement in which the value of their securities portfolios was determined on the basis of their amortized cost fairly presented the financial condition of their reporting business entity, perhaps because in such market circumstances the business entity needs time to heal (Power, 2010, p. 204). Intriguingly, it would be fascinating to know whether they would have been willing to attest and certify that an audited financial statement in which the value of their securities portfolios was determined using fair value accounting principles would also have fairly presented the financial condition of the reporting business entity? Where, then, does all this leave the accounting and auditing concept of ''material misstatement''?

Fair value auditing: the challenges of boards of directors

It is the board of directors that must approve a reporting business entity's audited financial statements. The now broadly internationally accepted Sarbanes-Oxley financial reporting standard requires that they be free of untrue statements of material facts, and do not omit, misleadingly, any material facts, and thus are free of material misstatements, which, essentially, means that they fairly present the financial condition of a reporting business entity. To this end boards need to be well-informed about, and engaged with, the assessment of the level of risk of material misstatement associated with the estimation models and management assumptions underpinning the fair value accounting estimates embedded in the financial statements and the adequacy of the related explanatory disclosures (see, for example, Gaa, 2010; Lafranconi and Robertson, 2002; Song and Thomas, 2010).

It is management who are ''responsible for the making of financial estimates included in financial statements'' (Generally Accepted Auditing Standards, AU Section 342, Clause .02). Illustratively, American financial reporting practice, under Sarbanes-Oxley (Sect. 302, emphasis added), requires management, who in the form of the chief executive officer(s) or chief financial officer(s), to certify, subject to criminal penalties for non-compliance with all requirements (Sect. 906), that he or she, among other things:

> . . . has reviewed the [financial] report; (2) based on the *officer's knowledge*, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, *in light of the circumstances under which such statements were made*, not misleading; (3) based on such *officer's knowledge*, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report . . . .

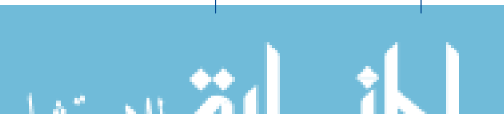
Management is not expected to, cannot, and does not affirm the correctness (truthfulness) of the fair value accounting estimates nor attests to the absence of unintentional financial misstatements in financial statements. They are only attesting to the fair value accounting estimates being calculated in good faith and in a manner they reasonably believe to be in the best interests of the business entity, and using the best of their knowledge of an unknowable future state of affairs, and to the related explanatory disclosures being adequate to describe methods, models and assumptions under which the fair value accounting estimates have been made, thereby permitting others to judge the level of risk of material misstatement present.

The external auditors are not expected to, cannot, and do not affirm the correctness (truthfulness) of the fair value accounting estimates, nor attest to the absence of unintentional financial misstatements in audited financial statements, as they are only ''responsible for testing and evaluating the [management's] fair value measurements and disclosures'' (Georgiades, 2005, p. 1) and for reporting their findings, with or without reservations, to the board of directors or its audit committee. Illustratively, Sarbanes-Oxley (Sect. 204, emphasis added) requires external auditors to report to the board of directors, through its audit committee, on:

> (1) *all* critical accounting policies and practices to be used; (2) *all* alternative treatments of financial information within generally accepted accounting principles that have been *discussed* with management officials of the issuer [the business entity], *ramifications* of the use of such *alternative disclosures* and treatments, and the *treatment preferred* by the registered public accounting firm; and (3) other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences.

Such audit reports, as they related to fair value accounting estimates, are limited, to advising boards of directors on the judgments of external auditors, presumably adhering to the highest ethical and professional standards, that the audited fair value estimates are *fair* – not intentionally misleading, because they have been impartial calculated by management using, where necessary, reasonable methods, models and assumptions in conformity with internationally recognized accounting standards – and reasonable – taking into consideration their accounting significance, their variability, their subjectiveness, and their susceptibility to misstatement and bias (Generally Accepted Auditing Standards, AU 342; see also AU 328). Thus, the external auditor's judgement is limited to identifying the level of risk of material misstatement and the adequacy of the related explanatory disclosures. Thus, the auditing of fair value accounting estimates comes down to the extent to which the external auditors are in accord with management with respect to:

- the appropriateness of using the fair value valuations principle to value a particular financial statement item;
- the appropriateness of the choice and complexity of the fair value estimation methods and models used to estimate the value of that financial statement item;



- the risks of material misstatement associated with the estimation uncertainties of the fair value accounting estimates generated by inputting into the estimation models management's assumptions about the assumptions that future market participants would make in pricing the asset or liability being valued;
- the reasonableness of those fair value estimates in the light of the assessed risks of material misstatement associated with the assessed estimation uncertainties of the fair value accounting estimates; and
- the adequacy of the related disclosures in terms of the measurement methods, models and assumptions used to calculate fair value accounting estimates, and of the associated risks of material misstatements grounded in the assessed estimation uncertainties.

In the event of disagreement between management and external auditor regarding financial reporting, Sarbanes-Oxley (Sect. 301) empowers Audit Committees to resolve the disagreement.

Soberingly, Strahota (2002) notes that while Sarbanes-Oxley increases civil and criminal responsibility of corporate officers in the USA, it does not change the responsibility of directors, but it definitely increases their potential civil liability (see. for example, Fairfax, 2003). Directors have long been subject to set of governing principles that have become, over time, a set of fiduciary duties – most notably, in the context of fair value accounting principles, a duty of care, a duty of oversight, and a duty of obedience, any of which, if breached such that a foreseeable loss is incurred by another individual or legal entity, constitutes the foundation of a negligence legal action (see, for example, Hyatt and Charney, 2005).

Duty of care

> . . .a director's duty shall be discharged in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner that the directors reasonably believe to be in the best interest of the corporation (its shareholders, owners and other stakeholders) (Hyatt and Charney, 2005, p. 2).

In the context of fair value estimates, directors need to:

- determine the degree of risk of material misstatement associated with the fair value accounting estimates embedded in audited financial statements that is acceptable in the best interest of the business entity, its shareholders and other stakeholders;
- inform themselves about the estimation models and management assumptions underpinning fair value accounting estimates; and
- satisfy themselves that the fair value accounting estimates incorporated into financial statements have been appropriately calculated in accordance with best industry practice and are in the best interest of the business entity.

Duty of oversight

> . . . a corporate director is subject to liability when he (1) utterly fails to implement any reporting or information system or controls, or (2) having implemented such a system or controls, the director consciously fails to monitor or oversee its operations, rendering the corporation unable to recognize and address risks or problems (Piccini, 2011).

In the context of fair value estimates, directors need to:

- implement any reporting mechanism to enable the board of directors or its audit committee to be kept informed about, and debate with management, on its thinking about the assumptions underpinning fair value accounting estimations;
- assess and determine whether that key sensitive management assumptions used in the calculation fair value accounting estimates are in accord with the best interest of the reporting business entity, its shareholders and other stakeholders; and

- assess, in the light of the external auditor's judgment and management certification of the level of risk of material misstatement and the adequacy of the related explanatory disclosures associated with the fair value accounting estimates, and determine whether the level of risk of material misstatement present in the audited financial statements is within the degree of risk acceptable to the Board of Directors in the best interest of the reporting business entity, its shareholders and other stakeholders.

Duty of obedience

> Directors have a duty to follow the organizations governing documents [and] [. . .] comply with [. . .] laws that relate to the organization and the way it conducts its business [including] [. . .] financial filing requirements (Hyatt and Charney, 2005, p. 2).

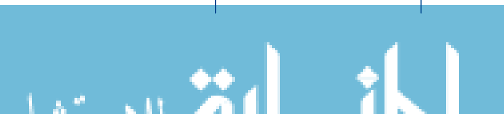
In the context of fair value estimates, directors have an obligation to satisfy themselves, by reference to independent advisors, if deemed necessary and appropriate, in the absence of audit and management certification that the financial statements are free of untrue statements of material facts and do not omit, misleadingly, any material facts, that the fair value accounting estimates do not constitute instances of unintentional material misstatements that would bring into question whether that financial statement fairly presents the financial condition of reporting business entity.

Conclusion

The accounting profession has long been epistemologically conservative, judging reliability to be more important than relevance in the compiling and auditing of financial statements. With the fair value accounting standards reform, however, relevance has achieved the ascendency over reliability. Thus, accounting facts are being replaced with accounting suppositions, the truth-value of which is problematic to determine. The search for relevance has, indeed, taken financial accounting beyond the search for the empirical truth – the verifiable value of assets and liabilities – into the search for the defensible suppositions about their hypothetical fair value in illusory markets. The resultant financial statements have become factually opaque, with an illusion of mathematical rigor, and a density of mandatory disclosures. This raises daunting challenges for boards of directors tasked with fairly presenting the financial condition of the reporting business entity.

This paper has described the accounting standards reforms that have moved the accounting profession away from rule-based towards principles-based accounting practice and financial reporting, has described the fair value accounting principle, has explained how fair value estimates are externally audited, and has explored the implications for boards of directors of fair value estimates contaminating financial statements with financial misstatements. In doing so it has critically reviewed the internationally accepted accounting, auditing and financial reporting standards with respect to fair value accounting and has identified their implications for directors' fiduciary duties — their duties of care, oversight, and obedience.

As neither management nor auditor can either affirm the correctness (truthfulness) of the fair value accounting estimates, or attest to the absence of unintentional financial misstatements in audited financial statements, boards of directors – not to mention stakeholders (including shareholders, creditors, and regulators) – cannot take for granted that those statements fairly present the financial condition of the reporting business entity. The crucial implication for corporate governance is that boards of directors need to be well-informed about, and fully engaged with, all aspects of the fair value estimation process, that is, with the assessment of the level of associated risks of material misstatement, and with the adequacy of the related mandatory explanatory disclosures. They also need to be ever alert to the ethicality of both management and auditors, as both grapple with the ethical dilemmas associated with estimating and auditing financial estimates of that are, and will always remain, unknowable, because confirming or denying accounting facts cannot be ascertained at any time in the future.



Notes

1. This is usually taken to be the International Accounting Standards (IAS), issued by the International Accounting Standards Board, and the Generally Accepted Accounting Practices (GAAP), issued by the US Financial Accounting Standards Board.
2. This is the Sarbanes-Oxley corporate reporting standard defined by US federal legislation, i.e. The Sarbanes-Oxley Act of 2002 (henceforth Sarbanes-Oxley), Sec. 302(a)(2) and (3)).
3. Amendments were made to the International Accounting Standards (IAS) 39 ''Financial Instruments: Recognition and Measurement'' and to International Financial Reporting Standard (IFRS) 7 ''Financial Instruments: Disclosures''.

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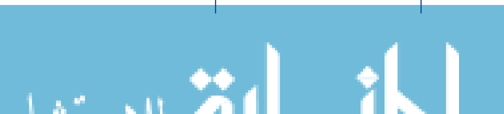
About the authors

John Dixon is Distinguished Professor of Public Policy and Administration and the Dean of College of Social Sciences, Kazakhstan Institute of Management, Economics and Strategic Research, Almaty, Kazahkstan. He is Emeritus Professor of Public Policy and Management at the University of Plymouth (UK), a Fellow of the British Academy of the Social Sciences, an honorary life member of the American Phi Beta Delta Honor Society for International Scholars, and Visiting Professorial Fellow at the Graduate School of Business at the University of Wollongong (Australia). He is a member of the Editorial Advisory Board of, among others, *Corporate Governance*, *International Journal of Public Administration* and *Journal of Politics and Administration*. John Dixon is the corresponding author and can be contacted at: dixon@kimep.kz



Yuliya Folova is an Assistant Professor of Management in the Bang College of Business, Kazakhstan Institute of Management, Economics and Strategic Research, Almaty, Kazahkstan. She has a BSc in Accounting and Management, a MBA with a major in Accounting, a recent DBA in Management, and professional qualifications in accounting – Certified Management Accountant (USA) and Certified Accounting Practitioner (Kazakhstan).

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