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Fair value accounting from a distributed cognition perspective

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ABSTRACT

This study offers a unique interdisciplinary perspective on fair value accounting. The growing influence of esoteric financial instruments whose valuation is becoming increasingly complex makes it necessary to focus on actual valuation practices. Based on an extensive review, this paper regards fair value accounting for complex financial instruments as involving processes distributed among actors located inside and/or outside a reporting entity. It also draws attention to collaboration by organizations that apply their external and internal resources to perform complex financial valuations. Furthermore, it demonstrates that cases involving unusual market conditions underline the importance of human interactions to the valuation process.

1. Introduction

After the revelation of the devastating effects of the recent global financial crisis, fair value accounting (FVA) has been under severe attack by politicians[1] and regulatory authorities.[2] Labeling of FVA as one of the causes of the massive damage that occurred during the financial crisis has rekindled the debate over appropriate accounting valuation.[3]

However, as some have cast doubts on the significance of FVA, the usefulness of FVA is still disputable.[4] Both proponents and opponents of FVA have occasionally criticized the arguments of their counterparts[5] because both have reached their respective conclusions on the basis of specific consequences of FVA.[6] Although the previous literature has indicated various consequences of FVA,[7] we still lack clear criteria for judging its appropriateness. Nonetheless, the fact that the International

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[1] For example, Andrew Haldane, the Executive Director for Financial Stability at the Bank of England, and member of the Financial Policy Committee, considered FVA a cause for concern from a financial stability perspective (Haldane, 2012: p. 3).

[2] For a recent review of the actions of the United States and the FASB (Financial Accounting Standards Board), see Bougen and Young (2012).

[3] The impact of FVA on the recent financial crisis tends to be discussed in terms of pro-cyclicality. For a discussion of the matter, see IMF (2008: Chapter 3). This paper does not examine the economic consequences of the pro-cyclicality of FVA.

[4] For example, when we performed a test search using the phrase "financial accounting" as the search term (in Title, Abstract ID & Keywords with All Dates) in the social science search engine Social Science Research Network (SSRN: http://www.ssrn.com), 738 papers were returned in the results (accessed 17 March, 2014). When we then performed a similar search using the term "fair value accounting," 287 papers were returned in the results. This simply means that more than one third of the total amount of financial accounting papers can be considered equivalent to FVA-related papers.

[5] Exceptionally, Bignon, Biondi, and Ragot (2012) adopted a balanced, neutral argument regarding FVA.

[6] For one of the most comprehensive reviews of FVA studies, see Obinata (2011).

[7] As for a summary of the pros and cons of FVA, see Nissim and Penman (2008: Appendix A) and Ryan (2008).

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Accounting Standards Board (IASB) recently issued a set of standards for FVA (IFRS 13) implies its further global diffusion and penetration.

The question then arises as to why accounting standard setters such as the IASB and FASB have pursued FVA for various items. To address this question, an assumption of accounting standard setting is necessary. Assuming that accounting standard setting depends on the standard setter's assessment of the similarities and differences of corporate transactions, the crucial process "cannot be regarded as value-free judgments resulting from a strictly technical process" (Young & Williams, 2010: p. 511). Accounting standard setters might not fully recognize the clear advantages of FVA over other valuation methods because their political decisions have been based on subjective value-judgments rather than objective evidence. Based on this postulation, it is still uncertain whether FVA truly reflects the fair value of corporate assets/liabilities and is superior to traditionally accepted historical cost accounting (HCA). Even in one of the top-ranked accounting journals that has tended to favor economics/statistics-based research, Kaplan (2011: p. 377) warns that "all this [accounting] scholarship takes the 'fair value' as given and does not explore how fair values actually get estimated. The accounting profession is in danger of potentially outsourcing this critical measurement, and its valuation, to others." This provocative remark stresses the importance of investigating the practical as well as pragmatic aspects of FVA.

Based on this view, the present study focuses on particular aspects of FVA practice and takes the concept of distributed cognition as an interpretative framework. This unique framework particularly sheds light on the distributive aspect of FVA for complex financial instruments. The framework indicates that the practice of FVA with respect to complex financial instruments is to some extent distributed inside and/or outside of a reporting entity. It also points out that the practice of FVA with respect to certain complex financial instruments incorporates various tools and knowledge. Furthermore, based on a consideration of specific valuation cases, concern over FVA is highlighted from the perspective of distributed cognition. The paper thus aims to present an interdisciplinary perspective on FVA to highlight the intersection between FVA and the theory of distributed cognition, and to provide an alternative understanding of FVA. This can contribute to regulators and practitioners who seek an appropriate FVA framework for complex financial instruments.

This paper is organized as follows. The next section reviews recent controversies over FVA. Based on a review of FVA developments, current FVA issues are then pointed out. Section three introduces the concept of distributed cognition. Section four examines the actual practice of FVA from the perspective of distributed cognition, and also analyzes the distribution intention and mechanism. Then, considering the recent global financial crisis and the controversy over FVA, particular attention is paid to the FVA of complex financial instruments. Based on an analysis of FVA practices in areas where valuation appears to be relatively difficult, this study highlights cases in which knowledge of the actors and tools involved in FVA can be distributed both inside and/or outside a reporting entity. Section five considers a specific case of valuation in the early stage of a financial crisis. Subsequently, section six looks at the problematic uneven distribution of cognition beyond formal contractual relationships in FVA. The final section discusses the main findings and identifies future research directions.

2. How FVA has developed and become controversial

2.1. The development of FVA

FVA has been applied to various corporate assets and liabilities through the development of major accounting standards. The US SFAS (Statement of Financial Accounting Standards) 157 defines "fair value" as "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" (FASB, 2006: para. 5). The IASB recently issued "IFRS 13-*Fair Value Measurement*", which has similar requirements to SFAS 157.

FVA differs markedly from traditional HCA. According to the historical analysis of FVA (Georgiou & Jack, 2011),[8] since 1990 more and more HCA-based accounting standards have been replaced by FVA-based ones. For example, not only SFAS 157 in the US, but also FRS (Financial Accounting Standards) 7: *Fair Values in Acquisition Accounting* in the UK and IASC's IAS 39: *Financial Instruments: Recognition and Measurement* are typical examples of such standards (Georgiou & Jack, 2011: p. 319). Recent movement has occurred based on the notion that "mark-to-market might be implemented not to solve a problem in private markets, but to remove regulatory discretion provided by historical-cost accounting" (Epstein & Henderson, 2011: p. 521). Currently, "a fundamental conceptual issue [facing accounting standard setters] is the extent to which the standard should move away from traditional cost based accounting to marking assets and liabilities to market, euphemistically referred to as 'fair value' accounting".[9] Typically, proponents of FVA have emphasized its relative advantages, such as better reflecting corporate reality or risk management activity. They sometimes look at the HCA-based balance sheet and call it a disgrace: "Reporting assets at their historical cost is like driving down the road looking in the rear-vision mirror!" (Penman, 2011:

[8] Few studies have comprehensively explained the adoption of FVA in major accounting standards such as the IFRS or the US FASB standards. Notably, Georgiou and Jack (2011) attempt to highlight the historical development of FVA in the UK and US using three time periods, 1930–1970, 1970–1990, and 1990–the present.

[9] Speech by Paul, A. Volcker, Chairman of the Trustees of the International Accounting Standards Committee Foundation in a statement before the Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee of the U.S. House of Representatives, Washington DC, June 7, 2001 (Penman, 2011: p. 167).