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A note on value relevance of mark-to-market values of energy contracts under EITF Issue No. 98-10

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ABSTRACT

This paper examines whether marked-to-market values of energy trading assets and liabilities of companies that enter into energy contracts are related to market value of equity. The Emerging Issues Task Force of the Financial Accounting Standards Board ruled in November 2002 to ban the use of mark-to-market accounting for energy contracts out of concern that fair values can be easily inflated. We find that the excess of fair value over original value of energy trading assets and energy trading liabilities is not relevant for valuation. It may be inferred that fair values which are subject to management estimates and not verifiable are poor signals of worth and performance (Watts, R., 2003. Conservatism in accounting Part I: Explanations and implications. *Accounting Horizons* 17, 207–221).

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1. Introduction

The debate over fair values or historical costs has become increasingly intense. In June 2005, the Securities Exchange Commission (SEC) endorsed fair value accounting (*The Economist*, July 30th 2005, p. 14, 65). The Financial Accounting Standards Board (FASB) has also issued guidelines for applying fair value accounting (example, FAS 157 on Fair Value Measurement (FASB, 2007a), and FAS 159 on The Fair Value Option for Financial Assets and Financial Liabilities (FASB, 2007b)). Proponents of fair values argue that they are more relevant than historical costs. However, critics of fair values are concerned about the reliability of fair value measures as they are more heavily based on estimates (*The*

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Economist, July 30th 2005, pp. 65–66). Empirical evidence indicates that management estimates are in error or misstated (Noland et al., 1998; Beaver and McNichols, 2001; Lehavy, 2002), subject to manipulation (Bergstresser et al., 2006), and do not improve the quality of financial information (Lev et al., 2009).

This paper examines whether marked-to-market values of energy trading assets and liabilities of companies that enter into energy contracts are relevant for establishing market value of equity. Energy trading companies enter into contracts for the purchase and sale of energy commodities. In addition, these energy contracts have been entered into for the purpose of speculating on market movements and for trading purposes. In October 1998, the *Emerging Issues Task Force* (EITF) of the Financial Accounting Standards Board (FASB) released EITF Issue No. 98-10 (FASB, 2000). The Task Force reached a consensus that energy trading contracts should be marked-to-market (that is, measured at fair value as of the balance sheet date) with the gains and losses included in earnings and separately disclosed in the financial statements.

EITF Issue No. 00-17 reiterated that the estimate of fair value should be based on the best information available in the circumstances. Where quoted market prices are not available for these contracts, companies must use other techniques to estimate fair value. The discussion note of EITF Issue No. 00-17 states, “When available, current market transactions provide the basis for estimating subsequent changes in fair value. Valuation models, including option pricing models, should be used only when market transactions are not available to evidence fair values. When valuation models are used, the Task Force noted that the best information available would consider, but is not limited to, recent spot prices and forward prices, and for option pricing models, the volatility implied by recent transactions, when available, or the historical volatility of the commodities and/or services underlying the contract.”¹

A series of events led to EITF Issue No. 98-10 being rescinded in November 2002. EITF Issue No. 02-3 (FASB, 2002) ruled to ban the use of mark-to-market accounting on contracts to deliver and store energy entered into after October 25, 2002. “Under mark-to-market accounting, companies can book the estimated profits of a long-term energy contract, which could take years to settle, immediately. Analysts have condemned the practice, saying the value of those contracts could easily be inflated with generous assumptions about prices and other market conditions. Enron Corp., Williams and others have been accused of using unrealistic assumptions to boost the mark-to-market value of their trading transactions... The Securities and Exchange Commission pushed for the change following the collapse of Enron, once the world’s biggest energy trader. The action is an effort to restore credibility to an industry plagued by a series of trading and accounting scandals... The FASB is trying to end an extremely embarrassing period for itself and the accounting profession.” – Ray (2002), *Tulsa World*, November 6, 2002. E1, E2.

The implication of the EITF ruling to ban mark-to-market accounting is that mark-to-market accounting is subject to manipulation,² and therefore, may not be value relevant. That is, fair value of such assets and liabilities may not be associated with market value of the firm. In this paper, we examine this empirical issue of whether fair values of energy assets and liabilities are associated with market valuation. This paper contributes to research on understanding alternative accounting numbers, and an understanding of accounting of energy trading firms. We contribute to extant studies on market valuation of disclosures such as SFAS No. 33 on current cost accounting (for example, Beaver and Landsman, 1983; Beaver and Ryan, 1985, 1987; Bublitz et al., 1985; Haw and Lustgarten, 1988; Hopwood and Schaefer, 1989; Lobo and Song, 1989; Murdoch, 1986), SFAS No. 107 on fair value of financial instruments (for example, Barth et al., 1996; Eccher et al., 1996; Nelson, 1996), market valuation of recognized fair values of derivative financial instruments relative to disclosed values (Ahmed et al., 2006), and risk relevance of

¹ Industry practices indicate that energy traders value contracts at quoted prices in active (liquid) markets. Where markets are less active (illiquid), valuation techniques such as Black Scholes and Monte Carlo simulations are used. Key inputs in the valuation process include determining volatility of commodity prices and estimating future cash flows, which are subject to a certain degree of uncertainty.

² Example, “Williams Cos. Inc. lost \$814.5 million, or \$1.59 a share in the first quarter [of 2003], chiefly due to the accounting change which bars companies from booking the estimated profits of certain long-term energy contracts, and requires energy companies to book those profits as they are accrued.” – Ray (2003), *Tulsa World*, May 14, 2003. E1, E8.

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