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Fair value in financial reporting: Problems and pitfalls in practice A case study analysis of the use of fair valuation at Enron

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Abstract

This paper contributes to the debate on the use of mark to market accounting in financial reporting by means of a case study-based examination of the use of mark to market accounting by Enron Corp. in the years immediately preceding its collapse. Set in the context of historical developments in and theoretical discussion upon asset valuation and income measurement, the case study highlights: (i) the ease with which Enron was able to 'monetize' physical assets so as to bring them within the remit of mark to market accounting; (ii) the unreliability of valuation estimates provided by independent third parties; and (iii) the asymmetry between management desire to recognise mark to market gains through the income statement in contrast to their desire to avoid recognising mark to market losses.

Notwithstanding the particular features of the Enron case, it is argued in the paper that these issues are generic and should be taken into account by standard setters as they move toward encouraging more widespread use of mark to market accounting under IAS 39, SFAS 157 and previous statements, and by other regulators with an interest in the provision of financial information to the capital markets, such as the SEC in the US, the FSA/FRC in the UK, and the ASIC/FRC in Australia.

Keywords: Mark to market; Fair value; Income measurement; Enron

> 'So much are the modes of excellence settled by time and place, that men may be heard boasting in one street of that which they would anxiously conceal in another.'
> (The Works of Samuel Johnson, vol. 4)

1. Introduction

Issues as to the most appropriate manner in which to record assets and liabilities in the balance sheet, and how to reflect changes in these measures in periodic statements of income, have been integral to financial reporting since the development of balance sheet oriented financial statements in the nineteenth century and the emergence of the income or profit and loss statement in the twentieth. In the nineteenth century and earlier, a variety of balance sheet valuation bases were employed in the UK and elsewhere (Herrmann, Saudagaran, & Thomas, 2006; Richard, 2005; Yamey, 1977). Over time, however, the historical cost approach in which assets are recorded at cost and, if they have a finite life, written off over that life, became the dominant convention in the UK, the US and many other jurisdictions.

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In the twentieth century there emerged an academic literature which sought to determine the most appropriate valuation bases for assets, as, for example, in the work of Bonbright (1965), Baxter (1967) and others[1]; and the most appropriate method to measure reported income or profit (Chambers, 1966; Edwards & Bell, 1961; Paton, 1922). Paralleling this work, but, to an extent, divorced from it, was the continuation of a much longer tradition within the economics literature focusing on issues of valuation and income. This work, which can be traced back in origin to that of Ricardo and other classical economists,[2] was, in the main, directed to issues of distribution and accumulation. Some economists, for example Fisher (1906), Lindahl (1933) and Hicks (1946), however, focused, directly or indirectly, on the determination of measures of periodic income within a framework of the calculation of present values of future cash flows associated with assets and liabilities.[3]

Although these streams of thought were influential in academe, in themselves they had little, if any, effect on the nature and practice of financial reporting. In the UK, however, the high levels of inflation experienced in the 1960s and throughout the 1970s occasioned much debate as to the most appropriate methods of financial reporting within an environment of rapid price change.[4] This, in turn, overlapped with more basic issues as to the appropriate methods of accounting for and reporting changes in relative price levels[5] (for a comprehensive review of both the issues and the debate see Tweedie & Whittington, 1984). Whilst the accounting developments consequent to the issuance of SSAP 16[6] faded with the fall in the level of inflation in the UK during the 1980s,[7] and the standard fell into disuse before being eventually withdrawn, the need to ensure that current cost accounting was legal under UK company legislation meant that 'alternative accounting rules' were introduced into the 1981 UK Companies Act—and have remained in the legislation ever since.[8] These provisions allow a variety of bases of valuation for different classes of assets; in essence allowing that all assets (other than goodwill) be valued at one of (or, for some categories of asset, at either of) current cost or market value—even if this is greater than historic cost. Any valuation gains until 2004, however, were not permitted to be credited to the profit and loss statement; rather, they had to be taken direct to equity and shown in a revaluation reserve.

Meanwhile, international interest in the more widespread use of market values in financial statements grew, particularly in relation to financial instruments. For many the conceptual framework statements developed by, inter alia, the Financial Accounting Standards Board (FASB) in the US, the Accounting Standards Board (ASB) in the UK, the Australian Accounting Standards Board (AASB) and the International Accounting Standards Committee (IASC) (now reconstituted as the International Accounting Standards Board (IASB)) were seen as presaging, and to an extent accompanying (or even following), the introduction by standard setters of much more widespread use of market values within financial statements. In December 2000, the Joint Working Group of the major standard setting bodies (the JWG)[9] produced a draft 'standard' which unequivocally recommended the use of market valuation in respect of financial instruments with changes in value being reflected through the income statement.[10] Two years prior to this, the IASB had issued its first version of International Accounting Standard 39 *Financial Instruments Recognition and Measurement* (IAS 39), itself heavily reliant upon US GAAP and, in particular, Statement of Financial Accounting

[1] These authors identified measures such as deprival value, i.e., how much worse off an entity would be if an asset was taken away from it, as possessing characteristics which might be considered more suitable for financial reporting than a strict historical cost approach. See, inter alia, Bell and Peasnell (1997), Stark (1997), Clarke (1998), Australian Accounting Research Foundation (1998) and van Zijl and Whittington (2006) for more recent contributions to the historical cost/deprival value/fair value debate.

[2] See Sraffa (1951–1973).

[3] A number of the leading studies in this field, including some of those referenced above, are reproduced, together with an overview of the relevant issues, in Parker, Harcourt, and Whittington (1986).

[4] This debate was live elsewhere, including the US and Australia—albeit those jurisdictions experienced lower levels of price inflation.

[5] As Solomons (1961, p. 374) noted: 'In recent years discussion of the measurement of income has been largely colored and dominated by changes in the value of money. Serious as these problems are, they are really secondary ones, for they presuppose some basic agreement about the nature and measurement of income during a period of stable prices. Between accountants and economists, it need hardly be said, no such agreement exists'.

[6] Statement of Standard Accounting Practice 16, *Current Cost Accounting*, Accounting Standards Committee, UK, 1980.

[7] SSAP 16 required supplementary current cost disclosures, but also permitted companies to use current cost as the sole basis for their accounts (thereby necessitating a change in the UK Companies Act). Its requirements became non-mandatory in 1986 and it was withdrawn in 1988 (Pong & Whittington, 1996).

[8] Found in Part C of Schedule 4 of the UK Companies Act 1985.

[9] The Joint Working Group comprised representatives from the IASC, FASB and eight other international bodies.

[10] See http://www.icanz.co.nz/StaticContent/download/AGS/summary.pdf; and Hernández (2004).