FAIR VALUE ACCOUNTING AND THE MANAGEMENT OF THE FIRM

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The development of accounting standards reveals that the historical cost accounting (HCA) is being replaced by the fair value accounting (FVA) paradigm. FVA, in contrast to HCA that hides the real financial position and income, is more value relevant. The relevance of financial reports should be measured, in addition to association between market and accounting returns, in terms of its contribution to the stewardship function, reduction of agency costs, enhancement of management efficiency, and providing relevant information to stakeholders and workers in their social conflict. FVA-based reports call the attention of shareholders to the value of their equity and enhance the function of stewardship. Managers will be asked to guard the value of shareholders’ equity and to account for their efforts. This will causes a basic change in managers’ perceptions of their duties. The FVA provides also a complete full disclosure and it is compatible with transparency.

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Introduction

An analysis of the development of accounting standards reveals an interesting phenomenon. Along with new financial reporting innovations in sporadic areas, there is a steady process of change of a basic accounting paradigm. The old historical cost accounting (HCA) is being replaced by the new fair value accounting (FVA) paradigm. These changes reflect the needs of users of financial accounting and the efforts of accounting standards setting bodies to reverse the pattern of declining relevance of financial information (Francis & Schipper, 1999; Lev & Zarowin, 1999). Whatever the reasons, the incorporation of FVA into the inventory of generally accepted accounting principles (GAAP) has deep meaning to the field of accounting and to management philosophy. This process has intensified with the expansion of global economy and the rapid growth of information technology (IT), two major factors that have created an impressive infrastructure for the evolution of an international efficient market mechanism.

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HCA-based financial statements obscure real financial position and the results of operations of a firm and provide ample room for manipulation. Often the historical book value of assets and liabilities has only a remote association with market values. This situation permits management to manipulate reported earnings and to hide their lack of real accomplishment.

FVA, in contrast to HCA, measures and discloses the current value of assets and liabilities and is more value relevance. Empirical evidence indicates that fair value rather than historical cost numbers are more highly associated with stock returns. The academic literature provides consistent evidence suggesting that fair values of certain financial instruments should be included in the balance sheet and that changes in the fair values of these instruments should be included in the income statement (AAA's Financial Accounting Standards Committee, 1998).

Nonetheless, the value of financial reports does not depend on the statistical association between accounting and market returns (Francis & Schipper, 1999). The value should be measured in terms of its contribution to the stewardship function, reduction of agency costs, and enhancement of management efficiency. It ought to be assessed, also, in its providing relevant information to stakeholders and workers in their social conflict.

Reporting the fair value of assets and liabilities in the balance sheet calls the attention of shareholders to the value of their equity and to periodic changes in this value, as is reflected by the market mechanism, that determines the price of assets and liabilities. This, in turn, increases the importance of the function of stewardship. Managers will be asked to guard and maintain the value of shareholders’ equity and to account for their efforts. Moreover, shareholders will be in a position to distinguish between two tasks of management: maintaining equity and generating a return on equity. Consequently, they will be able to judge management activities as well as their abstain from acting where needed (i.e. hedging), more effectively. The FVA model affects, thus, the effective management of the firm. It decreases principal-agent conflicts and agency costs, and increases the efficiency with which the firm is managed.

The new outlook on the tasks of management causes a basic and a substantial change in manager’s perception of their duties to shareholders. Managers who understand the duality of their duty must also apply methods of risk management to assist them in achieving these goals simultaneously, be aware of the local and global business arena, and utilize hedging activities (including the use of derivatives). The expansion in the objectives and methods of management will bring a cognitive change in the management of organizations.

We may expect a change in the perception of financial statements by shareholders. In preparing HCA-based financial statements, managers have a dominant power over the process. They are able to manage income and to “window-dress” the statement of financial position. Hence, the “manager’s voice” is clearly heard and is highly reflected. Shareholders must, therefore, be tuned to the “manager’s voice.” The FVA paradigm reduces the “manager’s voice” in favor of the “market’s voice” in an economic setting of perfect and complete markets the “market’s voice” takes its power from the measurement, valuation and reporting of assets, liabilities and consequently, income, at fair values, which are independent of the manager’s influence. In a more realistic situation, the fair value of many accounting items is not well defined.
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