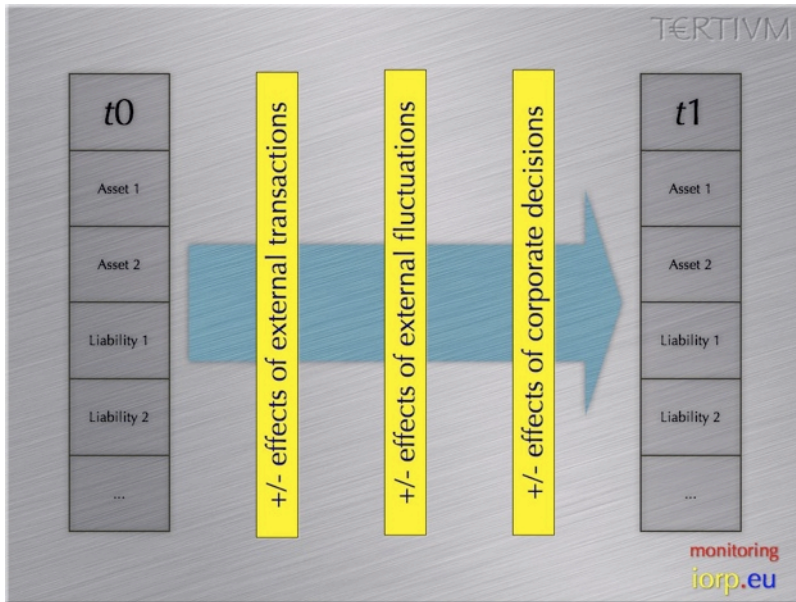


Fair value - A conflict between transparency and stability?

- ☐ topic of discussion is whether there is a conflict between transparency and stability
- ☐ my preceding speaker has warned about conducting an ideological debate for or against fair value. Let me stress that from the point of departure of the currently predominant mixed attribute model, that warning is already an ideological statement of its own.
- ☐ But back to the conflict between transparency and stability: funny question - of course there is a conflict
- ▼ ☐ but fortunately, the conflict is irrelevant because transparency & stability are not equivalent
 - ☐ goal of transparency is to enable the user of financial statements to gain a true & fair view of the reporting entity's status - or rather: statements need to faithfully represent economic reality
 - ☐ stability however is altogether subordinate to that goal - it may be a perceived outcome of financial reporting, IF reporting represents faithfully, and IF economic reality is in fact stable
 - ☐ hence stability cannot be a goal of financial reporting if financial reporting is set to faithfully represent economic reality
- ☐ I guess I could sit down now, but that wouldn't quite fulfill my mission, which is to show you how the user community thinks that transparency will enable users to understand the sources of variance.
- ☐ Variance, volatility, instability, change - all these words stand for one thing: reality.
- ☐ Incidentally, we're really in the realm of philosophy here: Enlightenment philosopher George Berkeley's main tenet was that *esse est percipi*. In plain English that is: *La réalité, c'est percevoir, et être perçu*. Reality and perception are two sides of the same coin.
- ☐ Applied to accounting, that probably means that the value of financial reporting is a function of its reality content. If there is a disconnect between reporting and reality, reporting is worthless.
- ☐ Contrary to what some preparers think, there IS a reality beyond what is being reported, and it's the analyst's job to reconstruct it.



- □ So, it's established then - transparency is instrumental in achieving faithful representation, and the object of that faithful representation probably is expressed in fair values. But that's another story ...

- □ Let's address then the ways in which users can better make sense of the variance they get thanks to increasing transparency. They will need this better understanding to properly appraise their investments on the one hand, and to pass judgment on the stewardship of management on the

other.

- □ Variance is observed by looking at a list of attributes of an entity at two distinct points in time. For the sake of simplicity, let's use the balance sheet in T0 and T1.
- ▼ □ Then, we can try to identify the sources of variance. Conceptually speaking, there's three categories of changes:
 - □ Changes that have their origin in transactions with the entity's outside world.
 - □ Changes that arise through external fluctuations that are beyond the entity's control, and
 - □ changes that are a function of unilateral decisions taken by the entity.
- □ If that matrix is familiar to you, then you're right - some variations of it are in the CFA Institute's Comprehensive Business Reporting Model, and the IASB has also proposed it in a discussion paper.
- □ In the current one column reporting model, these categories are all jumbled up. That's why it's called mixed attribute. Reported items often contain aspects of all 3 categories, and users are hard pressed to prise them apart.
- ▼ □ Because that's what they'll have to do if they want to arrive at high quality forecasts of an entity's performance.
 - □ They will have to form an opinion about future transactions with third parties, i.e. the entity's business success.

- ☐ They will want to be able to form forecasts of value fluctuations of assets and liabilities, ideally replacing management's assumptions with their own - or accepting them if they're good.
- ☐ Finally, they want to be able to appraise separately the impact of management decisions on reported numbers. In a full fair value model, this category would be empty anyway.
- ☐ The University of Western Australia has conducted a global experiment with users of financial statements. The purpose of that project is to find out how well experienced users of conventional financial statements can handle the matrix format, and how efficiently they arrive at the conclusions they are looking for. I've personally participated in that experiment, and I can tell you it's very hands on.
- ☐ The results of that experiment are soon to be published, but thanks to preliminary results I am not divulging privileged information if I tell you that the results are indeed encouraging.
- ☐ So, in summing up, I would like to posit that while increased transparency may indeed lead to more variance and less stability, this is no reason to panic. Macroeconomic stability is not the same thing as stability at the firm level - quite on the contrary, as the planned economies of yonder proved. Their development was stable alright - until the entire system collapsed wholesale. Financial markets are not slaves to past ratios, multiples and risk premia - they will be unfazed by increased variance if they get the feeling that these numbers represent economic reality more faithfully.

Brussels, 7.12.06

Christian Dreyer, CFA

+41.76.334 0800

christian.dreyer@tertium.biz

www.tertium.biz