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Reflexive Governance in the Public Interest

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ACCOUNTING STANDARDIZATION AND GOVERNANCE STRUCTURES

**A CRITICAL ANALYSIS OF THE INTERNATIONAL ACCOUNTING
STANDARD-SETTING PROCESS**

Preliminary version – Not for quotation – Comments welcome

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Abstract

The objective of this study is to characterise more precisely the governance structure conveyed by the IFRS standards. After an analysis of the different Corporate Governance conceptions and their implications in the financial information process, we draw the outlines of the governance structure, implicitly recommended by the IASB. We focus our examination of the IFRS standard-setting process on the controversy that took place about the generalization of the fair value-based principles for financial instruments. By using the socio-organizational approach of the “Economies de la Grandeur” (“Economies of Greatness”) as our methodological framework, we provide empirical evidence on the impact of managerial lobbies and on the theoretical groundings of the financial and economic priorities of the accounting standards-setters.

Keywords: governance structure, IFRS standards, standardization process, fair value.

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INTRODUCTION

Since January 1st, 2005, all listed companies in Europe must disclose their financial statements in accordance with the international accounting standards IAS/IFRS. The application of an international and unique accounting standards system represent a strategic and crucial stake because of the technical and theoretical developments involved in the IFRS standards.

In this respect, the IFRS 32 introduced in 1995 the notion of fair value as an accounting measurement system for financial instruments. This conventional notion is in the centre of debates regarding the balance between relevance and reliability of financial statements, because fair value measurement questions the historical cost estimation and the prudence principle. This evolution leads to examine the legitimacy of the justifications adduced by the supporters of these two accounting measurements. Those principles must in any case be based on various qualitative representations of financial information. Furthermore, the effective transition process of the accounting measurement system to another one challenges sharply the accounting ideology related to control and governance conveyed by the international accounting standardization.

The objective of this study is to characterise more precisely the governance structure conveyed by the IFRS standards. After an analysis of the different Corporate Governance conceptions and their implications in the financial information process, we draw the outlines of the governance structure implicitly recommended by the IASB. Our purpose is to focus our examination of the IFRS standard-setting process on the controversy that took place about the generalization of the fair value-based principles for financial instruments. Using the socio-organizational approach of the “*Economies de la Grandeur*” (“Economies of Greatness”) as our methodological framework, we provide empirical evidence on the impact of managerial lobbies and on the theoretical groundings of the financial and economic priorities of the accounting standards-setters.

1. Theoretical assumptions and emergence process of the international accounting standardization.

1.1. Theoretical foundations: a review of literature

1.1.1. The traditional approaches to Corporate Governance

Historically, the notion of Corporate Governance has emerged around the famous approach of Berle and Means (1932). These authors emphasize the problems generated by the separation between ownership and control of a company. This study was extended by the approach of Jensen and Meckling (1976) highlighting what is called the “agency” problem. According to this conception, the separation between ownership and control leaves the managers with a large span of discretion to seek their own interests to the detriment of the owners, who sustain the residual risks. In such conditions, it is not only right but especially effective that the shareholders will exert the whole set of residual control rights because it is presupposed that the maximization of the owners’ residual income maximizes the probability that the other stakeholders will obtain what is stipulated in the contracts they conclude with the company (Fama and Jensen, 1983).

In its traditional meaning, Corporate Governance is defined as a set of rules and mechanisms aimed at controlling the relationship between the managers and the owners (Schleifer, Vishny, 1997). These devices come within the scope of a shareholder model of governance and can prevent the drifts of the managerial company. This model is commonly regarded as an adequate mode of regulation for listed companies with dispersed ownership and constitutes a regulatory reference in the Anglo-Saxon countries. The theoretical effectiveness of this model of governance is based on the hypothesis of efficiency of financial market as markets for control: if the performance of the company is not considered satisfactory, the shareholders can give up their securities. The firm may for example become the target of unfriendly takeover bids. This threat may lead the managers to redirect the company’s strategy on the objective of creating value for the shareholders (Schleifer, Vishny, 1997). Devices such as the challenges by other managerial teams or the exercise of voting rights constitute other disciplinary mechanisms aimed at guiding the managers’ behaviour towards the creation of shareholder value (Alchian and Demsetz, 1972).

This approach belongs to the contract-based theories of the firm proposed by neoclassical microeconomics and supposes that managers will in any case behave opportunistically. Wirtz (2004) points out that the links established in the academic studies in corporate finance between the agency conflicts, the discipline and the creation of value constitute the main justifications of what is qualified to be the best practices in the governance codes promulgated in Europe.

1.1.2. The emergent approaches to Corporate Governance

The alternative governance model traditionally identified in the literature is the stakeholder model of governance. It implies the absence of an irreducible divergence of

interests between investors and the other stakeholders. In this case, the creation of shareholder value is not the only objective assigned to the company. The studies related to this model of governance are often multidisciplinary (Wheeler et al, 2002). The traditional stakeholders identified are the shareholders, the employees, the suppliers, the customers, the creditors and the public institutions. In this respect, the difficulty for the firm is to satisfy a plurality of interests in terms of creation of value and of safeguard of the organizational capital, by keeping in mind the evolution in the structure of the firm through time (Zingales, 2000). According to Zingales, the objective of Corporate Governance should be firstly to prevent the conflicts between stakeholders because these conflicts can harm the growth opportunities. Secondly, Corporate Governance should ensure the respect of the general interest as a whole by allowing a fair distribution of income, which would encourage a cooperative behaviour of all the stakeholders in spite of the heterogeneity of their respective interests.

Comparative international studies related to Corporate Governance have showed significant differences in the regulation mechanisms according to legal and institutional systems. For example, the common law in the Anglo-Saxon countries would be a better protection for the minority shareholders than the civil laws and consequently, would encourage the dispersion of the shareholding. (Roe, 1993, La Porta et al, 1998). We can traditionally note the existence of the stakeholder model of governance in the continental European countries, where financial markets are less developed and where Corporate Governance falls under the law regime¹.

However, authors like Coffee (2002) and Roe (2002), studying the evolution of the financial markets and the shareholding dispersion, qualified the importance of the legal frame as a variable able to explain the governance structures. These authors rather emphasize the self regulatory mechanisms pre-existing to laws such as the rules governing the American financial markets. For instance, the emergence of the law related to the protection of minority shareholders in the United States has only been possible thanks to the construction of self regulatory mechanisms pre-existing to laws, which create a new perception of the context in the financial environment (Coffee, 2002). However, according to Roe, the existence of such mechanisms is not enough to explain the evolution of a governance structure. This remark leads to reconsider the conditions of the evolution of a governance system.

Recent works in the theory of the norm and the governance (Lenoble, Maeschalk, 2003) related to the collective decision process in organizations show that every change in Corporate Governance must not only be based on a decision justified rationally, but must be supported also by the construction and the appropriation by all the actors involved of a common perception of the context and of the solution to be brought into play. This contextualization is a necessary condition for the effectuation of the change. According to Lenoble (2004, p.6), “*a norm produces only effects according to the perceptions of the final addressees*”. It involves that a collective learning process relating to the construction of a common perception of the context around the definition of the problem to solve must precede and go with the creation and the disclosure of new norms. The expression of “*reflexive governance*” indicates normative devices which stimulate among the actors a collective learning process allowing the enforcement of a decentralised system of standard processes. These mechanisms allow a better adaptation of the standards to the specific characteristics of the context (the “*comply or explain*” principle is an example of such devices). Furthermore, these reflexive incentives allow solving more efficiently and more fairly the problems with which the actors are confronted and thus encourage the emergence of a collective form of life considered more satisfactory.

¹ In Germany, the law on control and transparency of Corporate Governance dated January 1st, 1999, requires a minimum of four annual meetings of the monitoring board.

Contrary to the contractarian theories of Corporate Governance, which can be considered as an extension of the neoclassical economic model, these new approaches enhance the explanatory contribution of the cognitive theories² and constitute an original and precursory approach of Corporate Governance.

1.1.3. The role played by the international accounting standardization with respect to Corporate Governance

What is the role played by the disclosure of financial information with respect to Corporate Governance? A review of literature shows that financial information is often seen as offering an important source of useful information for the realization of the governance mechanisms while contributing to solve the agency problems (Bushman and Smith, 2001, p.239). Besides, in a more global meaning, the disclosure of financial information constitutes also a product from the mechanisms of Corporate Governance implemented in the company (Sloan, 2001). Paradoxically, we did not find any academic works having studied the influence of the international accounting standardization on the Governance processes. As the financial statements published *ex post* are considered a monitoring mechanism for the companies, the accounting standard-setting process, which is an *ex ante* process, by modifying the informational demand which is heavily weighted on the companies, has been led to play an essential role in the control of the organizations.

The various lines of study conducted in the frame of international accounting standardization highlight the importance of the political factor in the accounting standard-setting process. The accounting rules are no longer considered as a neutral tool. On the contrary, they result of a political negotiation determined by the economic interests of the respective stakeholders. The contribution of Newman (1981) insists on the tensions between the private sector interests and the concerns of the SEC. We can add the studies of Chandler (1992) relating to the links between the IFAC, the IASC and the IOSCO and of Ahadiat and Stewart (1992) about the SEC, the OECD, the United States, the European Community and the IASC. Other studies insist on the historical Anglo-Saxon influence over the international accounting standard-setting process (Hoareau, 1995; Flower, 1997; Van Hulle, 1993), the geographical dispersion of the entities who comment the IASB Exposure drafts (Kenny and Larson, 1995), the involvement of the “big four” audit companies in the accounting services at an international level (Speidel and Bavishi, 1992), and the characteristics of the members of the IASC (Standish, 2003). All of these studies show the Anglo-Saxon influence over every process analyzed.

This review of literature leads to set out the following proposal: the international accounting standardization such as it is proposed by the IASB is far to be neutral and constitutes moreover a governance structure, which means “*a system [or part of a system] by which companies are directed and controlled*” (The Cadbury Report, 1992, p.14). IN order to take into consideration the variety of the approaches to Corporate Governance, it is essential

² These theories reject the substantialist definition of rationality in favour of procedural rationality. The procedural rationality is not focusing exclusively on anticipating the consequences of the decisions to be made but is also considering – in a perspective of bounded rationality- the adequateness of the collective learning process embedded in the decision making process itself. For example, the value creation process is then considered from a very different point of view, in so far as the cognitive theories attach a great importance to the construction of the skills and abilities of the firm to innovate, to create investment opportunities and to modify its perception of the environment. The studies related to the innovator firm made by Lazonick and O’Sullivan (2001) provide one of the best illustrations of approaches aimed at considering jointly the conflicting and cognitive aspects of the organizational change.

that we should characterise more precisely the nature of the governance structure conveyed by the IFRS standards.

1.2. The emergence process of the international accounting standardization

1.2.1. Objective and scope of the international accounting standardization

The international accounting standard-setting process constitutes a particular type of regulation. Indeed, it does not come from the same actors and mechanisms than the national accounting standardization. The role of the State is reduced in favour of private or public intergovernmental entities. In the scope of accounting standardization, the European Union has decided to collaborate with an independent organization, named the IASC. The regulation of the accounting system by means of directives was considered too difficult to bring into operation with regard to the new demands for information from financial market³. The European Community proposed to the Council of European Union and to the European Parliament to delegate the accounting standardization to the IASC and its operational arm: the IASB.

The IASC is an American private foundation and has the objective to develop in the general interest a unique set of high quality accounting standards, comprehensible and applicable in practice, requiring transparent and comparable information in the financial statements in order to help the actors to take economic decision in the financial markets. The IASB, entity which works under the aegis of the IASC is responsible for the preparation, the adoption and the modification of the international accounting standards. The Board has become the central organ of the organization and develops a set of rules aimed at increasing comparability and transparency of financial statements.

The private character of the standardization entities and the importance of the accounting conventions they promulgate for the companies' financial life lead to question the legitimacy of these entities to publish standards aimed at achieving the general interest. According to Heem and Aonzo (2003), the IASB legitimacy is based on the independence of its organization⁴, the technical skills of these members⁵ and the existence of a formalized standard-setting process, commonly called "Due Process".

Furthermore, the decision taken by the European Union to integrate the IFRS standards in the community laws – kind of a delegation of sovereignty - conferred to the IASB an institutional legitimacy that it was lacking (Community rule of July 19th, 2002). To have force of law, the IFRS standards have to be endorsed by the European Union according to a

³ Due to the lack of skilled staff and the heaviness of the juridical mechanisms, the legislative acts and powers of the European Union are ill-adapted to the accounting subject which is very technical and evolutive.

⁴ On April 2001, the IASC acquired its independence from the accounting profession. The IFAC has now the power to nominate 5 of the 19 trustees of the IASC. Among the others, we can found financial executive, an investor and an academic. The 11 remaining members are chosen through a consultation process of representative organizations. This restructuring has brought to an end the organizational system that left the accounting standard-setting process in the sole hands of the chartered accountants. The choice of the trustees is based on a geographical representation (6 Europeans, 6 Americans, 6 from the Asia/Oceania region and 4 from any area, subject to maintaining overall geographical balance).

⁵ The 14 members of the IASB are chosen by the trustees (IASB) according to their professional competence and practical experience as main criteria and independently from the geographical origins, even if the Anglo-Saxons are the better represented. The IASB is composed of 5 auditors, 3 financial statement makers, 3 users of financial statements and 2 other specialists.

community mechanism of adoption⁶. The existence of such a device theoretically provides at least theoretically, the European Union with a significant leverage to influence beforehand the decision process of the IASB. It makes it possible for the EU to propose amendment of the accounting standards proposed by the IASB.

1.2.2. The formalized accounting standard-setting process (“Due process”)

1.2.2.1. Description

Considering that the rules will find an easier acceptance among the actors who will have to apply them when they are elaborated within a formalized process associating these actors, the IASB has organized a standard-setting process allowing the consideration and even the confrontation of the various interests involved. The steps of this procedure are detailed hereunder:

1. *The IASB identifies the scope of any project with respect to the IASB framework. The IASB technical staff considers the topics and the national practises related to the theme to deal with;*
2. *The Board consults the Standards Advisory Council, SAC, in order to determine if the project has to be added in the IASB agenda;*
3. *The IASB may establish an advisory committee to give it advice on the issues arising in the project. Consultation with this committee and the SAC would take place throughout the project;*
4. *On major projects, the IASB develops and discloses a Discussion Paper for public comment;*
5. *The IASB discloses for public comment consultative documents such as Discussion Papers and Exposure Drafts of proposed Standards and Interpretations. The usual comment period is ninety days. The projects to comment are set online.*
6. *After receiving and reviewing comments, the IASB may hold public hearings to discuss proposed standards and conduct field tests to ensure that proposals are practical and workable around the world;*
7. *Finally, the IASB issues a Standard when the Board obtains a majority of 8 votes out of 14. The standard contains a Basis for Conclusions to explain how the Board reached its conclusions and how they dealt with the comments.*

The guarantees inserted in this formalized process are commonly regarded as ensuring the impartiality and the objectivity of the decisions taken by the IASB. The creation of standard has to be based on a rational decision taken in a rational process and has to rely on justifying argumentations. We note the opportunity for the stakeholders to intervene in the accounting standard-setting process by means of comment letters is a process that allows the international standard-setters to understand better the accounting context and the stakeholders’ points of views. The Due Process aims at ensuring the free consultation of the actors who want to express their opinions on the contents of the standards. This principle on which the IASB legitimacy is based can be qualified as procedural, because the legitimacy of the accounting standards comes from specific standard-setting processes (Boy, 1998, p.115). In this respect, the emergence of a process of contextualization can be made possible. The construction of a rational accounting standard may thus involve the interaction of actors in order to build a common perception of the context and, in addition, of the solutions to be brought, in order to ensure an effective implementation of the change. The exchanges points of view at the time of

⁶ Each standard is subject to a consultative notice by a committee of representative EU members, the ARC (Accounting Regulatory Committee). The votes of this committee are submitted to a “special majority” rule.

calls for comments as well as the answers given by the IASB can lead to the emergence of governance process that takes into account the interests of the stakeholders involved in the consultation process.

Moreover, the legitimacy of the international accounting standards falls within the scope of the search for general interest, in accordance with the objective declared by the IASC. Traditionally defined as the expression of a will superior to the particular interests, this definition of the general interest may be called a voluntarist conception. In opposition, It should be recalled that in its utilitarian version, the general interest is the algebraic sum of the individual interests. Consequently, the public interest is better served if we let the individuals satisfy freely their own interests. When adopting a voluntarist concept, the public institution is not only in charge of defining general interest, but also of validating this definition via democratic processes and of ascertaining its observance. However, the increasing numbers of decentralized processes of consultation and regulation by independent authorities complicate the formulation of a concept of general interest integrating and surpassing particular interests. In this respect, the substitution of procedures of constraint by procedures of consultation can nevertheless constitute an adequate solution to promote collective, and thus legitimate, decision making procedures. Since the final arbitration falls to the authority democratically invested with the competence to define the general interest, the legitimacy of the choices adopted will be strengthened by a better collaboration of the stakeholders in the elaboration and the implementation of the decisions that affect them.

In the scope of the international accounting standard-setting process, the opportunity for the stakeholders to intervene in the standard-setting process and the assertion of a voluntarist conception of the general interest lead to put forward the hypothesis that the governance model conveyed by the IFRS is a stakeholder model.

1.2.2.2. Underlying theoretical arguments

In spite of the contention by IASB members that they will promulgate accounting standards in the general interest, the framework for the preparation and presentation of financial statements published by the IASB in 1989 was based on a classification of the users of financial statements⁷ and paragraph 10 of the framework statement was explicitly setting investors in the leading position: “*as investors are the providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of others users that financial statements can satisfy*”. This choice had not been imposed by a supervisory organization. It is thus all the more interesting to question the presuppositions of such a choice in reference to the existing theoretical representations of the firm and of the functioning of the financial markets.

As we have mentioned above, the economic literature shows different categories regarding the conception of the firm. For instance, we will limit ourselves to two broad categories. The company may be seen, on the one hand, as a nexus of contracts with the maximization of shareholder value as its unique objective⁸. It may be considered, on the other hand, as an economic institution which is characterised by notions such as the “social interest of the company” and for which the objectives are the creation of wealth thanks to the cooperation of various stakeholders and an equitable sharing of the rents created. In this way,

⁷ This framework comprises seven categories of potential users and their respective needs for financial information: the investors, the employees, the suppliers and others creditors, the customers, the public institutions and the public in general.

⁸ See a.o. JENSEN & MECKLING (1976). For critical comments, see AGLIETTA & COBBAUT (2003).

the company has to achieve not only economic, but also social and environmental objectives⁹. According to the concept that is brought up, the objectives and functions of the accounting will have to be conceived in drastically different ways.

The first conception is based on the contractarian model of the firm. The core of this conception builds up around axioms such as autonomy, substantive rationality, information and with market as the pre-eminent - -if not unique – mode of coordination of individual decisions. This contractarian paradigm may be characterized by three complementary theoretical constructs, each one of them emphasizing one of the facets of the basic approach.. The property rights theory illustrates the concept of autonomy by making it possible to define the boundaries of the firm provided one single agent¹⁰ will be the exclusive holder of the “residual” decisions rights, i.e. all the rights that have not been already allocated by specific contracts. The theory of transaction costs solves the apparent paradox of the effective plurality of the modes of coordination by defining for each specific class of economic situations the adequate (the rational) mode of coordination as the one that minimized transaction costs, providing a rational justification to the definition of the firm as a “nexus of contract”. The agency theory, through the concept of “optimal incentive contract”, settles the problems borne from asymmetry of information, that opens a door for opportunistic behaviour of the managers to the detriment of outside. This axiomatic representation describes the contractarian model of the firm because it is completely based on mechanisms of contracts. This model has become the dominant theoretical reference in microeconomics

According to this dominant conception, the objective of the accounting system is essentially to provide investors with specific information about the firm as value creation process. As we have underlined above, the investors, considered as the holders of the residual control rights, by aiming at maximizing their own residual surplus, maximize also the probability that the other stakeholders, who are holding senior claims, will obtain what they may expect in accordance with the contract they have concluded freely with the company.

The contractarian theory’s contention is thus that the governance structure of the corporate firm, allocating the whole set of residual control rights to the common shareholders, who are the only ones to bear the “residual risks”¹¹, is a fully efficient device from the point of view of every stakeholder of the firm. To the extent that one does fully agree with this contention, paragraph 10 of the framework statement of IASB is thus fully justified.

In order to operationalize the contractarian theories, and in particular the agency theory, a basic requirement is that every calculation will be performed using “true” economic values. Since such values are inobservable directly, one should be able to rely on observable variables that will be at least unbiased estimates of the true economic values. As a consequence, the “efficient market hypothesis” (EMH), which is the microeconomic correspondent of the “rational expectations hypothesis” in macroeconomics, appears like the cornerstone of the modern financial theory about asset pricing. The EMH can be synthesized by a very simple statement: the organization¹² of the trading system generates close to perfect competition among investors, which in turn ensures that available information is embodied in financial

⁹ For a presentation of this current, see LENOBLE (2003).

¹⁰ Who can be a “collective agent”, like the general meeting of shareholders in a corporation.

¹¹ This means that they are the only ones to hold a claim on the company that is not fully determined by the provisions of their contract. This in turn implies that all the other stakeholders are fully protected by the (supposedly “complete”) contract they have concluded with the firm. BLAIR (1995) presents convincing evidence that this is far from being the case for an important and growing portion of the employees. To the extent that employees “co-specialize” their human capital with the (tangible or intangible) assets of the firm, they will also bear residual risks.

¹² Often called «market microstructure »

market prices if not instantaneously and in a fully correct manner, at least very rapidly and without significant or durable bias. In order to ensure the efficiency of the whole corporate system, it is thus of utmost importance that investors be provided accurately and on an equal footing with every piece of information that is relevant for the valuation of financial assets. This is defining the essential task – even the unique one in the views of many – for public as well as for self-regulation. EMH is nevertheless an increasingly controversial topic among academic people with a great variety of arguments mobilized against EMH: excessive variability of stock market prices with respect to the supposedly underlying fundamentals¹³, neglect of the behavioural dimension of investors' decisions¹⁴, in case of radical uncertainty¹⁵, substitution of another concept of rationality – e.g. mimetic rationality¹⁶ – for the substantive concept of rationality postulated by the standard contractarian theory.

The deliberate choice by IASB to give priority to the investors in terms of accounting information is based on the choice, at least implicit, of the contractarian conception of the firm and the efficient market hypothesis as its theoretical references. We can therefore formulate a second – and alternative assumption: the privilege granted to the investors in terms of accounting information results of the adoption of a design of Corporate Governance congruent with the contractual conception of the firm and the dominant representation of value provided by the modern theory of finance.

These considerations developed above imply the two types of governance systems we have identified as *a priori* compatible with the IASB normative system have to be considered as mutually exclusive. The first type, congruent with the first assumption is based on the IASB declaration of intent to promote the production of accounting information in the general interest. The second type of governance, congruent with the second assumption is based on the assertion of the primacy of the investors. To the extent that one does not subscribe to the utilitarian conception of the general interest which underlies the contractual theory of the firm, this interest can only be considered as particular.

What now remains to be done is to characterise more precisely the governance structure conveyed by the IASB by situating the arguments developed by the stakeholders with respect to the IFRS accounting standard-setting process. We must also have a critical look over the justifications given by the actors in order to explain the theoretical presuppositions on which their arguments are based. Furthermore, comparing the whole spectrum of the argumentations developed with the solution finally approved will allow us to conclude about the type of governance finally adopted within the IASB. On a methodological level, the study of the IFRS accounting standard-setting process leads to analyzing the perception of all actors involved via the study of the statements they have been making in the consultation process, and checking whether the perceptions of the actors have been effectively taken into consideration in constructing what ought to be considered as the common perception of the context.

¹³ See SHILLER (2000)

¹⁴ See SHLEIFER (2000)

¹⁵ This means: a situation with such a degree of complexity that the outcomes cannot be probabilized.

¹⁶ See ORLÉAN (1999)

2. Empirical analysis of the Full Fair Value project

2.1. Methodology and data

After introducing the emergence process of the international accounting standards and its implications in terms of governance, this second part aims at testing the validity of the hypotheses that have been formulated. We decided to analyze and contextualize the debate that has been taking place around the consultation process regarding the Full Fair Value project, an especially controversial topic that was very likely to give rise to acute tensions between the two concepts of governance we have identified above as potentially compatible with the system of the norms of IASB. The analysis of the controversy is less about the fair value principle itself than about the generalization of the fair value to all financial instruments. We expect that this approach will provide the best opportunity to be confronted with and to evaluate the arguments of the various constituents who have contested the validity of the fair value principle and to determine in what way the final version of the standards for financial instruments (IFRS 32 “*Financial instruments: disclosure and presentation*” and IFRS 39 “*Financial instruments: recognition and measurement*”) have taken into consideration the arguments of the stakeholders involved.

2.1.1. The review of IFRS 32 and 39 regarding financial instruments

From 1989 on, the IASB has been committed to the development of a global standard regarding financial instruments, particularly in matters of recognition, measurement and disclosure. The IASB’s objective was to favour through the application of these new principles the increase in the volume of capital raised and the number of quotations abroad.

A first phase was finalized in 1995 with the approval of the IFRS 32 “*Financial instruments: disclosure and presentation*”. In this text, the fair value is defined as “*the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction*”¹⁷.

In March 1997, the IASB and the Canadian Institute of Chartered Accountants have publicized their will to generalize the application of the fair value to all financial instruments. Conscious of the emergency for the investors and the companies to be able to refer to the IFRS standards, the IASB took a double decision: to publish at latest by the end of 1998 a temporary standard on recognition and measurement of financial instruments (IFRS 39) and to develop jointly with the national standard-setters the project of a global standard based on the concepts developed in the March 1997 document.

This second phase ended in 1998 with the approval of the temporary standard (IFRS39, “*Financial instruments: recognition and measurement*”). This standard established the measurement of financial instruments halfway between the historical cost and the full fair value based principle. In December 2000, the publication by the IASB of a working paper

¹⁷ The exact significance of this definition will be developed in 2.2.1.

edited by the Joint Working Group (JWG)¹⁸ and headed “*Financial Instruments and Similar Items: Draft Standard*” confirms the will of the IASB to introduce the full fair value principle for all financial instruments.

2.1.2. Methodology and characteristics of the textual data

On a methodological level, the study of the accounting standard setting process is devoted to analyzing the perception of all actors involved via the study of the statements they have been making during the consultation process. The objective is to focus on the justifications of opinions expressed by the stakeholders.

This imperative of justification is a term borrowed from Boltanski and Thévenot (1989) in their reference work called “*De la Justification: les Économies de la Grandeur*” (“The Economies of Greatness”). This theoretical model is a sociological approach to the justification regimes, dedicated to study in depth the problems of the coordination of actions and to understand the dynamics of negotiation of the agreements between individuals in organizations and institutions. The analytical interest of such an approach lies in the search for the various principles of rationality invoked by the actors, which can be based on hierarchies of different interests. The models developed by Boltanski and Thévenot present conventional agreement principles, built from various political philosophies and considered as ideal-typical forms aiming at characterizing various situations and relations. Seven models, called “worlds” by the authors, have been identified, including the “connexionist” model developed by Boltanski and Chiapello (1999). These models determine legitimate orders of “greatness”, allowing individuals to characterise situations and relations thanks to either a shared system of equivalences or to common and coexistent systems of order able to create the agreement. However, the stability of such agreements is not guaranteed. The heterogeneity of the orders of justification may cause tensions due to the incompatibilities among the different orders. These tensions may be resolved by means of a “proof-testing” where each actor asserts his/her rationalization process and the legitimacy of her/his action. The notion of rationalization that has been elaborated by Thévenot (1989, p.159) is a complex one, since he is making reference, on the one hand, to the reasons on which a person relies to behave or the reason which governs his rational decision (rationality principle) and, on the other hand, to the fact that good reasons to behave must be comprehensible, acceptable, objectivable, justifiable with regard to the other people (legitimacy principle).

The models of coordination are mainly based on theoretical orders of justification which can serve conversely as a tool to interpret the controversies between actors in a given situation. Each model mobilizes different principles, subjects, objects and devices which can be considered as relevant indicators for the analysis of contents. Each model allows to assert a different conception of the reality.

We have retained five models of coordination which seemed to be useful to point out the different theses upheld in matters of accounting measurement. We have excluded deliberately the models of the “inspiration” and of the “opinion”, which cannot constitute a usual reference for the members of the accounting community:

- The “domestic model” of coordination is mainly based on hierarchic and close relationships. It does involve a coordination linked with the passage of time and

¹⁸ The Joint Working Group (JWG) is composed by the representative members of the national accounting standard-setters of Australia, Canada, France, Germany, Japan, New-Zealand, Netherlands, United Kingdom, United States and members of the IASC.

relying on the adaptation, the evolution of the rules and on the local and specific adjustments of the different actors.

- The “civic model” of coordination has the particularity to give importance to the collective persons and to rely on the notion of common good. It can be pertinently evoked about accounting if we consider the accounting actors as a professional and collective set subject to a specific normative process. In that meaning, we may qualify accounting as a social institution.
- The “market model” of coordination, directly stemming from the neoclassical economic theory, considers competition as the coordination principle par excellence, the market as the privileged, if not exclusive place for exchanges and the price as the measure of all actions. In this model, the competitive market coordinates the relationships and the decisions of the actors. The relative prices reflect the relation between supply and demand and offer a global system of equivalence and thus a global coordination of the system of transactions.
- The “industrial model” places the emphasis on the notion of specialization and on technical standards. The interactions are governed by means of rules and formalized processes. The industrial coordination points out the productivity and builds its system of equivalence on regular and methodical measurement.
- The “connexionist model” of coordination favours a finite temporal perspective by considering the participation of all the constituents in specific projects and by placing the emphasis on the mobility and the flexibility of the constituents. This type of coordination attaches importance to the network as the exchange’s place and to the information as the matter exchanged.

These orders of justification have only a theoretical existence and cannot constitute pure and simple justifications. However, they make it possible to connect a system of arguments with a dominant model of coordination. These models can also be combined and thus open new opportunities to interpret reality.

For the empirical analysis, we have retained first the set of debates around the JWG proposal, edited in 2000, focusing our attention on the discussions about the implementation of full fair value to all financial instruments. Our textual database includes the JWG working paper, edited by some national accounting standard-setters and a set of 118 comment letters issued by various stakeholders. The comment period stretched from December 2000 to July 2001¹⁹²⁰. Two third of the letters were from financial statements preparers. Responses from users were few in number. Before going further, we should note that the comment letters are not an exhaustive and strictly representative view of the stakeholders’ opinions in the full fair value debate. The comment letters represent only the opinions deliberately expressed by their authors as a response to the JWG proposal.

In a second phase, we have followed the fair value controversies by analyzing the IFRS 39 standard process until 2005 in order to observe the evolution over time of the actors’ perceptions.

¹⁹ These documents are freely available on the IASB website, see http://www.iasb.org/current/iasb.asp?showPageContent=no&xml=16_56_67_22042002.htm.

²⁰ 122 comment letters have been received by the IASB during the comment period, but some of them have been sent twice, in English and in French, which reduced our sample to 118 comment letters, see http://www.iasb.org/current/iasb.asp?showPageContent=no&xml=16_56_67_22042002.htm

2.2. The Full Fair Value controversy

2.2.1. The arguments in favour of Full Fair Value

We have analyzed the arguments of the JWG proposal and the comment letters in favour of full fair value by pointing out the justifications invoked in order to legitimate the implementation of full fair value to all financial instruments.

The study of the arguments shows wording structures mainly based on the “market” and “industrial” models, and to a lesser extent, on the “connexionist” model.

The justifications attach a special importance to the market as a privileged place for exchange and to the price as a measurement system. Thus, as proposed by the JWG, generalising full fair value to all financial instruments comes is congruent with the advances in globalisation of capital markets and the accelerated use of sophisticated derivatives and other complex financial instruments²¹, which have changed fundamentally the business environment.

According to this way of reasoning, the market is the main determinant of the economic life and its evolution governs the agents’ behaviours. In this respect, the JWG proposal justifies the full fair value for all financial instruments by rephrasing the arguments in favour of the fair value²².

The relevance of fair value for and its coherence with an active management of financial risks, based on interest rates and present values issued from the market, are the main qualities attributed to this measurement model. Furthermore, the JWG insists on the foreseeable nature, the comparability and the neutrality of the amounts published in the financial statements due to the exogenous character of market estimates. Finally, fair value allows the recognition of the global performance by conferring a value to the company’s decision to keep or not a financial asset and/or liability.

The nature of the representation that we can deduce from the JWG argument attributes to the market the monopoly of the objective estimation. This character of objectivity stems from the narrow links between finance and founding principles of the neoclassical economic theory such as rationality of the agents and market efficiency. According to the “market model”, the financial market is the inescapable arbitration authority, since the information synthesized in the price corresponds to the true value of the security. Thus, to define the price as the true value is basically linked with a market-type of argument. However, several fundamental hypotheses must be assumed. The hypothesis of perfect information coming from the general equilibrium theory and the efficient market hypothesis commonly postulated in financial theory are the essential theoretical presuppositions underpinning the assertion of the fair correspondence between the market price and the value. In this respect, the conceptual case for fair value measurement developed by the JWG benefits from the support of a large body of market-based empirical research²³ which assert the relevance of the fair value principle and of the efficient financial market hypothesis.

The JWG proposal considered also the estimation of fair value without observable market prices. In such a case, fair value should be estimated using a valuation technique that

²¹ See the JWG proposal, Financial instruments and similar items, Summary, p.(i).

²² See the JWG proposal, Financial instruments and similar items, Basis for Conclusions, p.150-152.

²³ American Accounting Association’s Financial Accounting Standard Committee, Response to a Discussion Paper issued by the IASC/CICA Steering Committee on Financial Instruments, (March 1998), “Accounting for financial assets and financial liabilities”, Accounting Horizons, pp.90-97.

incorporates estimations and assumptions that are consistent with available information that market participants would use in setting a price for the instrument, but with some degrees of uncertainty. Fair value can be estimated either by the price on which the independent parties agreed in the frame of an arms' length transaction, if necessary determined by an expert, or by observable market prices for similar instruments. It can be also estimated by the calculation of the net present value of future cash flows discounted at the market discount rate. Both future cash flows and the market discount rate, which must be risk-adjusted, are not observable and must be estimated. The conceptual case for fair value is even larger than the market value estimation and may call upon specific valuation techniques that always refer directly or indirectly to the market²⁴. The reliability of fair value without observable market prices does not constitute a problem in the JWG proposal. It is legitimated by invoking the use of valuation techniques that are consistent with accepted economic pricing methodologies. These specific estimation techniques are supposed to be objective as they are based on a set of information identical to the one used by the theory to explain asset pricing in the market.

The comment letters received from the stock exchange regulatory authorities support and legitimate the full fair value²⁵ on the ground of the exogenous character of market pricing. However, that reasoning does not represent the majority of the constituents' comments received by the IASB. These letters come from the most important exchange regulation authorities (IOSCO, SEC) whose opinion carries a heavy weight within the international accounting standards' process. Even if these authorities do not participate directly to the accounting standard-setting process, they have the power to grant them an official recognition. So they exert *de facto* an undeniable control on the IASB process. The will to full fair value all the financial instruments is not considered as a perfect project. By the way, the fact that it has been initiated is a manifestation of the political influence of the exchange regulatory institution in the accounting standards' process.

The justifications based on the "industrial model" refer essentially on the necessary expertise in the estimation of fair value if observable market prices are not available or in case of illiquid markets. The JWG insists on the importance of a control of the estimates supported by well-adapted internal control processes²⁶. The control of the estimates based on mathematical models refers explicitly to the industrial logic. Note nevertheless that the valuation models used are all issued from the financial theory and manifest the will of the JWG to orient the accounting towards an expression of a market value, which proves again the dominance of the financial market dogma.

Finally, it is possible to link several justifications with the "connexionist model". This model insists on the characteristics of adaptability and reactivity. In this respect, fair value reflects immediately in the accounts the effects of management's decisions and the risks generated by the company's activities. The risk management policy is considered as immediately readable and attributable to the various companies' projects²⁷. Consequently, the users of the financial statements can have quicker reactions in front of the decisions made by the company.

²⁴ The underlying theoretical argument is that fair price is obtained by discounting the expected future cash flows at the risk-adjusted discount rate issued from the market. The axiomatic construction of the substantialist theory of value is a common reference for the majority of the constituents in favour of full fair value. As a matter of fact, this view is also largely shared by the opponents. It is developed in some details in appendix 2.

²⁵ See the comment letter CL113, OICV-OISCO, p.2.

²⁶ See the JWG proposal, Financial instruments and similar items, Basis for Conclusions, p.155.

²⁷ See the comment letter CL77, Danish Financial Supervisory Authority, p.1.

Fair value is also viewed as a strong disciplinary mechanism, preventing management from any drift. In this respect, fair value as a valuation model constitutes a fully traditional mechanism of governance aiming at reducing the agency costs between shareholders and management. Although no explicit argument in the JWG proposal is asserting the pre-eminence of the shareholder value ideology, the numerous references to the market value as an objective reality and as an exogenous datum fit in the framework of the dominant discourse on value creation. Indeed, value creation is a categorical imperative in the companies' management. By assuming a total application of full fair value, the balance sheet would display each accounting item at its market value. The bottom line of the profit and loss account would be measured by the differential variation between assets and liabilities values, displaying both the operational result based on real transactions and the financial result based on the fair value variations. The importance given to the market stems undeniably from the strengthening of shareholders' power and attests the enhancement of the regulatory power of financial markets. The fair value accounting allows estimating the theoretical market value and in comparative terms to evaluate the increase in wealth for the shareholders. Fair value is a device translating within the company the shareholding command over management issuing from the constraints imposed by the dominant investors of the deregulated markets.

The justifying rhetoric of the JWG proposal on full fair value as a new accounting measurement model leads to draw the outlines of the governance system tacitly praised by the IASB. The nearly total support of the IASB to full fair value²⁸ fits in the framework of governance focusing on value creation for shareholders. The discourse developed by the JWG translates the will to move from an accounting system based on historical costs and prudence, and relatively disconnected from the exchange environment, to a fair value accounting, allowing the calculation of a global result and improving the accounting expression of the financial value by reflecting the creation of wealth for the shareholders. Economic Value Added (EVA) or Shareholder Value Added (SVA) are the most accomplished expression of this objective. In this respect, our analysis of the justifications that are put forward by the full fair value supporters has validated our second hypothesis. The international accounting standardization conveys a governance structure coherent with the dominant representation of value, the assumption of market efficiency and the contractarian conception of the firm. The validation of this hypothesis challenges the framework of the procedural legitimacy on which the international accounting standards-setting process is based.

2.2.2. Models of justifying the opposition to Full Fair Value

The banking and insurance sector representing an important part of our comment letters' sample were strongly opposed to the JWG project, as were the majority of non financial companies and accounting firms.

²⁸ Note however that the JWG proposal devotes its last part to the dissenting views made by the French and German delegations during the draft process. The French delegation considered substantially that fair value is not a relevant measure for the banking transactions and for assets with narrow markets. They protest also against the full fair value application in the scope of the bank' creditworthiness rating as well as the recognition of the interests' variation in the profit and loss account. Although it did not claim about the general orientation of the full fair value for all financial instruments, the German delegation criticized the JWG proposal by pointing the lack of operational character of the draft.

The arguments' analysis shows that the authors developed common structures of reasoning and justifications. The main concerns are objections regarding the accounting principles and pragmatic claims.

The objections regarding the accounting principles include:

- The inadequation of fair value as an accounting measurement system in relation to the operational and managerial intents, especially in the banking and insurance industries;
- The ambiguity of a performance estimated from the variation of fair value between two accounting periods. What about the significance and the distribution of profit composed by latent gains and losses which may not be realized?
- The accounting mismatch due to the distortion between elements estimated either in fair value or historical costs, and disclosed in the same balance sheet.

The main pragmatic objections were:

- The volatility induced by unmastered accounting data and the lack of external information regarding the assets and liabilities valued without observable and liquid markets;
- The complexity of the fair value measurement system 's implementation;
- The larger part left to the management's and auditors' subjectivity in the control of the estimates.

The argumentative structure commonly used in the comment letters invokes the lack of reliability of the fair value measurement system for some financial instruments in the case of no available observable markets price. It insists also on the lack of neutrality and comparability of these accounting measurements. These estimates are based on valuation techniques involving a numerous set of hypotheses for which the least variation in the parameters' values may induce important modifications in the estimates. Indeed, the main valuation model consists of the calculation of the net present value (NPV)²⁹ of the future expected cash flows (noted C_t), for each period (t), discounted at the risk adjusted discount rate (k) for every financial instrument.

$$NPV = -I_0 + \sum \frac{C_t}{(1+k)^t}$$

Where

- I_0 = initial investment at $t = 0$
- C_t = cash flow for the period t
- k = risk – adjusted discount rate
- t = time period ($t = 1, \dots, T$)

The NPV formula is an equation with two unknown factors (C_t et k), which implies a larger part left for the management interpretation in the estimation of the expected cash flows as well as the risk-adjusted discount rate. The fair value's lack of reliability when it is "marked to model" crystallized the majority of the unfavourable opinions.

After describing the structures of the arguments used by the anti full fair value constituents, we will point out the orders of justification to which the authors of these

²⁹ See the axiomatic construction of the value detailed in appendix 2.

comment letters did have recourse so as to be able to identify the criteria on which the legitimacy of their arguments is resting.

2.2.2.1. The civic justifications

The “civic model” of justification shows the particularity of granting primacy to the collective entities and of resting on the notion of common good.

By analyzing the content of the argumentation developed by the opponents of fair value, the lack of reliability seems to be the argument that crystallized the dispute. The reliability and the objective criteria, through considered in the IASB conceptual framework as equally important as relevance, do not seem to be ensured due to the inefficiency – or even the inexistence – of the markets that are presupposed to offer accurate reference prices. The subjective span of discretion effectively left to the management in the elaboration of the accounting estimations is considered as opposed to the civic order. According to Boltanski and Thévenot, (1989, pp.206-207), the civic order insists on the objectivity of the rules detached from persons or representation mechanisms.

Opponents, such as the European delegation, insist on the risks of instability generated by the full fair value for the economic and financial sectors as a whole. Indeed, the volatility and the short term vision induced by the fair value in the financial statements could weaken the positions of banks as the providers of long term finance and discourage lending to sectors where credit ratings are volatile. Indeed, fair value can also create a bias against fixed rates instruments. The JWG proposal could therefore have a significant impact on the liquidity of the fixed rates debt markets and could result in systemic changes in the type of financing available, should it be the case that financial institutions would decide that they will no longer bear the risk exposure inherent in fixed rates instruments. Given such a threat for the whole economic and financial community, it looks like a fair and legitimate cause in favour of which the mobilisation of constituents is required in the frame of a collective action aimed at opposing the full fair value.

Finally, a further comment looks imperative. The above arguments fall underline the convergence of the interests of the whole economic and financial community and not of only the investors. One should remember that the international accounting standardization has as its declared objective to produce accounting standards in the general interest. These civic claims recall the needs for a governance structure that would tend to serve the interests of every stakeholder and not just the investors’ ones.

2.2.2.2. The justifications based on the industrial order

The rhetorical analysis of the arguments shows that the opponents of full fair value based the legitimacy of their arguments on specific characteristics, significantly less exogenous than those developed by their partisans. On the contrary, the specific character of the firm and of the management’s intentions may be in conflict with the exogenous character of the estimates issuing from the market. These elements can be properly validated by the “industrial model” of justification. The opponents mainly call upon the going concern assumption³⁰, and the

³⁰ Extract of the comment letter CL21, Confederation of Netherlands Industry and Employers p.4:
“The use of market exit prices in all circumstances contradicts with the other main principle of the conceptual framework: the going concern assumption”.

management intent to hold financial instruments up to maturity. Consequently, these arguments contest the liquidation-based valuation of every financial instrument.

By relying on a temporal perspective based on a succession of estimates through time, the “industrial model” of height can legitimately be referred to by the partisans of the historical cost measurement system. In the arguments analyzed, the objectivity of the accounting estimates must be based on the reality and the specificity of the transactions within the company. The historical cost is a reliable and objective measure because it is based on the reality of a transaction, certified by documented evidence and a succession of predefined accounting records such as the depreciation or the amortization. The historical cost, associated with the prudence principle, acquires what it is essential from a legal point of view, the conclusive character of the transaction.

Another claim concerns the misunderstanding stemming from the accounting treatment of the fair valuation of a company’s own debt that leads it to report an increase in earnings when its credit ratings is downgraded. For example, if a bank has issued a bond with a 8% yield that climbed up to 10% because of the downgrading of the company’s rating, the methodological requirements of the fair value principle would be to recognise a profit reflecting the decrease in the discounted value of future payments. This counterintuitive accounting interpretation crystallized the controversy against fair value because it questions fundamentally the relevance of this measurement model. The inadequate character of the fair value measurement in that case is considered as a weak status of greatness in the frame of the industrial order.

Finally, fair also questions the notion of performance measurement. According to Richard (2001), the managers considered throughout the twentieth century the historical cost model as providing relevant information for performance measurement. Their main concern was to determine the proper rules allowing to measure the efficiency of their actions. In this meaning, they have followed the example of the nineteenth century’s lawyers, whose objective was to ensure the compensation of the creditors in case of bankruptcy. So they substituted to book values market values as a fictitious liquidation-based valuation. The claims of the opponents of the full fair value manifests their interest in performance measurement and their fear that it would be loose any practical interest in terms of internal and external management. The problem stems from the paradoxical coexistence of two types of performance measurement: the one aimed at highlighting only the variation in fair value, the other one aimed at reflecting the effective operational process of the firm.

2.2.2.3. The market-based justifications

However, the arguments’ analysis shows a complete consensus regarding the fair value as the true value of all financial assets and liabilities when they are traded in an active and liquid financial market. This manifests the degree of penetration of the conceptual framework of market-based justifications within the arguments of the anti-full fair value supporters. Indeed, the opponents do agree to the conceptual presuppositions of this order of justification. The market is the place for objective estimation, provided that it is efficient. Consequently, the opponents of the full fair value agree to the Anglo-Saxon conception of economy and the financial markets pressure in order to obtain information regarding the true value. The claims about full fair value come more within the scope of a new definition of the accounting principles and of the pragmatic problems raised by the implementation of full fair value than of a questioning of the contractarian view of the firm or of the shareholding view of governance. According to the financial community, the main problems regarding the full fair value are essentially pragmatic.

2.3. The IASB reactions

2.3.1. Evolution of the fair value controversy

According to the consultative process, the IASB discussed on January 2002 an analysis of the responses to the JWG proposal. The minutes of the meeting consist exclusively of a summary of the objections mentioned above but did not report the position of the IASB in this respect. The silence of the IASB has suspended the full fair value controversy in the standardization process. US academic studies (Barth, Beaver and Landsman, 1996; Nelson, 1996; Eccher, Ramesh and Tiagarajan, 1996, Simko, 1998) had already affirmed the informational usefulness of fair value and its impact on the US financial reporting, while European studies (Bernheim and Escaffre, 1999) argued from their mitigated results to keep going the European fair value debate. Their main conclusion was that the adequacy of fair value is context dependant.

We must remember that the standard regarding financial instruments temporarily adopted in 1998 had restricted the fair value principle to some speculative financial instruments. The categories concerned were the “available for sale” and the “held for trading” financial instruments. The board had considered that the fair value for these categories could be considered as reliably settled. The standard proposed also to record the change in value in the income statement for the held for trading instruments and directly in equity for the available for sale instruments. Thus, this standard established in a restrictive way the measurement of financial instruments halfway between the historical cost and the full fair value based principle.

In 2002, the IASB elaborated a project of amendment of the IFRS 39 in order to take into consideration some issues mentioned in the JWG comment letters. It decided to simplify and improve IAS 39 *Financial Instruments: measurement* by introducing an option to allow any financial asset or liability to be measured at fair value, with value changes flowing through the income statement (*the fair value option*). The idea seemed to be an adequate solution to measurement of instruments that had an embedded derivative. According to the IAS 39 adopted in 1998, the derivative should be measured separately from the underlying instrument, but this measurement is in most instances very complex when not based on the market value of the underlying instrument, so that generalizing fair value was seen as a simplifying solution. In debating improvements, the IASB came to the conclusion that this option could be beneficial and simplify measurement in a wider set of circumstances. The original intention of standard-setters had been to have all financial instruments measured at fair value. Allowing the option was to encourage people to go in the direction of what was seen as the best valuation practice for financial instruments. At a practical level, it also dealt with a mismatch problem for insurers who could find themselves, when they applied IFRS 39 in 2005, carrying assets at fair value and the related liabilities at historical cost, giving an accounting mismatch that might be misinterpreted by users. Where there was an economic match between some assets and liabilities, it would also eliminate any need for hedges.

The draft comment period ended on October 2002. The Board decided on December 2002 to hold a series of public roundtable discussions with the respondents to the IFRS 39 amendment’s exposure draft. The chairman of the IASB, Sir David Tweedie, recognized that their review of the comments received regarding the proposed improvements had indicated

that there remained a wide range of views and perspectives that the IASB could benefit from. The objective of the roundtable discussions was to improve interactions between the Board and its constituents and to provide mutual education. While it was possible to qualify this decision as the creation of a possible interaction between the stakeholders, the Board agreed that a set of guiding principles and questions would be distributed to participants prior to the roundtables forums and therefore established unilaterally the agenda. The justification of the Board was that the participants should focus their efforts on those issues that they in their opinion should be improved. During the roundtable forums, the participants expressed concerns that the *fair value option* might be used inappropriately. Firstly, it could permit companies to report increased profits when their own creditworthiness had deteriorated. Secondly, it may be difficult for companies to determine reliable fair values and for auditors to audit these estimates as far as illiquid financial instruments would be concerned. Consequently, the option might enable companies to manage earnings in ways that would not easily be detected by financial statement users. It is thus a corporate governance issue.

Notwithstanding this set of objections, a revised, simplified and presumably improved IFRS 39 was on the books by the end of 2003, to come into effect in 2005, with earlier application permitted. Then, in the early 2004, long after closure of official exposure periods, came a letter from the European Central Bank issued a letter of objection. Informed and motivated by the European Central Bank, the European Union adopted in November 2004 a regulation endorsing the financial instruments set of rules, with the exception of two “carve-outs”, one relating to the *fair value option*, the other to hedge accounting. The Commission carved out the proposals relating to the *fair value option* because of the concerns expressed by the European Central bank and prudential supervisors represented in the Basel Committee of banking supervisors³¹. In addition, as article 42a on the Fourth Company Law Directive (Directive 78/660/EEC) does not allow full fair valuation of all liabilities, EU listed companies could in theory only fair value assets.

The IASB reacted by publishing an exposure draft with an amendment to IFRS 39 which severely restricted the use of the *fair value option*. The Board decided to reconsider the ability for an entity to designate any financial asset or liability as at fair value, while preserving the key benefits of the option. The new proposals would allow entities to irrevocably state financial assets or liabilities at fair value through profit and loss at inception, under three sets of circumstances:

1. Where using fair value addresses the measurement inconsistency which would arise from measuring assets and liabilities on different bases (an 'accounting mismatch').
2. Where a group of financial assets or financial liabilities is managed on a total value basis, in accordance with a documented risk management or investment strategy.
3. Where a financial instrument contains an embedded derivative.

Currently the option is available for any financial asset or liability at the entity's option.

2.3.2. *The dominant actors in the fair value option controversy*

During the *fair value option* controversy, we have observed the influential role of regulatory actors which had the ability to question the IASB standardization process. These

³¹ The Basel committee on Banking Supervision is a committee of banking supervisory authorities which consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, The Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States.

actors are the Basel Committee, the European Community and the European Central Bank. As an example, at the moment when the exposure period for the *fair value option* amendment came to an end, about 120 comment letters had been received and virtually all financial statement preparers, accounting firms and standard-setters who responded did not want the *fair value option* to be restricted. However, the regulatory authorities kept the controversy going as they feared that intemperate banks might use the *fair value option* to slide around problems with their prudential ratios.

The IASB decided to move to a new tack and to try to specify in what circumstances this option could be used. However, they were hampered by the lack of feedback from the bank regulators. Finally, in February 2004, Sir David Tweedie released the information that there had been a “very useful” meeting with representatives of the European Central Bank and the Basel Committee and that their views had been taken into account in the final proposal. The new *fair value option* has been finally adopted by the European Union, following the recent modifications made by the Board, in June 2005. However, all the legitimate arguments developed by these influential actors are not taken into consideration by the new *fair value option*. It is particularly the case for the own credit risk issue.

Thus, the IFRS standards authorize a further reporting option, what is in contradiction with one of the main objectives of the IASB improvement projects, namely to eliminate or simplify reporting options. The use of the *fair value option* may reduce the comparability of financial statements. With the support of the dominant actors in the standardization process, the fair value has become an essential accounting concept that involves a more aggressive “financialisation” of accounting.

Despite the existence of a specific consultation process that allowed any stakeholder to participate in the accounting standard-setting process, the IASB consultation process did not allow the actors to enter effectively into interaction. It is pointed out that due to the specific *fair value option* issue, the reactions received by the Board included oral and e-mail communication. None of the comments had been posted onto the IASB website. Consequently, the consultation process remained in fact a bilateral mechanism between each stakeholder and the IASB and thus did not allow the construction between the actors of a common perception of the context. As a particularly revealing evidence of that, we have noted the unilateral elaboration of the meeting agenda, fixed by the Board itself without any consultation of the stakeholders. Even if the IASB has been adopting a specific procedure called the “due process”, this is only a formal process that could not give rise to the building by the actors of a common perception of their context and of the desirable changes to be brought in this context. In other words, it did not give rise to a collective construction of the public interest. We are thus far from a reflexive process of governance. At best, we can mention the existence of a bilateral but nevertheless formal consultative process.

The introduction of a new convention in terms of accounting measurement has been facilitated by the deliberate choice of the international standard setters to orient the accounting evolutions towards the needs of the investors. In this case, the governance structure conveyed by the IASB and shared, though in a somewhat ambiguous manner, by most shareholders conditioned the change of the accounting measurement convention.

CONCLUSIONS

The study of the JWG project and of the comment letters received by IASB validate our second hypothesis. Namely, the governance structure conveyed by the IASB norms is coherent with the contractarian theory of the firm and the dominant representation of value, provided by the modern financial theory. This structure of governance substitutes a market conception to the general interest conception, which should normally govern the accounting standardization process. The introduction of the fair value as an accounting innovation takes place in a context of emergence of a new type of investors who consider themselves as short term – or at best medium term – creditors of the exchange listed companies. This new state of mentality involves a set of claims in terms of value creation. Indeed, value creation – and even “shareholder value” creation – has become the imperative in terms of sound management. By introducing the fair value, the IASB participates to what Hoareau and Teller (2001) have been calling the shareholders’ value ideology. However, even if the marking to market in the case of financial instruments dedicated to short term negotiation on liquid markets, the JWG and the IASB did not succeed in convincing all the stakeholders with the attributes of justice of fair value when it is applied to financial instruments without observable or reliable prices. As a consequence, the full fair value project has suffered a defeat.

However, in an environment entirely dedicated to value creation, we have noted that the lobbying by the stock exchange authorities in the course of the standardization process was resting on their power to provide the standards with an official recognition in order to ensure their proper enforcement. Consequently, the international accounting standards under political constraint which tends to legitimate the shareholder model of governance. The will of the stock exchange regulatory entities is that financial markets become the controlling authority of last resort. This presupposes that they exert the valuation function in full conformity with the perfect information and market efficiency hypotheses, which presume that every stakeholder involved disposes at any moment and in the same conditions of the whole set of information that is necessary. But, the financial markets’ regulation can be seriously called into question if we are taking seriously the arguments about autoreferentiality and specularity of financial markets (Orléan, 2004). If we consider the market as a collective mechanism that produces valuation, i.e. a common opinion on the firm’s value but not necessarily a true and fair value, we conclude that financial markets as systems that produce valuation tend to exert an extensive control on the economic life without being subject of the same level of control.

What have been the consequences of the civic claims issued by the banking and commercial industries in such a context? The claims did not remain without answers. The IASB did not give a favourable end to the full fair value accounting for financial instruments. In this respect, we noted the significant impact of the opposition conducted by the banking and insurance sectors through the IASB consultative process. As a consequence, the IFRS 39 has established a mixed model of accounting measurement (historical cost/ fair value) which does not form a satisfactory compromise between the relevance and the reliability of the financial statements.

Analyzing the IASB consultation process, we have underlined the limits of its procedural legitimacy in international accounting standard-setting process. The initiative of IASB projects did not result from a collective process of consultation. As regards the full fair value project, we have noted the influential character of the stock exchange authorities.

These considerations lead to conclude that despite a specific Due Process, the IASB consultation process did not allow the actors to enter concretely into an effective interaction.

The consultation process remained in fact a mechanism of juxtaposition of opinions between each stakeholder and the IASB. It is only a formal process unable to contextualize efficiently the different perceptions of the actors concerned in order to build an acceptable solution in the general interest. We are far from a reflexive process of governance. The full fair value project stems from a rational decision made by the JWG, but which is based exclusively on the market and industrial orders of justification.

By affirming the will to ensure the comparability of the financial statements, which seems somewhat illusory, IASB imposes on itself a restrictive normative process. The discretionary margins are limited and the transactional capacities of the standards in relation to the context are almost inexistent. The consultative process allows only the IASB to evaluate the differences in perception of the context among the actors but not to create a common perception of the context. The collective action is purely formal.

As a consequence, the legitimacy of the IASB as a private entity aiming at producing international accounting standards can be called into question. The weight of the stock exchange authorities has been significantly increasing through the influence it does exert in the definition of the topical needs of the international accounting standardization. While the function of valuing the companies can be considered as a collective good, one must recognise that the deliberative system of the IASB does not allow concretely a collective appropriation of the standardization process. These considerations call upon a reform of the accounting standard setting process. The IASB seems to be conscious of the problem and has initiated recently a project aiming at improving the Due Process.

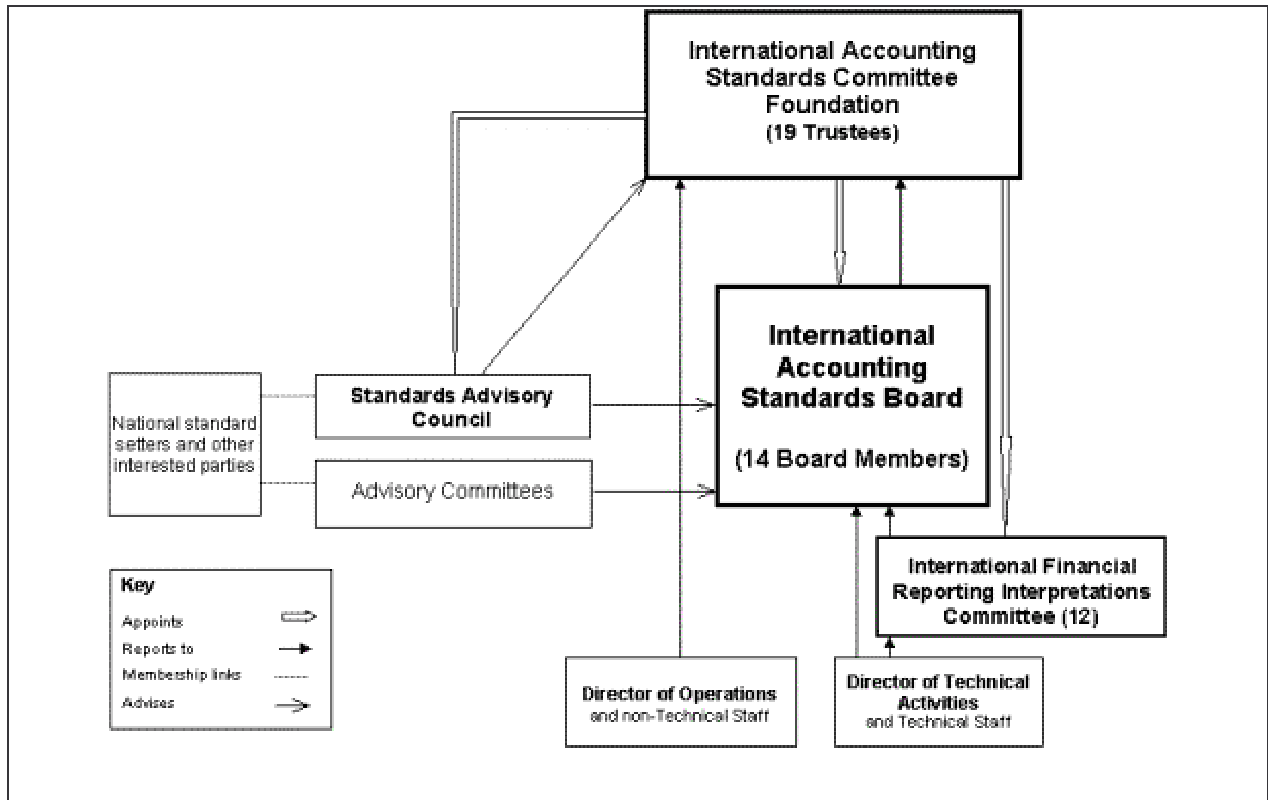
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Appendix 1: IASC structure



Source : <http://www.iasb.org/about/structure.asp>

Appendix 2 Axiomatic of value

In the contemporary economics, the concept of value is based on an axiomatic construction, which is often named « *rational expectations hypothesis* ». J. Muth developed the basis of this hypothesis, by defining three axioms:

1. All market's participants identify similarly the factors, called "fundamentals", which determine the value of a good which is subject to the exchange.
2. The exact relationships between the value of the good and its fundamentals are common knowledge.
3. There is no material or cognitive limit to the calculation ability.

In other words, as Muth defined it, the expectations, considered as informed predictions of future events, are fundamentally the same as those predicted by the relevant theory.

As the future is not known with certainty, the pricing process can be represented by the following formal system:

$$\tilde{V} = f(\tilde{D}_i) \quad (1)$$

$$\tilde{P} = E(\tilde{V}|\tilde{D}_i) + \tilde{\varepsilon} \quad (2)$$

$$\tilde{\varepsilon} = N(0, \sigma) \quad (3)$$

Where,

D_i = a vector of "fundamentals" $i \in [1, \dots, n]$

V = the "fundamental" value of the good

P = the price of the good

ε = a residual term, i.e., a random variable normally distributed with mean equal to zero and a constant standard deviation σ

As the expected value of V is a conditional expectation, the probability distribution of P is stable if and only if all the underlying random processes are also stable, that is invariant through time.

When the good considered is a capital good of capital, a good without value in use (production good or financial asset for which the sale allows to get money in order to buy the capital good), according to the *rational expectations hypothesis*, its value can be defined as follows: "The value of every capital good is equal to the sum of the discounted cash flows that the possession or the implementation of this capital allows to realize³²."

This definition can be described by the following formal equations:

$$E(\tilde{V}_0) \equiv \sum_{t=1}^T \frac{\tilde{C}_t}{(1+k)^t} \quad (4)$$

$$E(\tilde{P}_0) = E(\tilde{V}_0) \quad (5)$$

³² R. COBBAUT (1997), *Théorie financière*, Paris, Economica, 4^{ème} édit., p. 49.

C_t = cash flow at time t

Where k = cost of capital

t = period of time ($t = 1, \dots, T$)

When the capital good considered is a security, the periodical cash flow is equal to the temporal sequence of dividends or coupons.

The sign of equivalence used in (4) shows that the underlying axiomatic proposal is a definition. We postulate *a priori* the relationship between three items which are: the economic value, considered as an unbiased estimate, the market price observed and a risk-adjusted discount rate or cost of capital. When we determine two of these items, we can deduce the value of the third one by:

- *an operation of estimation*: in order to determine the value of a security, the market participants agree to discount the expected future dividends at a risk-adjusted discount rate [$V = f(C, k)$].
- *the determination of the risk-adjusted discount rate*: by knowing the rational expected value of the future cash flows and observing the security market price, the managers deduces the risk-adjusted discount rate [$k = f(P=V, C)$]

Appendix 3:Textual database

The *Joint Working Group « Financial instruments and similar items »* proposal (2000) and the comment letters received by the IASB: See the IASB website

http://www.iasb.org/current/iasb.asp?showPageContent=no&xml=16_56_67_22042002.htm

Please find enclosed a summary of the *Comment letters received* and of the *JWG* proposal.

The *fair value option* draft (2004) and their comment letters received by the IASB

http://www.iasb.org/current/comment_letters.asp?showPageContent=no&xml=16_91_79_26072004.htm

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Abbreviations :

ARC : Accounting Regulatory Committee

EVA: Economic Value Added

IASB : International Accounting Standard Board

IASC : International Accounting Standard Committee

IAS/IFRS : International Accounting Standard/ International Financial Reporting Standard

IFAC : International Federation of Accountants

IOSCO : International Organisation of Securities Commission

JWG : Joint Working Group

OECD : Organisation for Economic Co-operation and Development

SAC : Standard Advisory Council

SEC : Security Exchange Commission

SVA: Shareholder Value added

NPV: Net Present Value