

Chapter 2

FAIR VALUE, ACCOUNTING AGGREGATION AND MULTIPLE SOURCES OF INFORMATION

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Abstract: Accounting information is formed by an aggregation of the information available to the accounting system. Introduction of fair value accounting represents a new solution to the accounting aggregation problem as market information is merged into the accounting system. Multiple sources of information are available to market participants and accounting information is but one of these sources. Fair value information is available to the accounting system, to the public, and to individual market participants, hence, the aggregate information available in the economy – aggregate informativeness – depends on the confluence of accounting information and other sources of information. Particularly, the price process might well be informative but is influenced by the accounting policy chosen and, hence, it is not obvious the introduction of fair value accounting leads to an improvement in aggregate informativeness. Fair value accounting may destroy the aggregation mechanism of the market.

Key words: Fair value, Accounting Aggregation, Information

1. INTRODUCTION

FASB and IASB have been promoting fair value accounting in response to the demand for accounting information that is more in line with market valuation of the firm. This idea has been picked up in many of the studies on quality of earnings, and indeed one of the measures of quality of earnings that has been suggested is exactly the extent to which the accounting value mimics the market value. The argument behind this is straightforward provided accounting is the only source of information. If the purpose of the accounting information is valuation of the firm, introduction of fair values

will certainly improve the valuation. The accounting value of the firm will be better aligned with the market value of the firm.

In the presence of multiple sources of information the picture changes. Often some information is provided by the financial reports while other sources of information directly feed the market participants. The accounting system can only process the information it has access to and the resulting financial report will reflect that. Furthermore, the accounting system aggregates information. In the presence of multiple sources of information it becomes important how the private information of the investors and the accounting information interact under various regimes. Mixing information sources is complicated and adding fair values to the accounting system might have a negative effect due to the interaction. The investors might not be able to "undo" the accounting aggregation.

Our task is to analyze the interaction among accounting reports, investors' private information and market valuation. The accounting system has access to accounting information and market information with noise and must provide an aggregated report. The market participants also have access to market information. The market determines price based upon the accounting report and the investors' private information, taking into account that the market participants learn from the price. Consequently, a rational expectations equilibrium is employed. In this setting the information processing is not invertible and the choice of accounting policy becomes more involved. Fair value accounting does not uniformly dominate transaction based accounting. The choice of accounting policy must reflect the influence of accounting on information aggregation in the market. Transaction based accounting can be preferred even when it seems the accounting system has comparative advantage in assessing fair values.

2. THE MODEL

We consider a two period pure exchange economy with a single firm, an associated auditor, a riskless asset, and a set of atomistic investors. Trade takes place in the first period while consumption takes place in the second. Prior to the opening of the market each investor costlessly observes two pieces of information pertaining to the payoff from the firm's assets, \tilde{x} . Firstly, an auditor assists in the release of a public signal, \tilde{V}_i , concerning the future value of the risky asset and secondly, each agent observes a private signal, \tilde{y}_i , pertaining to the same.