EFRAG CONFERENCE
«Accounting Meets Valuation»

Fair value - the theory

Merits and limitations of fair value in financial reporting

Introduction – Mauro Bini

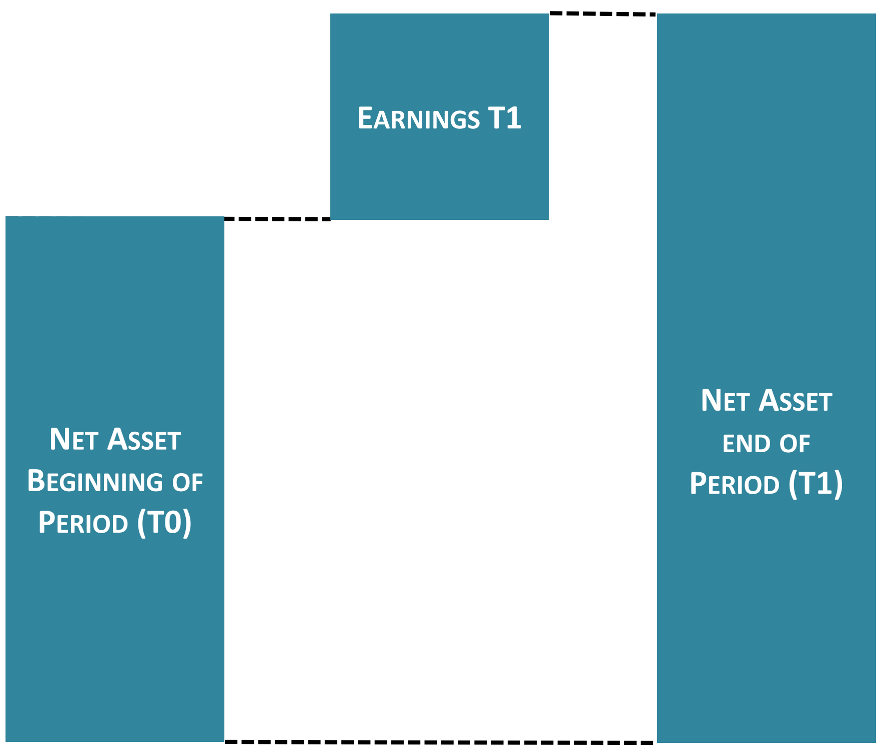
Brussels- 05.12.2017

Prof. Mauro Bini
Full Professor in Corporate Finance
Bocconi University, Milan

Contents

1. Fair Value and Predictive Ability of Income

Net Income = Net Asset End of Period +
– Net Asset Beginning of Period



With more estimates of the future incorporated into today's measures of assets and liabilities, income becomes less predictable

Fair value accounting makes earnings less predictable. Is this an issue?

- Predictability of income itself is not an objective of financial reporting.
- Rather, it is income’s predictive ability of future cash flows that matters.
- From a valuation point of view: intrinsic value is a function of the future cash flows.
- Fair value is a mean not an end. A mean for better intrinsic value estimates
- In a volatile world persistent and stable incomes are poor indicators of future cash flows.

2. Fair Value and Accruals

Earnings must be more informative of future cash flows than actual cash flows

Time →

Effect on:	T = 0	T = 1		**Delta (T_1 - T_0) -** ***Volatility Proxy***	**Serial Correlation**
Asset	Inventory: +90	Inventory: -90		-180	
Cash Flows	Cash Flows: - 90	Cash Flows: + 120		210	*Strong Negative Serial Correlation*
Net Income	Net Income = 0	Net Income = 30		30	*No Serial Correlation*

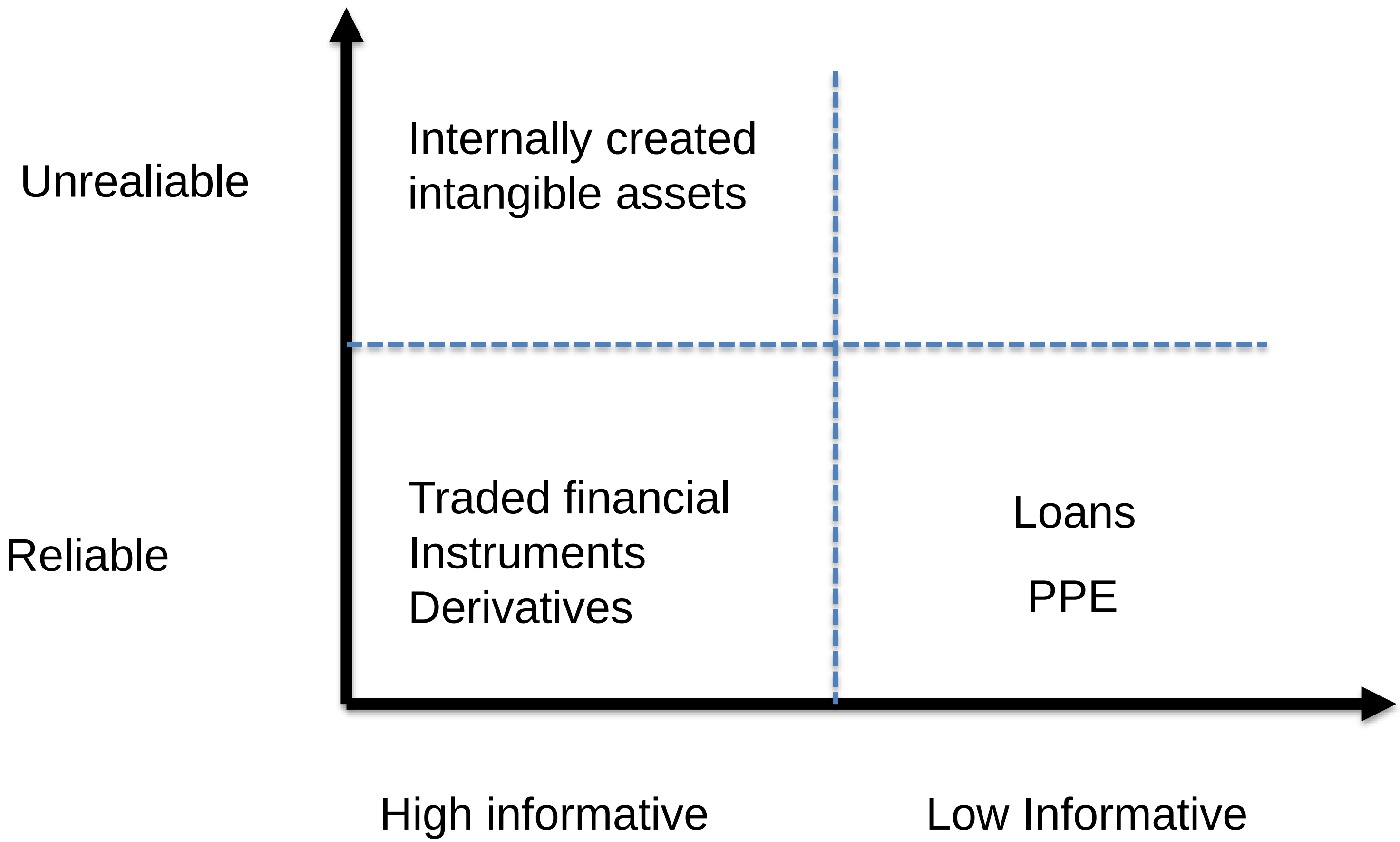
Accruals are the anchor to develop forecasts.
Are Fair Value Accruals (unrealized gains and losses) an anchor ?

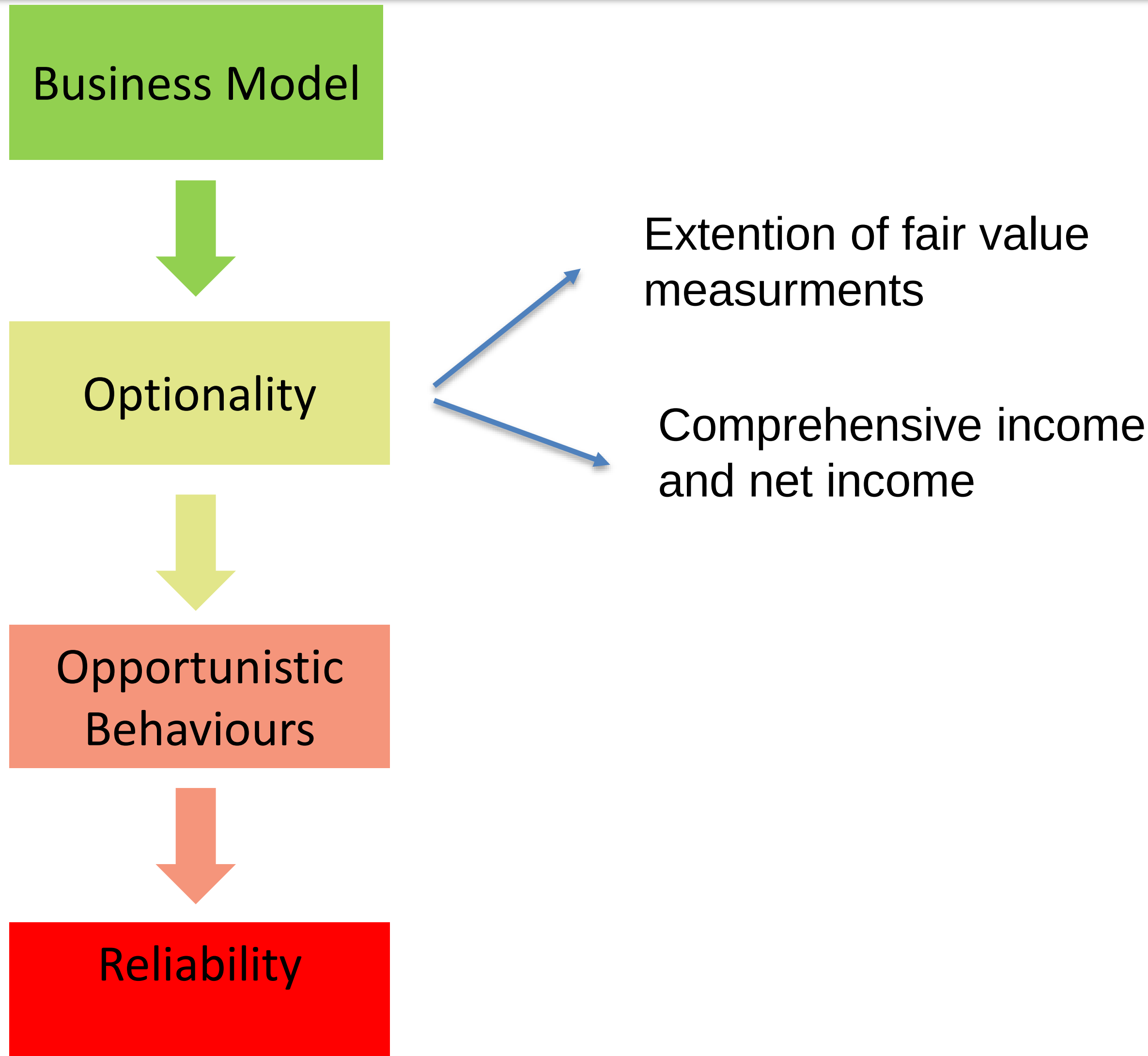
Not always. Incorporating fair value accounting information into an historical-cost-based accounting system is challenging. It involves the separation of two income concepts, net income and comprehensive income, as well as the "recycling" of certain income items from comprehensive income to regular income.

- Fair value is an «exit price». Fair value accounting is «exit price accounting», where:

- *Exit* presumes willing sellers ➔ but some assets will never be liquidated
- *Price* presumes active markets ➔ but sometimes fair value estimates assume hypothetical market participants in hypothetical markets

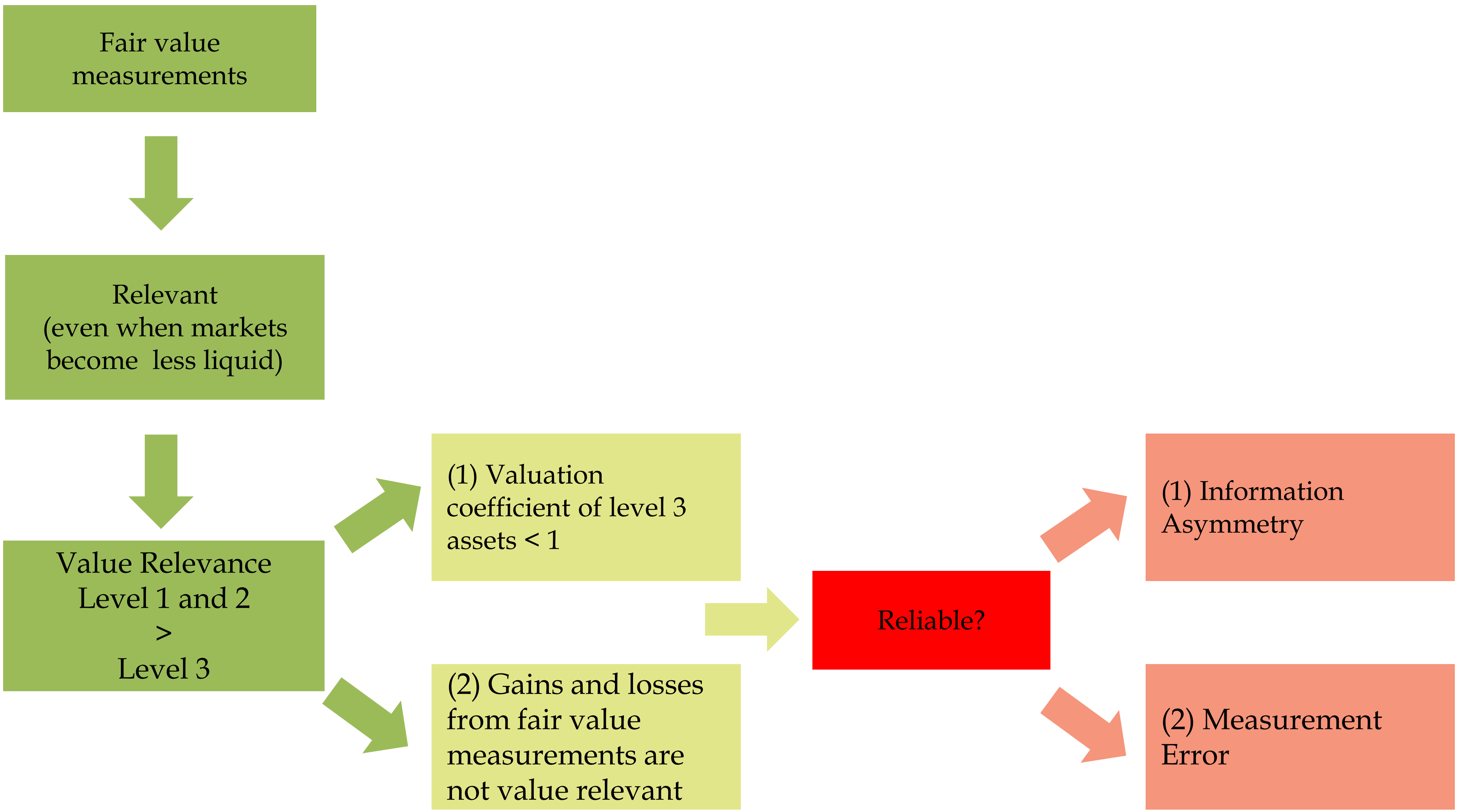
Fair value measurement





Prof. Mauro Bini
Full Professor in Corporate Finance
Bocconi University, Milan

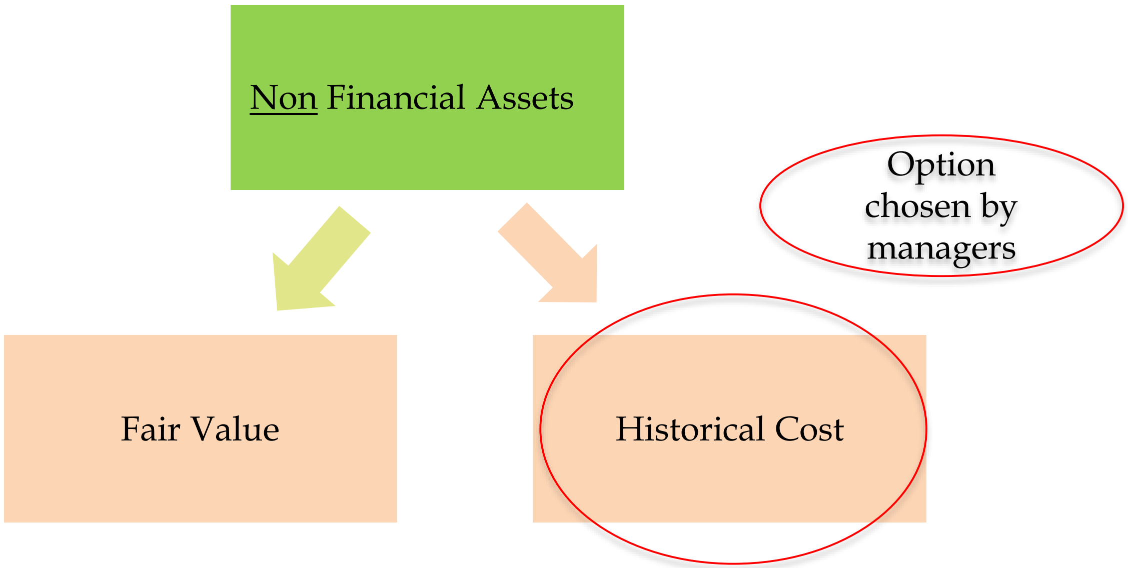
3. Relevance vs. Reliability



Prof. Mauro Bini
Full Professor in Corporate Finance
Bocconi University, Milan

Information Asymmetry	(1) Adverse Selection	→	Credible Signal
	(2) Moral Hazard	→	Disclosure
Measurement Error	(1) Noise (Intrinsic measurement error)	→	Audit issue
	(2) Bias (management-induced error)	→	How much latitude in estimating fair value

4. Reliability Costs



Counter-intuitive if we believe:

1) in the free market discipline
2) Net economic benefits $_{\text{fair value accounting}}$ > Net Economic benefits $_{\text{historical cost}}$

==> Reliability costs high
==> Net economic benefits of adopting fair value are too low

Thank you !