

Title: Financialized Accounting: Capitalization and leveraging the intangible

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JEL Codes: F3, G32

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Financialized Accounting: Capitalization and leveraging the intangible

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Abstract

This paper is about the financialization of international accounting standards by the International Accounting Standards Board (IASB). International Financial Reporting Standards (IFRS's) now incorporate fair value reporting for different types of corporate assets. Thus the interminable process of speculative recapitalization and financial volatility associated with asset trading in secondary capital markets is absorbed into the fabric of corporate financial statements. This change in the reporting process, within the financial statements, creates new forms of risk. First, the process of double entry bookkeeping transmits disturbance between line items that may or may not have an equivalent capacity to absorb these financial adjustments. Second, asset valuations in current time are very sensitive to changes in assumptions about future cash flow, risk and cost of capital. The IASB's financialization of accounting has the potential to generate dysfunctional economic and social outcomes because accounting line items are increasingly wired into capital market conditions and valuation modelling.

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1. Introduction

In this paper we start with a brief review some of the key perspectives on the nature of 'financialization'. Krippner (2005) describes the process of financialization as the 'rise of finance in the United States' where profits accrue through financial channels rather than through trade and commodity production. Defining 'financialization as a pattern of accumulation in which profits accrue primarily through financial channels rather than through trade and commodity production...' 'Financial' here refers to activities relating to the provision (or transfer) of liquid capital in expectation of future interest, dividends, or capital gains' (Krippner,2005:174-5).

According to Epstein 'some writers use the term 'financialization' to mean the ascendancy of 'shareholder value' as a mode of corporate governance; some use it to refer to the growing dominance of capital market financial systems over bank-based financial systems; some follow Hilferding's lead and use the term 'financialization' to refer to the increasing political and economic power of a particular class grouping: the rentier class' (Epstein, 2005:3). Orhangazi uses the term 'financialization' to capture the complex relations between 'financial markets and other aspects of the economy' (Orhangazi, xiv). Whilst Lazonick (2013) observes that financialization is about the dominance of an ideology based on shareholder value, that is, the 'mode of corporate resource allocation has been legitimized by the ideology, itself a product of the 1980s and 1990s, that a business corporation should be run to "maximize shareholder value" (Lazonick, 2013: 859). Lazonick's argument is that firms, in the US, have become preoccupied with maximising short-run returns on capital and distributing profit to shareholders to maximise their returns at the expense of long-term commitment to innovation and workforce skills for product and process renewal. This, Lazonick argues, is undermining the competitiveness of the US economy because the interests' of shareholders does not align with the broader stakeholder interests and sustaining competitiveness. For Lazonick, 'the key to the problem is the compensation of US corporate executives with indexed stock options that reward them for stock-price movements that are driven by stock-market speculation and manipulation and that are justified by the ubiquitous ideology that the role of these corporate executives is to "maximize shareholder value" (Lazonick, 2011: 1).

Froud et al (2006) suggest that the framing of the term 'financialization' shares a common thread about how a 'productive logic has been overlaid by finance' (Froud et al, 2006:69). Palley (2007) noting that: 'Financialization transforms the functioning of the economic system at both the macro and micro levels. Its principal impacts are to (a) elevate the significance of the financial sector relative to the real sector, (b) transfer income from the real sector to the financial sector, and (c) contribute to increased income inequality and wage stagnation (Palley, 2007:3). Froud et al suggest that financialization inaugurates a form of 'coupon pool capitalism' whereby the capital market stands between firms and households and that this arrangement has the potential to create 'instability, reversibility,

and unpredictability' (Froud et al, 2006:69). At the level of the national economy an accounting identity governs that assets are equivalent to liabilities. Thus assets held by the corporate, non-corporate and government institutional sectors are equivalent to the liabilities held by households (adjusted for investments and savings flows). Haslam et al (2012) argue that this neutral macro accounting identity conceals significant differences because the motivations of the actors located across these broad institutional sectors are variable. For example, some corporate actors may lever their balance sheet financial positions to a point where there is considerable potential for a value at risk adjustments. These financial disturbances have wider social consequence because adjustments are transmitted between different parts of the economic system through the mechanics of double entry book-keeping that preserves asset \equiv liabilities. That is, whatever happens on one side of the national accounting identity, for example, in corporate balance sheets will generate a displacement elsewhere into government and household sectors or both.

The perspective of financialization developed in this paper is that 'accounting' numbers are not just a neutral record describing the nature of the financialized world because professional bodies and accounting standards setting agencies are actors that have influence over the process by which financial information is filtered and recorded. The professional bodies have set their overriding objective to disclose information that is 'decision useful' to investors and capital market institutions. In a physical product market the last buyer along the value chain 'buys for consumption' and the difference between the price paid and cost of resources used is the profit and earnings generated by capital employed. Development and innovation of capital markets, in a credit based economy relies, on the fact that 'assets' can also be used as collateralised obligations to further extend and lever credit facilities. The trading of financial assets involves buyers purchasing with the intention to sell on to make a profit in an endless round of recapitalization(s) that exploit a difference between the bid/ask spreads and motivations of complex financial intermediaries. This process of on-going recapitalization is fuelled by leverage whereby the collateral embedded in the value of assets takes on an increasingly 'intangible' form. That is, in a financialized world the capital market takes on added significance in terms of facilitating the 'vendibility' of assets at the expense of maintaining the serviceability of this capital. That is, the materiality of underlying earnings from capital becomes of less relevance in supporting the on-going recapitalization of these assets. This argument is not simply about the logic of 'financial markets' and 'shareholder value' as a new epoch imprinting its dominance over the productively driven economy. Rather financialization is about how the process of on-going recapitalization has both 'technical' and 'rhetorical' elements (Froud et al, 2006:71). That is, the 'technical' nature of valuation and 'rhetorical' claims about transformation (Froud et al, 2000) are both embedded in the 'intangible' contribution to an assets market value or its quotation and it is this 'intangible' component, incorporated into the valuation of capitalized values, that tends to 'the widest and the freest' (Veblen, 2005:76). This volatile intangible element of value is now incorporated within asset

valuations on corporate balance sheets and this has the potential to amplify instability because write asset impairments would need to be absorbed by shareholder funds which have been thinned down. This alternative perspective on 'financialization' focuses on the process of financial reporting and how we account capitalization and recapitalization in credit based economies. In this financialized world balance sheet capitalizations become disconnected from underlying earnings capacity because tangible capital is blended with 'intangible assets' to form new 'collateral' that itself becomes leverage for on-going recapitalization(s).

The accounting profession and its international standards setting bodies facilitate this financialized world because these institutions are custodians of technical and rhetorical devices that are employed represent financial information. Zeff (1999) reminds us that the architects of the accounting conceptual framework have consistently taken the view that the financial statements should provide information to inform investors. The International Accounting Standards Board (IASB) has ratcheted this representation of the investor's interest making a series of adaptations to the conceptual framework governing the guiding principles of financial disclosure. In recent years this has included the removal of reference to 'true and fair view', 'prudence' and attention to capital maintenance.

The IASB has financialized the conceptual framework because removing the need for prudence and diluting commitment to a 'true and fair' view facilitates a new project, one that moves accounting towards representing and absorbing 'capital market' values. Thus the process of on-going capitalization and recapitalization and speculative leveraging of intangible asset values that we associate with secondary capital markets enters into the fabric of corporate financial statements. A range of accounting standards now permit the use of market valuations that recognise holding gains (or losses) from mark to market adjustments to assets (Palea,2014) . In financialized accounts the potential for financial instability is heightened because the balance sheet contains numbers that depend upon capital market conditions or are sensitive to valuation judgements and modelling because these can become 'impaired'. The financialized accounting project sponsored by the IASB is, we are informed, about the provision of information that will reduce risk and cost of capital for 'investors' thereby also promoting 'capital market efficiency'. However, this financialized accounting project comes with a health warning because representing the interests of the capital market includes also risks to financial stability and the public interest. The recent banking crisis revealed just how fragile leveraged business models are to changes in the market value of assets held on balance sheet.

In the next section of this paper we argue that the IASB project is the 'financialization of accounting'. The underlying conceptual framework that supports the development of international financial reporting standards (IFRS's) has become detached from the original principles set out in European legislation and reinforced by extant company law. In an earlier period European directives and corporate law addressed the need for accounting

information to present a true and fair view, be prudent, and ensure capital maintenance. The current EU Directive 2013/34/EU on annual financial statements and a series of IFRS's issued by the IASB promote the idea that balance sheet assets, income statements and shareholder funds can be adjusted to reflect market values or judgements about market values. Financial statements might once have reflected predominantly transactions in the current year and historic cost accumulation of assets employed to generate this income. It is now the case that assets, earnings and shareholder equity contain the product of recapitalisation that arises out of windfall gains from changes in and estimates of market value. These market values are the product of speculation and judgements about future possibilities and small changes in assumptions about 'the future' will amplify financial disturbance in current time.

The IASB's financialization of accounting project has the potential to generate adverse side effects because accounting line items are now wired into capital market conditions and valuation judgements. Fair value reporting does not simply adjust balance sheet assets to reflect changed prices in active secondary markets (equities, fixed interest securities, property and derivative markets). Mark to market accounting also involves making valuation estimations and the commissioning of expert advisers to make judgements and carry out modelling exercises that attempt to capture future earnings, risk and price changes. These valuations will tend to be more volatile than price changes attached to products that are sold for immediate use and consumption. This potential for financial instability is now, more and more, congealed into the numbers reported in a firm's financial statements. Valuation adjustments to asset values can set in motion a virtuous set of interconnections between reported line items whereby windfall holding gains inflate assets values, boost reported comprehensive profits and shareholder funds. But holding gains on assets can turn into holding losses that quickly erode profits, undermine shareholder funds, capital maintenance and accelerate firms towards insolvency.

2. Financialized accounting: Overriding true and fair, prudence, and capital maintenance.

In its 2013 discussion document 'A Review of the Conceptual Framework for Financial Reporting' the IASB invites readers to provide comments and responses to a series of questions asked. At the outset whilst this is a discussion paper it reveals the intentions and priorities of the reform agenda for financial reporting. With regards to the general purpose of financial reporting the IASB states that this is to 'provide decision useful information to investors and those providing financial resources to firms'.

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to users of financial statements (existing and potential investors, lenders and other creditors) in making decisions about providing resources to the entity (IASB, 2013: 20)

The primary objective is to provide information to investors that is relevant and faithfully represents the financial performance of the reporting entity. The usefulness of information provided to investors can be enhanced if it is comparable, capable of being verified, timely and easy to understand:

If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable (IASB, 2013: 21)

The IASB discussion paper also notes that financial disclosures often rely upon the estimates and judgements made by accountants rather than 'exact depictions' and that the conceptual framework is a guide to help with the making of these decisions.

The IASB also observe that:

To a large extent, financial reports are based on estimates, judgements and models rather than exact depictions. The Conceptual Framework establishes the concepts that underlie those estimates, judgements and models¹ IASB, 2013:196.

In 2014 the UK the Financial Reporting Council (FRC) published its report entitled 'True and Fair' noting that: 'Concerns have been raised on the operation of the true and fair override in IFRS and the absence of the term 'prudence' following changes made by the IASB in 2010 during the first phase of its Conceptual Framework project'. (FRC, 2014:1) The FRC report confirms the need for accountants to make judgements and that these should adhere to the need for a 'true and fair view' and also 'prudence'. The FRC report is a defence of the IASB 'Review of the Conceptual Framework for Financial Reporting' noting that: 'Whilst terminology has changed, the true and fair override requirement still exists in the same substantive form and the absence of the term "prudence" in the 2010 Conceptual Framework does not prevent accounts prepared in accordance with IFRS from presenting a true and fair view" (FRC, 2014:1).

The IASB discussion paper 'A Review of the Conceptual Framework for Financial Reporting' does not include the words 'True and Fair' and prudence is no longer a central conceptual organising element, because, the requirement to be prudent would lead 'to bias in the preparation of financial statements' (IASB, 2013: 185). With regards to capital maintenance it is noted that: the IASB 'may reconsider capital maintenance concepts if it undertakes a project on accounting for high inflation' (IASB, 2013:14). The Dutch Accounting Standards board (DASB) raised concerns about the extent to which 'financial statements under IFRS are still believed to meet the "true and fair view" objective and the needs of stakeholders'². In a comment letter, from long-term pension fund investors *The FRC's "True and Fair" paper*

¹ <http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Discussion-Paper-July-2013/Documents/Discussion-Paper-Conceptual-Framework-July-2013.pdf>

² <http://www.rjnet.nl/Documents/Uitgebrachte%20commentaren%202011/UC%2011-02-17%20IASB%20Status%20of%20Trustees%20Strategy%20Review.pdf>

(June 2014) falls short –A long-term shareholder perspective the signatories observe that: ‘We believe the reason IFRS has become disconnected from requirements for true and fair accounts as set out in EU Company Law is that IFRS accounts have different goals’.

Accounting requirements are governed by the requirements set out in EU Company Law which is designed to ensure directors are able to fulfil their legal duties to protect capital³. The original draft of European Council Directive 78/660/EEC outlined the legal obligations for the annual accounts of certain types of companies. Under section 1 on General provisions (article 2) it is noted that: the annual accounts shall give a true and fair view of the company's assets, liabilities, financial position and profit or loss. And within section 7 on valuation rules⁴ it is also noted that (i) valuation must be made on a prudent basis, and in particular: only profits made at the balance sheet date may be included. Key elements of European Council Directive 78/660/EEC are then reinforced by subsequent company case law. In ECJ C234/94 the Tomberger⁵ case it was concluded that the profits of a wholly owned subsidiary should be recognised in the parent company accounts as at the financial year end to present a true and fair view of profits earned in that year by the parent company. Furthermore, in the ECJ C-275/97 Bauunternehmung⁶ case it is noted that ‘potential debts’ would not be shown in the balance sheet, which would lead to an overestimate of the assets. Such a result would be incompatible not only with the principle of making valuations on a prudent basis the observance of which is prescribed by Article 31(l)(c) of the Directive. In ECJ C322/12 State of Belgium vs GIMLE the issue of valuation and prudence are again stressed in the *ratio decidendi*.

The principle that a true and fair view must be understood in the light of the principle contained in Article 32 of the Fourth Directive, pursuant to which the items shown in the annual accounts are to be valued based on the purchase price or production cost. Under that provision, the true and fair view which the annual accounts of a company must give is based on a valuation of the assets not on the basis of their real value, but on the basis of their historical cost.⁷

It was possible that there might be exceptions to this valuation approach under Article 2(5) of The European Council Directive 78/660/EEC but again it was ruled that even the undervaluation of assets in this case would not be treated as ‘exceptional’.

³ <http://www.uss.co.uk/UssInvestments/Documents/True%20and%20Fair%20View%20and%20IFRS%20-%20Investor%20Statement.pdf>

⁴ http://europa.eu/legislation_summaries/internal_market/businesses/company_law/l26009_en.htm

⁵

<http://curia.europa.eu/juris/showPdf.jsf?jsessionid=9ea7d2dc30db30e9fb0c9c0f4a318e8b85581dd5e1c9.e34KaxiLc3qMb40Rch0SaxuLaxr0?text=&docid=99913&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=1336509>

⁶ <http://curia.europa.eu/juris/liste.jsf?language=en&num=C-275/97>

⁷

<http://curia.europa.eu/juris/document/document.jsf?text=&docid=142616&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=138771>

There is now a considerable amount of drift between European directive 78/660/EEC and its extant company case law which had reinforced the importance of prudent financial reporting and valuation at historic cost. European Directive 2013/34/EU amends Directive 2006/43/EC of the European Parliament and of the Council and repeals Council Directives 78/660/EEC and 83/349/EEC⁸. The more recent European Directive 2013/34/EU permits, in the interests of comparability, the use of fair value (or mark to market) financial reporting:

The need for comparability of financial information throughout the Union makes it necessary to require Member States to allow a system of fair value accounting for certain financial instruments. Furthermore, systems of fair value accounting provide information that can be of more relevance to the users of financial statements than purchase price or production cost-based information (EU Directive 2013/34 para: 19)

Article 6(i) of EU Directive 2013/34 observes that items recognised in the financial statements shall be measured in accordance with the principle of purchase price or production cost. However, article 7 paragraph 1 permits fixed asset revaluation with the difference between fair value and cost or purchase price shown in a revaluation reserve. Whilst Article 8 also opens up the opportunity to account for the fair value of financial instruments (EU Directive 2013/34 Article 8a) and that fair value adjustments can also be applied to 'specified categories of assets other than financial instruments at amounts determined by reference to fair value' (EU Directive 2013/34, Article 8b)

The IASB's latest draft proposals on the accounting conceptual framework introduce the concept of 'neutrality' to replace 'prudence' whereby: 'a neutral depiction is without bias in the selection of financial information'⁹. In a speech 'The Concept of Prudence: dead or alive?' Hans Hoogervorst, Chairman of the IASB notes:

I think I made it clear in this speech that I think it is absolutely vital that our standards result in information that is as neutral as possible. A systemic bias towards conservatism undermines the value of earnings as a performance indicator. I have also shown my understanding for the fact that IASB felt a need to be completely unambiguous about this issue by removing the Concept of Prudence from our Conceptual Framework¹⁰.

The IASB commitment to neutrality so as to avoid bias is somewhat contradictory because it is also recommended that accountants make (or commission) judgements about the relevance of financial disclosure(s) on the basis of how investors, creditors and other lenders would assess the contribution of an asset or liability.

⁸ <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013L0034&from=EN>

⁹

<http://www.ifrs.org/Meetings/MeetingDocs/Other%20Meeting/2013/March/AP%203%20conceptual%20framework.pdf>

¹⁰ <http://www.ifrs.org/Alerts/PressRelease/Documents/2012/Concept%20of%20Prudence%20speech.pdf>

The IASB believes that the relevance of a particular measurement will depend on how investors, creditors and other lenders are likely to assess how an asset or a liability of that type will contribute to the entity's future cash flows.
(IASB, 2013: 108)

Thus the IASB's draft recommendations governing the accounting conceptual framework not only remove reference to 'true and fair' accounts but the concept of prudence is relegated and replaced with 'neutrality' and, in line with recent changes to the EU directive governing the preparation of accounts market valuations are also permissible. Corporate balance sheets are now awash with market values or imputed market values that are the product of estimates, judgements and modelling future earnings, cash flows and asset prices.

The recognition and measurement of some items in financial statements are based on estimates, judgements and models rather than exact depictions. As a result of the uncertainties inherent in business activities, certain items in financial statements cannot be measured precisely but can only be estimated. Estimation involves judgements based on the latest available reliable information (EU Directive 2013/34: para 22)

IFRS 13¹¹ outlines a 'fair value hierarchy' which suggests that: a] asset values can be based on quoted prices in active markets for identical assets or liabilities, b] quoted prices for similar assets or liabilities in active markets, or c] a reporting entity can develop and model, using unobservable inputs, to generate a valuation (using the best information available in the circumstances). Thus at the top of the hierarchy values can be adjusted against similar assets traded in active markets. Or at the bottom values are adjusted on the basis of imaginary estimates about anticipated future returns discounted by an appropriate cost of capital. The IASB is promoting the financialization of accounting because a reporting entity's financial condition is now conjoined to active capital market valuations or judgements that are speculative assessments about the current valuation of assets. Thus market values reported in a firm's financial statements mimic the process of capitalization and recapitalization associated with speculative capital markets. Recalibrating corporate balance sheet values using information from active asset markets or generated from estimates and models can lead to volatile windfall holding gains (or losses). Changes in asset values can inflate or depress reported income and shareholder funds amplifying financial instability because line items affected have variable quality to withstand a financial disturbance.

¹¹ <http://www.iasplus.com/en/standards/ifrs/ifrs13>

2.1 Absorbing market value into the financial statements.

There is a general understanding that 'investors' are interested in knowing the current market value of a firm's assets and liabilities and net worth rather than historic costs. Gigler et al (2013) suggest that : 'While the arguments supporting fair value accounting are not based on any formal analytical models that we are aware of, the intuition underlying its support seems to be the following. The current market values of a firm's assets and liabilities are much more descriptive of a firm's financial position/wealth than their historical acquisition cost' Gigler et al (2013:2)¹². In terms of informing investors it is argued that 'fair value' information provides valuations that reflect the fundamental performance of the firm and this contributes to informing investors and makes the capital market more 'efficient'. This logic surrounding the use of fair values to adjust information recorded in financial statements and disclosures have, according to Gigler et al become 'obvious and compelling' and thus a proliferation of accounting standards deal with the mechanics of fair value accounting.

The adoption of fair value reporting in the IFRS financial disclosure project is primarily about informing 'investors' so that they can make efficient capital stack allocations (debt and equity). The argument is that fair value disclosure(s) to investors will facilitate a better understanding about the risks attached to their investment(s) and thereby influence their funding allocations. Improving the quality of financial information disclosed to investors not only provides a better understanding of corporate financial risk it will also contribute towards a reduction in the cost of capital. A comprehensive review of the academic evidence on financial reporting, resource stewardship and capital market efficiency carried out by The Institute of Chartered Accountants in England and Wales (ICAEW, 2014) reveals that: 'It is not possible, however, to draw indisputable conclusions on the overall effects of mandatory IFRS adoption based on the available research. Different researchers arrive at different conclusions' (ICAEW, 2014:6). Thus, it is not at all clear that the IASB 'financialization' of accounting is associated with a lower cost of capital and enhanced capital market efficiency. A more plausible outcome is that the IASB has created work for accountants which Ryan (2008) observes is the need for discretion, judgements and sophisticated modelling to estimate fair values.

The main issue with fair value accounting is whether firms can and do estimate fair values accurately and without discretion. When identical positions trade in liquid markets that provide unadjusted mark-to-market values, fair value generally is the most accurate and least discretionary possible measurement attribute, although even liquid markets get values wrong on occasion. Fair values typically are less accurate and more discretionary when they are either adjusted mark-to-market values or mark-to-model values. (Ryan, 2008:4)

¹² <http://laef.ucsb.edu/pages/conferences/aae13/papers/kanodia.pdf>

In financialized accounts the change in orientation from recording historic cost to capturing market value within a firm's financial statements is reflected across a range of international accounting standards (IFRS's). Accountants can now justify the use of fair values and back this up with evidence derived from active markets, benchmarks or modelling. Mark to market adjustments are then registered in various line items and reconciled across the financial statements. However, recognition of changes in the fair value of assets has the potential to generate significant new risks that promote financial instability. To explore both the technical and financial aspects of fair value accounting we briefly consider three accounting standards: Business Combinations (IFRS3), Financial Instruments (IFRS9) and Property, Plant and Equipment (IAS16).

2.2 Business combinations IFRS3

There has been an on-going debate about how to account for the acquisition of one firm by another in a business combination. Two methods are commonly discussed: the pooling of interests method or the acquisition or purchase method. The former approach simply aggregates the income statement and balance sheet of both firms in a so-called 'pooling' of the accounts. That is, treating both firms as if they had previously been combined. In comparison the purchase or acquisition method recognises the market value of the acquired firm (as its stock market value plus any other premiums paid). It is the purchase method that is now applied under IFRS3.

Whereas under the pooling method the book values of both companies would have aggregated the purchase method shows the difference between the acquired company book and market value as acquired goodwill. This is then shown in the balance sheet as an intangible asset (see table 1). This goodwill is then periodically tested to establish the extent to which it is, or is not, impaired. This is a change in accounting practice because previously any goodwill accounted for would have been amortised, that is, written off over a period of time against earnings and shareholder funds. 'Today's impairment only accounting model for goodwill was introduced in 2004 to replace the previous amortisation-based model. The introduction of the current model followed the lead taken by the US Financial Accounting Standards Board (FASB) three years earlier' (KPMG, 2014).

Table 1: Business combination at market value

	Acquired Company Book value Currency Unit		Acquiring Company	
			Before Purchase Currency Unit	After Purchase Currency Unit
Cash	1500		1000	2500
Receivables	400		500	900
Inventory	1500		2000	3500
Property Plant and Equipment	1500		2000	3500
Land	1000		2000	3000
		Goodwill		1200
Creditors	-3100		-4000	-8300
Book value	2800			
Stock market value	4000			
Goodwill	1200			

Source: Author

In the aforementioned KPMG report 'Who cares about goodwill impairment: A collection of stakeholder views' (academics and analysts) opinions are sought on the relevance of goodwill impairments. These viewpoints are employed to establish the argument that goodwill accumulated on the balance sheet is not generally a value relevant financial statement item as far as analysts are concerned.

Goodwill as an asset on the balance sheet has limited direct relevance to the valuation of a business because in many industries valuations are based on market multiples and discounted cash flow analysis that do not directly incorporate goodwill balances (KPMG, 2014:5)

The financialization of accounting is driven by the provision of decision relevant information to investors but it would seem to be the case that investment analysts would rather use predictions about discounted future cash flows or employ relative valuation metrics such as the price to earnings ratio to inform their calculations. However a bi-product of accounting for the market value of business combinations is that goodwill is now accumulated on corporate balance sheets because it is not being amortised (see Biondi, 2013). The accumulation of goodwill can become a significant and potential new risk (see section 2.4 below) because impairments will now be increasingly large and 'lumpy' and could compromise a firm's capital maintenance and solvency.

2.3 Financial Instruments IFRS9

We have already noted that there is increased emphasis on fair value reporting in financial statements and disclosures. IFRS9 is concerned with the classification of financial assets and how changes in their market value can be accounted for. Again the imputation here is that the firm can generate holding gains or losses from financial assets and these will impact upon reported profits. Financial assets are characterised under three headings in terms of their impact upon profit.

- A] Financial assets at fair value through profit or loss (FVTPL): These are assets that are held for trading purposes (unless they are held for hedging arrangements). These assets are subject to periodic re-measurement to test the fair value and at each reporting date any movement in fair value is charged into the profit or loss for the year as a holding gain or impairment charge.
- B] Financial assets at fair value through other comprehensive income (FVTOCI). This classification relates to equity instruments and typically associated with equity interests that an entity intends to retain ownership of on a continuing basis.

The accounting treatment is to again employ an impairment review, with any change in fair value taken to other comprehensive income in the year.

- C] Financial assets measured at amortised cost. This applies only to debt instruments and involves undertaking a “business model or cash flow test” that is the reporting entity must hold (not trade) the financial asset and collect in contractual cash flows (interest and capital repayment) associated with that financial asset.

These judgements about the fair value of financial instruments depend on there being an active liquid market within which market valuations make sense. But when assets are traded in thin markets or not frequently traded then the value of these assets becomes a matter of considerable judgement and estimation. Fundamentally, there is a shift away from measurement of financial assets at their historic cost and amortising the value of these assets towards a ‘fair value’ measure that reflects a market value of assets. These valuations are subject to periodic impairment tests, for example, testing for changes in the cost of capital (discount rate) or timings of cash flows. These assumptions about cost of capital and cash flow timings into the future impart financial volatility into financial statements. In a KPMG blog about the introduction of IFRS9 it is noted that:

In addition to the changes to processes and need for enhanced data, there is a true financial impact when moving to an expected credit losses model. There will be an accelerated recognition of credit impairment provisions. In addition it is likely to introduce much more volatility into financial institutions' results. This is because loss provisions will increase (and decrease) based on expectations about future credit losses, rather than based on incurred events¹³.

2.4 International Accounting Standard 16: Property, Plant and Equipment (PPE)

In similar fashion to IFRS9 and IFRS3 the accounting standard on Property, Plant and Equipment (PPE) allows accountants to choose between a 'Cost Model' and 'Revaluation Model'. The cost model assumes that 'after recognition as an asset, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses'¹ (IAS16:5). Alternatively, an item of PPE whose fair value can be measured reliably shall be carried at a re-valued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses (IA16: 6).

The fair value of land and property is provided by 'valuation agencies such as real estate specialist' where the 'fair value of plant and equipment is usually determined by an 'appraisal'. If there is no market-based evidence for attributing a fair value, for example, because of the specialised nature of the item of PPE and the item is rarely sold, except as part of a continuing business, an entity may need to estimate fair value using an income or a depreciated replacement cost approach (IAS16:6).

Adjustments to an asset's carrying value are then shown as an increase (or decrease) in other comprehensive income (OCI) and then as an equivalent movement in equity within the revaluation surplus. Thus a firm which is carrying property and land which inflates in value, such as a real estate investment trust (REIT), can show this as an increase in OCI and as a boost to shareholder funds because revaluation reserves inflate. This, in turn, could help to reduce a firm's reported leverage (debt to equity) ratio leading to a more favourable credit rating and ability to lever additional debt financing.

The fair value election may have several advantages. When fair value is greater than the carrying amount, with all other things being equal, equity is increased, which may lead to improved solvency ratios. This could ultimately lead to improved credit ratings and lower interest rates on debt capital (Duff and Phelps¹⁴)

The decision to record PPE at cost or at market value itself may have advantages if, for example, the fair value of these assets is lower than the carrying amount. A judgement might then be made not to use the option of adjusting to fair value because this value is less

¹³ <http://blog.kpmg.ch/ifrs-9-becomes-reality-financial-instruments-accounting/>

¹⁴ <http://www.duffandphelps.com/expertise/publications/pages/ArticleDetail.aspx?itemid=185>

than the carrying amount and this would set in motion an impairment charge and a reduction in shareholder equity. In its 2015 annual report Tesco PLC announced property asset impairments of £7.66 billion relating to a weakening of retail property values. This revaluation forced the company to report record losses and this 6th largest for any UK listed company. This impairment reduced shareholder equity by 50 per cent and increased the debt to equity ratio from 0.6:1 to 1.5:1 even though total sales revenue had decreased by just 2 per cent. Tesco's credit rating in April 2015 was rated junk status which will make it difficult for the company to generate external funding. Not having to use a fair value adjustment could have helped to avert a negative impact on the solvency ratio of the company and maintain a stronger credit rating.

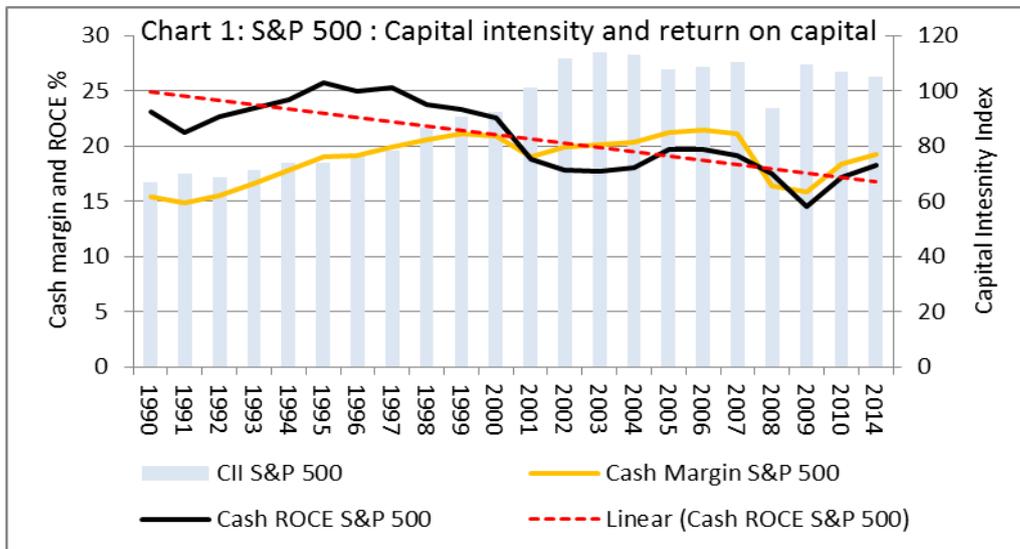
2.5 Financialized accounts: Market value absorption and financial instability

The IASB project is about the financialization of accounting because speculative capital market valuations are progressively included in a reporting entity financial statements. Capital market values are, as we have argued, the product of on-going secondary market trading where the buyer expects to sell on for a profit. This process of on-going recapitalization bears a distant relation to underlying earnings of these assets when intangible goodwill is also embedded in the valuation of these assets and on-going recapitalizations. In this way the *modus operandi of capital* markets is reflected in corporate financial statements, that is, capital values (balance sheet capitalizations) move ahead of earnings transformation. To explore the extent to which this might be taking place we consider the S&P500 group of firms which have a significant share of global stock market value and debt financing. Our analysis focuses on three key ratios: first the cash margin (EBITDA/Sales Revenue) as an index of the S&P 500 group of firm's capacity to extract earnings. Second the capital intensity index which is the debt plus equity funding employed to generate a dollar of sales revenue. Third the cash return on capital employed which represents the capacity of the S&P500 group of firms to generate a higher return on capital employed which is found by dividing the capital intensity index into the cash margin:

$$\text{Cash ROCE} = [\text{Cash/Sales}] / [\text{Capital} / \text{Sales}]$$

During the period 1990 and into the late 1990s US firms increased balance sheet capitalizations (debt and equity to sales ratio) but this was generally line with a transformation in cash margin (cash in sales). The cash return on capital remained steady at around 25 per cent on average for the S&P500 group of firms. From the late 1990s through to 2014 the average cash margin for the S&P500 group of firms then remains steady (albeit with some cyclical variations in the recent financial crisis) at around 20 per cent. However

the cash return on capital employed is on a steady downwards trend from 25 percent to roughly 17 percent in 2014 (see Linear Cash ROCE trend in chart 1).



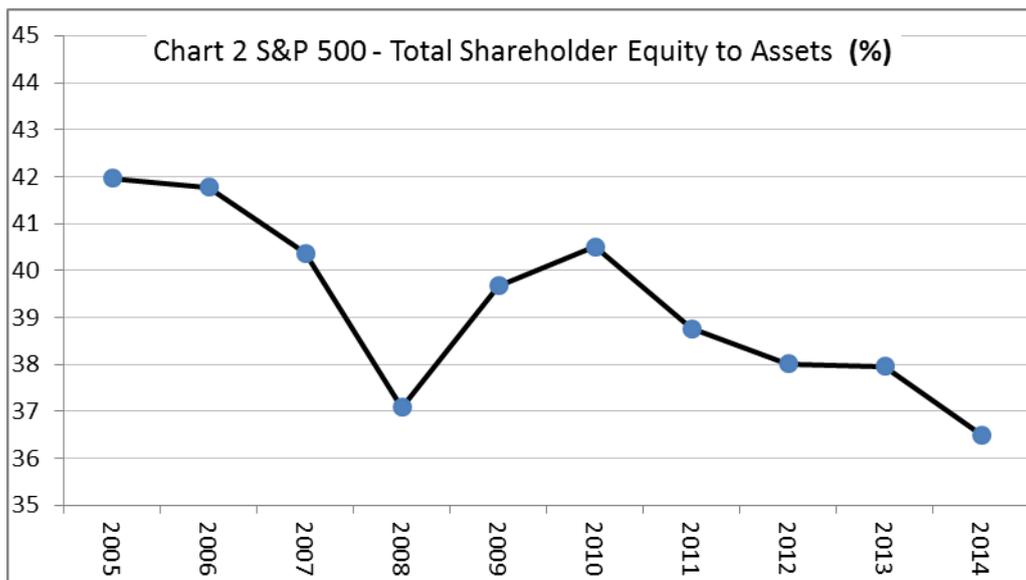
Source: Thomson Reuters.

The S&P 500 group of firms have increased balance sheet capitalizations ahead of their earnings capacity and this outcome is one that would be expected where firms are absorbing market values that are based on the growth in expected earnings. In 1990 the average S&P500 firm generated cash earnings out of sales revenues that would repay balance sheet capital every 4 years but by 2014 six years-worth of cash earnings is required to recover capital employed.

We have already noted that goodwill on acquisition represents the difference between the market and the book value of a business combination. Goodwill is also no longer amortised but accumulates in the balance sheet under ‘intangible assets’ until it is deemed to be impaired when, at that point in time, it would need to be charged against income and shareholder equity. Thus goodwill is an accumulating potential risk because a write down would trigger and adverse movement in shareholder funds and damage solvency ratios especially in circumstances where goodwill impairments tend to be ‘lumpy’. As Biondi (2014) observes: ‘If we imagine how many major events occurred in that time lapse in US economy, this accounting choice appears questionable; nevertheless, those companies and their auditors have considered that goodwill has not been impaired, even partially’ (Biondi,2014:152)

The risk of a goodwill write down triggering significant damage to shareholder funds (and solvency) has increased for two reasons. First, the S&P500 group of firms have been thinning down their equity funds. US firms have been actively buying back shares and distributing dividends out of operating income (Lazonick, 2013). In aggregate, over the period 2008 to end 2014 some 92 percent of S&P 500 operating profits had been distributed

back to shareholders¹⁵. This distribution of profit slows down the growth in shareholder funds relative to total balance sheet assets because the operating surplus is distributed rather than reinvested. Biondi (2012) makes a further observation that shareholder equity may be thinned down by distributions that are also out of windfall gains which bring forward earnings that are still uncertain because they have yet to be realised: The entity may distribute to current shareholders (or other recipients) windfall gains from revaluation and goodwill. The latter gains are still uncertain and conditional (Biondi, 2012:17) The net result is that the balance of shareholder funds, for an average S&P500 company, has fallen from a value equivalent to 42 percent of total assets to 36 percent of total assets in 2014.

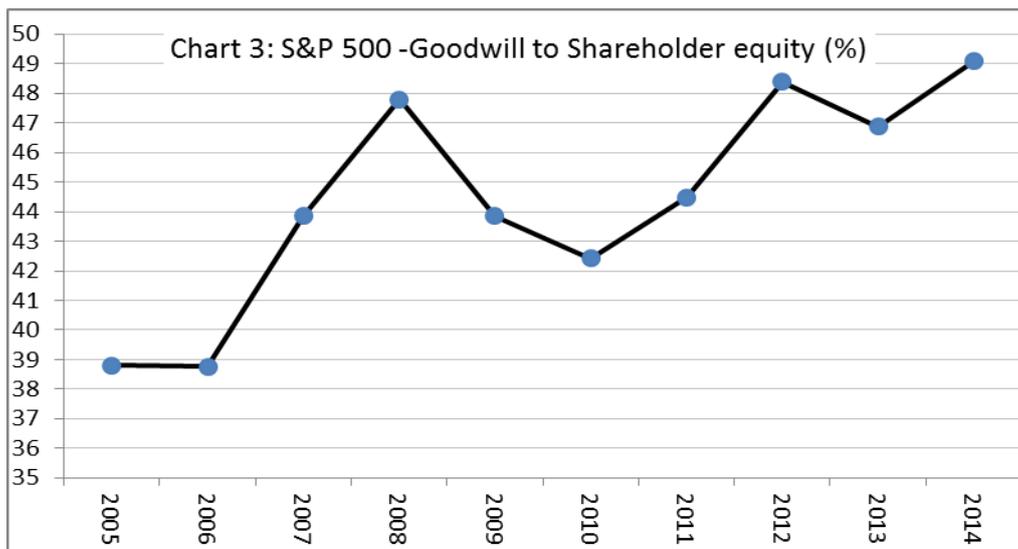


Source: Thomson Reuters.

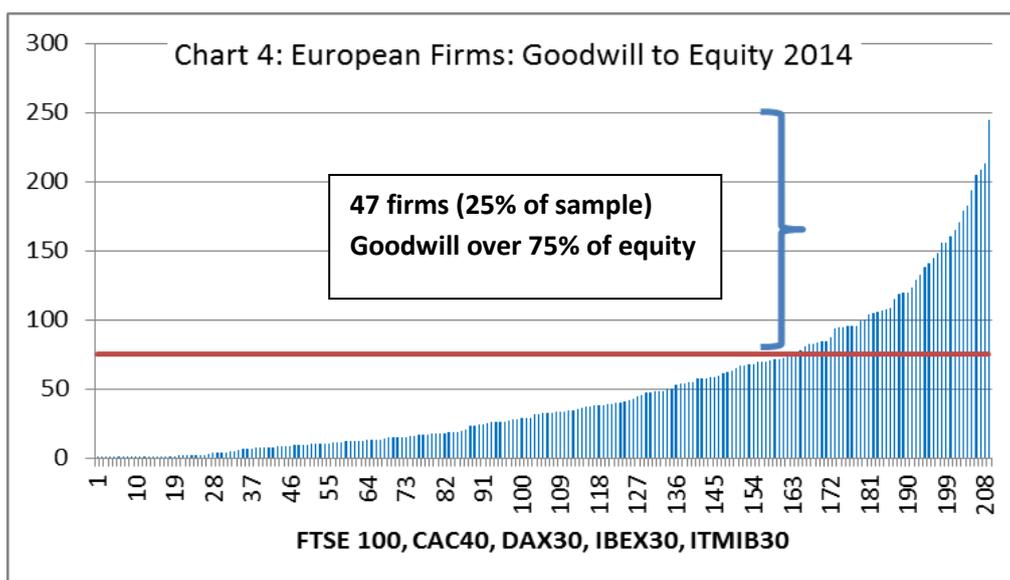
As shareholder funds relative to total balance sheet assets have drifted down the accumulation of goodwill relative to shareholder funds has inflated because goodwill is now accumulating rather than being amortised. Chart 3 reveals that, for an average S&P500 firm, the goodwill accumulated on balance sheet now averages 50 percent of total shareholder equity funds in the S&P500. A breakdown of this average reveals that one quarter of the S&P 500 group of firms have goodwill sitting on their balance sheets that is equivalent to 75 percent or more of total shareholder funds. There is a similar picture in Europe for firms listed in the leading European stock market index: FTSE100, CAC40, DAX30, IBEX30 and ITMIB30. In European leading stock market index's we find that roughly one-quarter of listed firms have goodwill that is equivalent to 75 per cent or more of total shareholder funds.

¹⁵ <http://www.prnewswire.com/news-releases/sp-500-q3-2014-buybacks-increase-25-over-q2-300013416.html>

As US firms accumulate goodwill onto their balance sheets this could potentially be charged off undermining solvency and triggering substantial financial instability. Goodwill write downs could be initiated if there is a general and significant fall in stock market values because this would lead to a re-evaluation of the goodwill held on a firm's balance sheet. During the financial crisis 2008-2009 US firms and European firms were forced to write down goodwill because stock market values had dropped significantly. In 2008 Royal Bank of Scotland (RBS) impaired its reported goodwill by roughly £35 billion and this immediately undermined solvency ratios. An equity cure from the UK Government was then required to maintain financial viability. In recent y

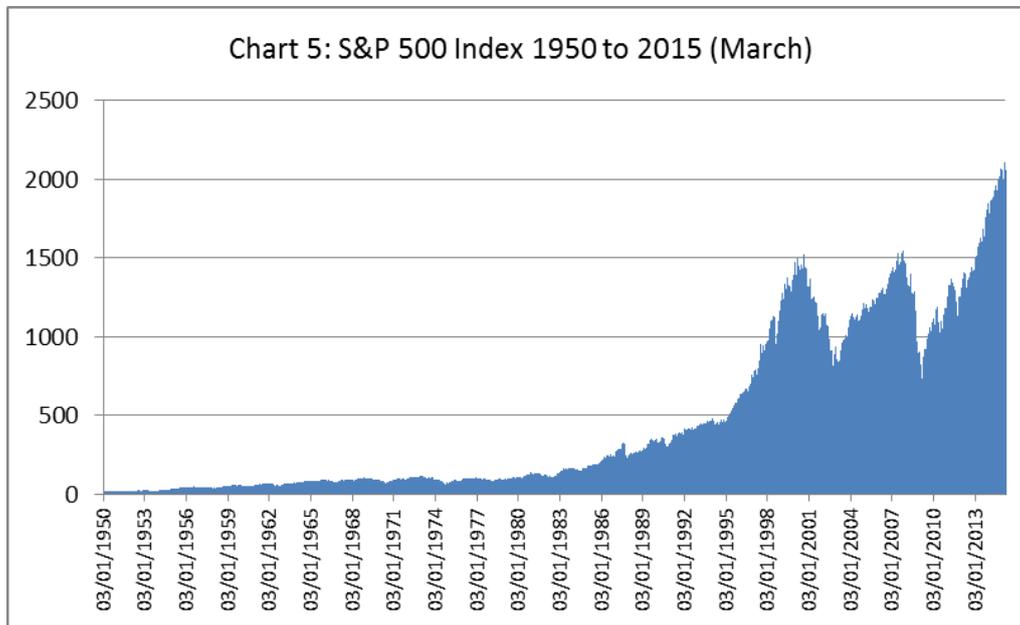


Source: Thomson Reuters.



Source: Thomson Reuters.

Stock market values could again fall to levels that motivate substantial goodwill impairments. In the last 15 years there have been two significant 40-50 per cent reductions in the market value of the S&P 500 (see chart 5)



Source: Yahoo finance UK, S&P 500 (^GSPC)

Table 2: S&P 500 Pension assets and liabilities at fair value \$bn

	2013	2012	2011	2010	2009	2008
Combined pension and OPEB assets	1,695	1,602	1,384	1,338	1,221	1,166
Combined pension and OPEB obligations	2,100	2,288	1,962	1,792	1,697	1,731
Combined pension and OPEB status	-405	-686	-578	-454	-476	-565

Source: Standards and Poors 'Ratings Direct', 2014

In 2013 the S&P 500 group of firms had market value investments totalling \$1.7 trillion in pensions and other post-employment benefits compared to a market value estimate of liabilities of \$2.1 trillion. If this deficit on pensions were to be made good in 2013 this would have been equivalent to writing down total gross operating earnings of the S&P 500 by 50 percent. The reaction of the S&P 500 group of companies has been to progressively shift the financial risk adjustment for pensions onto individuals through so-called defined contribution schemes whilst running down defined benefit pension schemes. This change is not only shifting the risk on to employees to fund their own pensions it also paves the way to closing the gap between pension asset and liability values. According to the Standard and Poor's report (2014) 'Pensions and OPEB's: Companies Pass the Buck to Individuals' the S&P 500 group of firms are passing on market to market pension realignments onto households and that: 'This reality replaces the American dream of a golden retirement for current

retirees and baby boomers whose resources are strained, leaving few options for a comfortable retirement' (S&P, 2014: 3).

The mark to market adjustments to pension provisions reveals a double standard. On the one hand the IASB challenges firms to record financial information at market values but when this involves pension funding the S&P Dow Jones Indices believe that: 'the US regulated pension system includes archaic accounting regulations that can distort the financial position of pension funds and their sponsors' (S&P, 2014: 3). This argument could also be made against fair value accounting more generally, because it too is the product of obscure often complex arbitrary judgments made by accountants. This double standard is a real moral hazard for the other 'stakeholders' because windfall gains arising from 'market to market' changes are acceptable so long as they are of benefit to 'investors'. If market values turn adverse then financial risk, as we see with pensions, will be displaced into households and society so as to protect the interests of 'investors'.

In this section we have argued that absorbing capital market values into the reported financials of firms will inflate capitalization ahead of earnings capacity. A firm's balance sheet mimics capital markets recapitalizations that are driven by speculation about growth in future earnings or prospects for on-going asset inflation. Absorbing capital market accumulations establishes new risks because asset value impairments will trigger large 'lumpy' value adjustments that will compromise solvency. The moral hazard is that firms will seek to displace these risks, when they arise, onto other stakeholders as investors try to protect their positions.

3. Discussion and Conclusions

Veblen observed that 'the market fluctuations in the amount of capital proceed on variations of confidence on the part of the investors, on current belief as to the probable policy or tactics of the businessmen in control, on forecasts as to the seasons and the tactics of the guild of politicians, and on the interminable, largely instinctive, shifting movements of public sentiment and apprehension. So, that under modern conditions the magnitude of the business capital and its mutations from day to day are in great measure a question of folk psychology rather than of material fact' (Veblen, 2005:74)

Financialization is a term employed to describe the way in which demands from the capital market and dominance of financial institutions are modifying the financial structure of national accounts and adjusting corporate behaviour. In this paper we have argued that the IASB's conceptual framework, associated IFRS's and modification to the European Directive 2013/34/EU are financializing accounting. The IASB's latest draft on the conceptual framework and changes to European Directive governing accounting dilute prudence and the conservative financial reporting of profit, assets and liabilities in the current period. This notion of prudence and historic cost accumulations has been replaced with the absorption

of asset market values that depend upon speculative assessments about future profits, risk and cost of capital. Relatively minor adjustments to an assets presumptive future earnings capacity, risk and cost of capital can impart substantial adjustments and disturbance to current values.

A significant number of IFRS's now provide for mark to market accounting and present a range of recommendations that facilitate valuations derived from active capital markets or judgements and modelling exercises where market based information is absent. Thus, Veblen's 'largely instinctive shifting movements of capital markets' become embedded in current financial numbers reported by firms. It is not at all clear that these arrangements are contributing to a more 'efficient allocation of capital resources' and lower cost of capital. Nor is it clear that analysts rely on these reported numbers when they do make estimates of their own.

Changing the basis upon which numbers are reported within financial statements creates new forms of risk that contribute to financial instability. These financial instabilities can also amplify when line items recorded in the various financial statements are not equivalent but are interconnected. Take for example the impairment of goodwill which can trigger large 'lumpy' movements in the comprehensive income statement and shareholder equity. Our analysis reveals that in the S&P 500 group of firms goodwill is accumulating and presents a significant risk if it is to be impaired. Goodwill is accumulating ahead of the shareholder funds line item because share buy-backs and dividend distributions arrest the growth of shareholder funds relative to goodwill. When it comes to absorbing adverse mark to market adjustments there is also an emerging 'moral hazard'. The S&P500 group of firms will actively off-load the impact of negative holding gains, as we see with pension provision displacing the risk back into society.

Power (2010) observes that accounting has always been pragmatic because the 'hybrid' nature of accounting means that there will be a fall-back position. The 'financialization' of financial accounting is not absolute but highly selective; that accounting will always be - whatever the extent of use of fair values - an impure hybrid of elements within a highly institutionalised presentational frame (Power: 2010: 209).

The fall-back position must be prepared. European political and regulatory institutions need to not only challenge but anticipate the dysfunctional consequences of a financial reporting project that has 'financialized accounting'.

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