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A Critical Evaluation of the Measurement and Effects of Fair Value in Financial Statements

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Abstract

Over the past decade, accounting standards for the valuation of financial instruments in financial statements have evolved to better reflect the economic reality facing publicly accountable companies. This pressure was as the result of Enron, dot-com, Worldcom and other corporate collapse, which was seen as a reminder that our financial reporting model, with its emphasis on historical information and a single earnings-per-share number – is out of date and unresponsive to today's new business model, complex financial structures and associated business risk. The main objective of the study is to review the literature, issues and recent development on fair value measurement in financial statements, by highlighting some of the advantages and disadvantages as well as the effect of fair value measurement on financial statements. Also consistency of the fair value measurement with financial instrument is considered, as well as, its impacts on the financial statements. The methodology adopted for this conceptual paper is based on theoretical considerations of models and concepts with a view to synthesising the existing literatures. It is concluded that, while neither the fair value measurement nor its main alternative – historical cost, are free from shortcoming but the arguments presented herein intend to show fair value measurement in a positive light, having the distinct advantage of being able to reflect the reality of current financial and economic conditions.

Keywords: *Fair Value, Financial Statements, FASB, IASB, IFRS*

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Background to the Study

Over the past decade, accounting standards for the valuation of financial instruments in financial statements have evolved to better reflect the economic reality facing publicly accountable companies. This pressure was as the result of Enron, dot-com, Worldcom and other corporate collapse, which was seen as a reminder that our financial reporting model, with its emphasis on historical information and a single earnings-per-share number – is out of date and unresponsive to today's new business model, complex financial structures and associated business risk (Damant, 2002). Fair Valuation was debated as an alternative to historical cost, replacement cost, net realizable value and deprival value. Fair value accounting is a financial reporting approach, which is known as the "mark-to-market" accounting practice, under generally accepted accounting principle (GAAP) and International Financial Reporting Standards (IFRS). IFRS defined fair value as the amount for which an asset could be exchanged, a liability settled, or an entity instrument granted could be exchanged between knowledgeable, willing parties in an arm's length transaction (IASB 2006, 2304). Using fair value accounting, companies measure and report the value of certain asset and liabilities on the basis of their actual or estimated fair market price, change in the asset or liability value over time generate unrealized gain or loss for the asset held and liabilities outstanding, increasing or reducing net income, as well as equity in the balance sheet (Oncioiu, 2012). Fair value can be much more than just a technical measurement convention, as it represents a change process which was global in aspiration and was increasingly intolerant of the apparent incoherence of mixed measurement system (Power, 2012).

However in some cases, analysts and some market participants have some crying foul. For example banks failure and sub-prime market meltdown in the USA have been attributed to fair value accounting (King, 2009 cited David, 2010) which American Banker Association (ABA) stated that the crisis in the financial markets has been exacerbated by the implementation of fair value accounting (David, 2010). Therefore in this paper, advantages and disadvantages of fair value measurement in the financial statements will be considered as well as the effect of fair value in the financial statements. Also consistency of the fair value measurement with financial instrument will be considered and the impact on the financial statements as well. Thus, this paper is based on theoretical considerations of models and concepts with a view to synthesizing the existing literatures and making the relevant conclusions.

Current Issues Regarding Fair Value Measurement

On the 12th May, 2011, the International Accounting Standard Board (IASB) issued IFRS 13 *Fair Value Measurement*. The US Financial Accounting Standard Board (FASB) together with IASB have achieved the goal of establishing a single set of global accounting standards to measure fair value (Duff & Phelps, 2011). The IFRS13 becomes effective for annual reporting periods beginning on or after 1st January, 2013, although few companies have earlier adopted as permitted by the Board. The providing of single source guidance and a precise definition of fair value across the globe was to (i) assist in improving consistency and comparability (ii) help preparers and auditors in fulfilling their role and (iii) contribute to users' understanding of what fair value represents. However, some analysts and experts say

overall, the new rules could have a material effect on valuation and results in additional operating cost to gather information and demonstrate compliance (Deloitte, 2011).

Measurement of Fair Value in Financial statements: Advantages and Disadvantages

Globalisation and capital market developments have shaped the financial statements component and users' interest. Nowadays, investors concentrate on investment opportunity, performance and future earnings. The measurement of fair value in the financial statements helps to provide information, which reflects the firm's financial position and the management's stewardship by stating assets and liabilities in the balance sheet at their current market (Gassen & Schwerdler, 2010). Income statement under fair value measurement also conveys the economic income of the firm because it reflects the changes in the firm's value over time. This is because fair value produces more relevant and understandable information which is useful to the shareholders and other stakeholders regarding the assets, liabilities and incomes in the financial statements than cost-based measures (Ashford, 2011). Therefore in general, we can say that fair value measurement in the balance sheet provides efficient value and that income statement conveys information about management performance and exposure risk. And also it limits the firm's ability to potentially manipulate its reported net income. For example, sometimes management may purposely arrange certain asset sales, to use the gains or losses to increase or decrease net income as reported at its desired time (Skoda & Bilka, 2012).

Fair value measurement is the only relevant and more realistic way of setting some transactions on to the balance sheet and openly disclosed (Arya & Reinstein, 2010). This is seen as in the rapid development of derivatives contract, which is under the cost-based system where a whole range of assets and liabilities were missing in the balance sheet. This is because they have little or no cost though they could gain or loss value subsequently as circumstances change due to interest rate, exchange rate, commodity price etc (PWC, 2012). Also some of the complexities associated with having several different categories for financial instrument has given fair value more support as the only credible single basis. The use of fair value to measure a good proportion of financial instrument in accounts is widely accepted and that it meets the supplying needs of investors in the capital markets (Sallu, 2009). Investors and their association seems to support fair value as the most relevant information for them and no major investor's bodies are calling for fair value to be scrapped or suspended or even to be used less. However, the reverse tends to be the case – where there have been calls for all cost-based measures to be scrapped (ACCA, 2008).

The central aim of financial reporting is to portray the underlying economic position of the company and to faithfully reflect the genuine economic fluctuation of the business cycle. This in turn, improves the relevancy and transparency of the information contained in the financial statements and improves investors' and regulators' ability to make informed decisions (Lachmann, 2011). Fair value measurements in the financial statements are inherently more transparent. When based on quoted price in liquid market they often require fewer assumptions than impaired historical cost. They are also transparent in sense that the position – good or bad – is cut in the open particularly when values are falling, there is no sense in which problems of declines in value are being swept under the carpet in the hope

that things will pick up later (Ernst & Young, 2012). The example of Japanese bank in the 'lost decade' of the 1990s is being cited as an example of when fair value were not used and the problem of over-inflated property and share stakes were disguised by the accounting. Therefore fair value measurement in the financial statements can be seen as enhancing informative power and increase transparency of a firm, which is particularly useful to potential investors, contractors and lenders as they have a better perception of the stability of a given firm and insight into it wealth (Gassen & Schwerdler, 2010).

Critics have complained that fair value measurements are overly subject to manipulations to show the result management would like. In practice, however, the main alternative to fair value measurement is historical cost, which can arguably be even more subject to 'earnings management' (Deloitte, 2013). In a bad economic time, management can influence reported income under historical cost accounting through sales of assets for example, as a profit is reported if the net selling price of an asset is meaningfully greater than the book value reported under historical cost. This in practice should not be attainable under fair value measurement as the underlying asset is reported at fair value and the result is reflected in the income statement, thereby reducing the possibility of income smoothing (Duff & Phelps, 2011). For investment at historical cost but with readily realisable value, the amount of profit is greatly influenced simply by whether or not management has chosen to sell the assets in the period. Profit or loss can be manufactured by 'churning' the assets(Gassen & Schwerdler, 2010).

However, the relatively long history of using fair value accounting has naturally brought with it a wave of so many criticisms. Although, the criticism has intensified significantly during the financial meltdown in the recent years, where many regulators and experts that fair value should be substantial reform or its implementation should be stopped (Paul & BBA, 2001). These criticisms even pushed for example by the European Commission and U.S congress to put pressure on the standard setters to slow the development of fair value measures. With all these criticisms, its malfunction can be attributed to some of the following;

One of the problems that fair value has been criticized is definition of the concept. The most recent proposals from the IASB would have consistently defined fair value as a current market exit value (Dorchester, 2011). This may be a useful tighter definition for many cases where slightly different measures might be more appropriate, for example where it is being used as a substitute for cost. Fair value is itself one of the families of current-value measurement bases – others include replacement cost or value in use. Also there are objections to fair value in principle (Skoda & Bilka, 2012). It is the value of business could have obtained from selling an asset at the balance sheet date, but this is therefore a value that it chose not to sell at. So in the current circumstances fair value measures what the business would get by selling the asset today, whereas the historical cost model is based on what the business is actually intending to do with the asset, i.e. often to hold on to it and receive the interest, and if necessary impair the asset (ACCA, 2009).

Fair value measurement is also criticised as increasing the volatility of the information in the financial statements which may erode relevance and reliability of information for investors (David, 2010). Companies' activities during the reporting period will naturally be reflected

through the changes reported in financial statements. There so many factors that can make fair value measures to introduce volatility into the financial statements which may include, the inherent volatility which is driven by the change in underlying economic conditions and is reflective of the changes in the value itself (KPMG, 2012). Also this can be by the way of the mixed-model volatility, it manifests itself because some assets and liabilities are measured at fair value whereas others may be at historical cost, while some others could be at current value. As mentioned volatility erodes the relevancy and reliability of information for investors, more specifically, the volatility may negatively affect investors' ability to confirm or to correct expectations and to form an understanding of past and present events. Furthermore, the use of unobservable and estimated input for fair value measurement may affect reliability of information as it reduces verifiability (KPMG, 2012). As such, the use fair value measurement may diminish the investor's ability to assess the economic risk of the company operations.

Fair value has been criticised for producing misleading results in the unusual recent market conditions which results are argued, that unduly hurt companies in the long run by exaggerating the risks inherent in their portfolios (ACCA, 2008). Critics advance the view that recording massive unrealized losses at fair value signals bad news to investors that ultimately may not occur. Recording unrealized losses during the recent unusual market conditions when management's view of an instrument's risk differs from the markets' is an illustration of one of the imperfections of fair values. Whether any fair value measurement accurately reflects or distort the expected cash payments at a particular point can only be decided in the long term (Dorchester, 2011). As fair value does not require a transaction to have occurred to recognise the change in value it can recognise profits and losses earlier than would the historical cost approach. Fair value risk overstating values and profit when markets are rising but equally has a tendency to overstate the declines in value on the way down. And finally fair value adds to so-called 'procyclicality' by amplifying the effects of the business cycle (Skoda & Bilka, 2012). Financial institutions have complained that fair value measurement has effectively been driving business behaviour rather than reflecting it, by encouraging banks to over-lend in good times while exaggerating their financial problems when the business cycle turns down. Although this tendency to follow the market has the advantage of transparency to investors, it may not produce the financial information most suitable for prudential supervision purposes (Ernst & Young, 2012).

Valuation Techniques for Fair Value Measurement

IASB in May 2009 recognizes that active market may not always exist in order to identify a market price for a specific asset or liability. Instead the standard established a hierarchy that prioritises the reliability of the inputs that may be used in valuating fair value (Deloitte, 2013). IFRS 13 seeks to increase consistency and comparability in fair value measurement and related disclosures. It categorises the inputs used in valuation techniques into three levels and give the highest priority to the most reliable inputs. Level 1 inputs are quoted price in active markets for identical assets or liabilities that the entity can assess at the measurement date (IASB, 2006). A quoted market price in an active market provides the most reliable evidence of fair value and is used without adjustment to measure fair value and is used without adjustment to measure fair value whenever available, with limited exceptions (IFRS 13: 76-77). Level 2 inputs are inputs other than quoted market prices included within level 1

that are observable for the asset or liability, either directly or indirectly (IFRS 13: 81). And finally level 3 inputs are unobservable inputs for the asset or liability (Duff & Phelps, 2011). The three widely used valuation approaches are; (1) Market approach – uses prices and other relevant information generated by market transaction involving identical or comparable assets, liabilities or a group of asset and liabilities. (2) Cost approach – reflects the amount that would be required currently to replace the service capacity of an asset. (3) Income approach – converts future amount to a single current amount, reflecting current market expectations about those future amounts (Deloitte, 2013).

Tax Implication on Fair Value Measurement

Tax considerations can have a direct effect on the use of the income valuation approach for fair value measurement used in financial statements. For tax amortisation benefit which is cash flows expected form tax depreciation or amortisation deduction, fair value measurement should reflect tax amortisation benefit irrespective of whether the particular owner acquired the asset in a manner that provides amortisable tax basis, or whether the owner is a tax paying entity and regardless of an owner's loss or credit carried forwards (PWC, 2008). Tax management can and should play a significant role in assessing the various dimensions of fair value measurement. It is important for tax management to be closely involved in the consideration of pretax accounting analyses, fair value measurement, due diligence for transactions and the cash and tax planning implications of fair value measurement (Gassen & Schwerdler, 2010). Recent market volatilities serve to heighten the focus on and possibly make even more significant the need for careful tax management input and assessment. The continued movement towards fair value measurement brings with it a variety of implications best managed through appropriate coordination across company functions (PWC, 2013).

Management Role in the Context of Fair Value Measurement

A critical aspect of making fair value measurement to work is for management to mitigate its limitations by providing explanations over its context and consequences. Management's perspective on the issue associated with the use of fair value measurement such as reported fair value versus intrinsic value, volatility, judgments and the use of valuation techniques which need to be explained to investors (Dorchester, 2011). The substance of the explanation should be largely left to management's discretion and to market forces that will tend over time to set a de factor standard. Management also carries responsibility for helping investors becomes more comfortable with fair value and modelling techniques. Fair value measurement is sometimes determined using an estimation technique, and in the circumstances the user must understand the model and the assumptions underlying it (Paul & BBA, 2001). Effective and understandable explanations will tend to move investors towards a deeper appreciation of the valuation process that generate estimate. In reality, informed parties would most likely come up with a range of values but for financial statement purpose a single numerical amount has to be used (Arya & Reinstein, 2010).

Conclusion

The fair value regime represents an evolving accounting system which has now permeated the regulatory environment and made its way into the social landscape. With the globalisation of capital markets and the advent of complex financial instrument in use today,

it has become apparent that fair value of assets and liabilities are of greater interest to investors than their historical costs. This will only become more intense as economic borders evaporate, as economies mature, as financial markets evolve, and as the public commands heightened accountability largely resulting from improved comprehension and confidence. According to the advantages and disadvantages of the concept of fair value measurement in accounting is quite obvious and clear that this concept is far from being perfect(Gassen & Schwerdler, 2010). It is very difficult to determine whether its contributes to the improvement of accounting is really beneficial as we have seen in the previous financial crisis. On the other hand there many reasons why the users of those methods are better off, but also on the other hand there also reasons why the users are worse off. In fact, many of the relevant sources express their mixed views about the extent to which IFRS are becoming imbued with the current IASB/FASB fascination with fair value measurement (Davidson, 2010 cited Skoda & Bilka, 2012). While neither the fair value measurement nor its main alternative – historical cost, are free from shortcoming but the arguments presented herein intend to show fair value measurement in a positive light, having the distinct advantage of being able to reflect the reality of current financial and economic conditions.

Inherently complex and instinctively responsive to the marketplace, the success of fair value measurement will nevertheless reside in the world's ability to harness its potential. In so doing, the fine-tuning of standards and of regulatory supervision will bear significantly on the ultimate end state. A certain simplification of the accounting standards for financial instrument may also be beneficial – to preparers, to analysts, to investors, to regulators, and to the broader public. And this may be complemented by shifting to a single, high-quality global standard to ensure consistent application and enforcement.

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