Current Issues in Fair Value Reporting

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ABSTRACT

Business environment changes over time where business activities are getting more complex than before. As transaction-based accounting and reporting have been used to provide financial information of businesses dominated by manufacturing and merchandising activities, it is argued as not being able to fairly report current business activities. Fair value reporting is claimed by many to be better than transaction-based accounting in meeting shareholders' needs and investors' expectations. However, there are few issues currently being debated by preparers, standard setters, regulators and users' representatives such as relevant vs. reliability, measurement and implementation issues, and lack of a single guidance and framework.

Keywords: *fair value accounting and reporting, entry price, exit price, exchange value, IASB (International Accounting Standard Board), IFRS (International Financial Reporting Standard), accounting standards*

Introduction

Financial reports are the main source of accounting information not only to managers but also to the shareholders, the ultimate owners of the business. Managers may refer to the audited financial statements as evidence of how well they manage the company and how much value they have added to the company's worth. As the agent, and internal parties, managers are in a better position to assess the true performance and value of the business than the shareholders. Although, every company is required to prepare financial reports, whether financial reporting under current transaction based accounting satisfies shareholders' needs remain questionable.

What shareholders need from financial reports are relevant and reliable information for two purposes. First, they need accounting information for valuation purposes. Shareholders would need accounting information that informs them about the value of equity. Second, shareholders would want to assess management performance, or their stewardship. How efficient have managers been in making business

decisions to add value for shareholders? To meet these needs, accounting setters are continuously working towards improving the financial reporting.

Basically, relevant is an important characteristic if quality financial reports and to improve the relevancy of financial reports, the key global accounting standard setters, IASB and FASB tend to favour the broad based adoption of fair values (Jarva, 2008). IASB has made several favourable moves towards fair value. For example, the boards had adopted accounting standards issued by IASC, the IAS 32 and IAS 39. In addition, IASB has also issued IFRS 2 and IFRS 7. Besides IASB and FASB, fair value accounting has also received support from regulators such as the Securities and Exchange Commission (SEC) in the US.

Current Issues in Fair Value Reporting

Definition of Fair Value

The first issue in fair value reporting centre on its definition. Different interpretation of fair value may confuse users. What is fair value? The FASB (2006a) defines fair value as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'. This definition implicitly endorses exit value as fair value.

There are three levels of inputs identified by FASB in Statement 157 to determine fair values, Level 1, Level 2 and Level 3. These levels are distinguished by increasing levels of subjectivity. Level 1 inputs are based on quoted price observed in active market. Level 2 inputs are quoted prices of similar assets or liabilities and Level 3 inputs are unobservable inputs for the assets and liabilities, reflecting the firm's own assumptions about the assumptions market participants would use in pricing the assets or liabilities.

Conceptually, an asset or liability's exchange price may fully capture its fair value. However, in practice, this may not happen if active market does not exist (Landsman, 2007). A definition by IFRS 3 covers other than active market. IFRS 3 defines fair value as 'the amount for which an asset could be exchanged, or a liability settled between knowledgeable, willing parties in an arm's-length transaction'. So far, a number of accounting standards have been issued to standardise the recognition and measurement of fair value for specific asset and liability. SFAS No. 115, SFAS No. 123 and SFAS No. 133 are among the most significant fair value recognition standards issued by FASB. FASB also has two key disclosure standards, SFAS 107 and SFAS 119.

Pervasiveness of Fair Value

Fair value accounting was initially known as market value accounting or marked-to-market accounting. Failure of GAAP financial accounting in the 1990s in providing relevant information to investors renewed interest in a re-examination of the financial reporting which required most assets and liabilities to be measured and reported at their historical costs basis (Shim & Larkin, 1998). White (1991a) argues that the GAAP measurement framework is seriously deficient, because it is backward looking rather than focused on current market values. Later, mark-to-market basis became the key concept behind fair value accounting.

According to Barth (2006), the use of fair value is increasing. Some view this as the indirect effects of changing business environment. The business activities are now getting more complex. Therefore, the present accounting model, which is largely transactions based, may not be able to provide fair reporting of current business activities. Conceptually, the dominant basis of measurement practices is heavily influenced by notions of realisation and completion of the earnings process. The transaction-based notions reflects the historical dominance of manufacturing and merchandising activities where the earnings process typically culminates at the point of sales transactions (Leisenring et al., 1995).

However, exclusive reliance on the stringent notion of completed transactions permits manipulation results by management. Management may choose when and which assets are sold. Furthermore, transactions based or historical cost basis may distort comparability across entities at a particular date, and among assets within an entity and resource allocation decisions by managers and others could be flawed if they rely on out-of-date information. This is another reason why the accounting standard boards consider fair value as a possible measurement attribute. Examples of related IASB projects are business combination, revenue recognition, insurance contracts, financial instruments, liabilities and equity, and the conceptual framework.

Relevancy of Fair Value

Any increased use of fair values is highly controversial (Barth, 2006). The most common worry is whether the fair value is more useful to users than the transactions based values. Despite being claimed as more relevant, fair value estimates may not be reliable. For example, FASB was concerned whether fair value estimates would be too noisy to disclose. In the US, much of the value relevance research assessing the reliability and relevance of fair value information focus on banks as banks' balance sheets mostly comprised of financial assets and liabilities.

Policy-based accounting research though cannot directly assess usefulness and reliability of fair value can provide evidence that helps standard-setters evaluate these issues.

Not much was known whether fair value accounting is better than transactions based accounting until Bernard et al. (1991) provide some evidence on empirical questions of the merits of marked-to-market accounting. They examine the possibility of employing marked-to-market accounting for US banks and thrifts through an investigation of Danish banking practices. They investigate the 'noise in reported accounting' by using marked-to-market accounting. Their findings suggest that the marked-to-market accounting numbers in Denmark are 'less noisier' than the historical accounting numbers in the US. In addition, Searfoss and Weiss (1990) raise current value reporting issues for the real estate industry and provide arguments supporting the economic benefits of the assets in terms of cash flows that might be generated through their future use or sale.

Another type of research is by studying the incremental association between recognised fair value amounts and their disclosures and share prices or share returns to asses the value-relevance of fair value accounting. Barth (1994) studied a sample of US banks with data from 1971-1990. She finds that investment securities fair values are incrementally associated with bank share prices after controlling for investment securities' book values. However, when examined in an annual returns context, the study reveals mixed results for whether unrecognised securities' gains and losses provide incremental explanatory power relative to other components of income. The previously mentioned findings suggest that fair values may be more relevant to users than historical values. Given these evidence, the next issue is whether fair value can be measured reliably or not.

Measurement of Fair Value

Measurement of assets, liabilities and equities historically has been one of the major issues in fair value accounting and reporting. It is one of the main issues put forward by the opponents of fair value accounting. The opposing arguments centre on lack of reliability, increased volatility in income, and high costs of preparing financial statements. The important question here is can we measure fair value reliably? Critics of using fair value asserts that fair values are not reliably measured (Barth, 2006). Due to this reason, fair values are argued to be not appropriate for financial reporting.

Existing accounting standard such as SFAS 157 and IAS 39 do not prescribe a specific measurement method for fair values. Nevertheless, a

few methods are available and allowed by accounting standards. These include manager's own assumption and measurement model which may be manipulated. Wyatt (1991) asserted that 'while managers tend to desire smoothness rather than volatility, the role of accounting is to approximate the real world as closely as possible. Too many existing standards artificially smooth real world volatility'. Harrison (1994), Crosson (1994), Reinstein and Bayou (1994), and Duet (1994) indicate their disapproval of fair value accounting by raising up its implementation issues. Thompson (1994) argues that SFAS No. 115 does not represent an improvement in financial reporting as it reduces the disparities among industries, the differences in recognising unrealised gains and unrealised loss, and the lack of even-handiness of the lower of cost or market method. However, despite some implementation issues, Wampler and Phillips (1994) argue that the overall impact of the standard is favourable, because the relevance of market value information outweighs the disadvantages.

Another implementation issue is how to estimate fair value in the absence of active market. Two studies by Barth et al. (1998, 2000) use binomial option pricing model to estimate the fair values of corporate debt and its components to provide evidence on the relevance and reliability of estimated fair values. The 1998 study is based on data from 1990 for a sample of 120 publicly traded US firms and its findings show that component value estimates are relevant in that they represent large fractions of total estimated bond value. The other study, Barth et al. (2000) provides details of how the binomial model is implemented which is based on models of Cox et al. (1979) and Rendleman and Bartter (1979). The model considers directly only default risk and includes information in the interest rate yield curve. However, additional evidence in the previous study suggest that model estimates of total bond value may lack reliability as estimated bond values for non traded bonds differ significantly from value estimates when all bonds are included in the estimation procedure.

Reliable measurement is very crucial in financial reporting as measurement errors may produce misleading signal to investors. Barth et al. (1995) used the same database lend support to the measurement errors explanation by showing that fair value-based measures of net income are more volatile than historical cost-based measures but the incremental volatility is not captured by the share prices. Barth (2004) identifies three sources of financial statement volatility that are associated with using fair values in financial reporting-estimation error volatility, inherent volatility, and mixed-measurement volatility. According to Barth (2004), estimation error volatility is unavoidable because most fair values are not observable from market prices. However, inherent volatility derives from

economic; not accounting forces and mixed-measurement volatility resulted from using fair values for some assets and historical cost-based amounts for others.

Lacking Consistent Measurement Guidance

Although IFRSs require all financial assets and liabilities and some assets, liabilities and equity instruments to be measured at fair value, guidance on measurement has been added only by piecemeal. Current measurement is still incomplete and there are no clear measurement objectives or measurement framework. As a result, the measurement guidance is very dispersed, which are not always consistent

To overcome these implementation issues and in respond to increasing adoption of fair value, current IASB projects aim to introduce a single source of guidance and a framework for measuring fair value. IASB has embarked on few initiatives such as valuation advisory group and standard-by-standard review. The former is intended to provide practical input about measuring fair value and valuation issues such as intangible assets and insurance. The latter is relating to existing accounting standards review. These reviews shall study existing measurements in IFRSs that are identified as 'fair value' to assess whether they were intended to be an exit price. From this review, IASB will come up with a standard definition of fair value. Fair value may be defined as either current entry or current exit price. A single method may be prescribed for measuring fair values, i.e. either entry or exit price.

Conclusion

The use of fair value in financial reporting is of great interest to preparers, auditors, users and regulators. Fair value reporting is seen as a moving step to cope with complex business activities and shareholders' needs. Despite increasing interest to adopt fair value, measurement is a major implementation issue. What is needed is a single measurement guidance which is crucial to tap maximum benefits from using fair value to both the preparers and users. A single measurement guidance and framework is essential to establish a clear international definition of fair value and a consistent framework for measuring it. It will reduce complexity and improve consistency in applying fair value and clarify the definition of fair value which will clearly communicate the measurement objectives.

In addition, the single guideline and framework will enhance disclosures on fair value, which is important to enable users of financial statements to assess the extent to which fair value is used to measure assets

and liabilities and to provide them with information about the inputs used to derive those fair values. Besides being useful to explain the nature and measurement of fair value, it will codify, clarify and simplify the guidance that is at present dispersed widely in IFRSs.

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