



VALUE MEASUREMENT AND DISCLOSURES IN FAIR VALUE ACCOUNTING

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ABSTRACT

Value measurement and disclosures in accounting is further effort and method to objectively determine quality of financial reporting which have continued for many decades. Quality characteristics are the bedrock on which accounting theories are formulated, since it is important to prepare and present financial statement with a view to meeting its objectives. Although, this study is literature approach, having explored rationale for fair value accounting, IFRS 13 sets out a framework for measuring fair value; and requires disclosures about fair value measurements. To increase consistency and comparability in fair value measurements and related disclosures, the IFRS 13 establishes a fair value hierarchy that categorizes into three levels the inputs to valuation techniques. The process of valuing an instrument to its fair value depends on how easy it is to determine a price for that instrument. Since fair value is the price at which a willing buyer and seller agree to trade, finding the right price is important to valuation.

Keywords: Value measurement, Fair value, Willing buyer and seller, Disclosures

INTRODUCTION

Effort and method to objectively determine quality of financial reporting have continued for many decades. [Riauhi-Belkaoui \(2004\)](#) observed that the American Accounting Association (AAA) in 1966, had recommended for accounting information measurement and disseminating of information four concepts of relevance, verifiability, freedom from bias, and quantify ability. The concept of relevance was given the highest ranking because of its inherent connection with the financial statement user. It emphasizes that the usefulness of accounting information is directly related to its relevance. It was also observed that the Trueblood Committee, its 1973 report suggested seven qualitative characteristics of financial statements, which includes: relevance and materiality, form and substance, reliability, freedom from bias, comparability, consistency, and

understandability. Quality characteristics are the bedrock on which accounting theories are formulated, since it is important to prepare and present financial statement with a view to meeting its objectives. It is with this view of meeting the qualitative characteristics that led to the development of historical cost accounting.

The historical cost accounting was believed to have fulfilled the consistency characteristic of financial reporting. However, over the years, companies have firmly established the practice of “closing” company ledgers each year and producing annual balance sheets and income statements according to accounting periodicity. In conventional accounting, historical cost accounting is so well it is recognized. Accounting recognizes gains and losses only when actually realized. The matching principle underlies the historical cost method, where expenses are offset against the revenues they support. This strong accounting principle held the faith of accounting for decades. However in recent times, investors, financial analysts, shareholders, creditors, employees, and communities, nevertheless, believe that historical cost financial statements have lost the characteristic of relevance and this has led to the development of Fair Value Accounting (FVA). (Ting and Soo, 2005).

Sanders (2011) stated that the International Accounting Standards Board (IASB) in 2011 noted that there were two dominant questions as to whether investors should be the primary audience for financial reporting and whether accounting standards should include a goal of financial stability. These questions have a direct connection with the current debate over fair value accounting. Fair value accounting has over the years generated heated reactions from those wishing to expand the measurement approach, and those wishing to limit it.

Volha (2010) noted that the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are the two most influential standard-setters bodies. IASB and FASB have a long standing commitment to work together in an internationally coordinated manner on improving financial reporting standards. The problem is that Fair value accounting and the other aspects of US GAAP and IFRS did not curtail the recent financial crisis. The crisis has made the financial statements preparers need additional guidance regarding how to measure fair value in illiquid markets. Also, users of financial reports need better disclosures about the critical estimates underlying level 3 fair values and how sensitive fair value are to those estimates.

This study aims at identifying the way forward on further exploring the rationale of Fair Value Accounting, according to the International Financial Reporting Standard (IFRS 13). Consequently, the study is subdivided into sections on the introductory, review of extant literature, the conceptual framework and conclusion.

EXTANT LITERATURE RATIONALE FOR FAIR VALUE ACCOUNTING

In the view of [Chouinard and Youngman \(2008\)](#), accounting information serves as key determinant in the efficient market economy. Financial statements facilitate the allocation of capital in the economy by conveying information to assist creditors and investors assess entity's future profitability. A sustained flow of timely and relevant information also underpins the stability of markets by enhancing transparency about entity's activities, thereby promoting market discipline. Therefore, it is imperative that they portray the economic reality of an entity's financial position and performance as accurately as possible if financial statements are to provide an appropriate guide for decision making.

Early accounting practice and rules were designed to record the results of transactions and allocate financial results across reporting periods. This approach is often referred to as a revenue/expense approach, where the income statement is the primary focus and historical cost is considered to be the most appropriate basis for measurement and reporting. Under this approach, revenue is recorded when it is realized and earned and expenses are matched in the same reporting period as revenue. ([Kieso et al., 2007](#))

In the 1980s, accounting standard setters began to shift away from this approach, in part due to concerns that the combination of historical cost and delayed loss recognition were producing financial results disconnected from economic reality. Historical cost accounting was also criticized for providing managers with the means to smooth profits through hidden, excess reserves and selective sales of securities. [Casualty Actuarial Society \(2000\)](#), observed that during this period, there was savings and loan crisis of the United State, where banks held many financial assets at historical cost experienced financial strains. Many became aware that their reported balance sheet value could be improved by selling those assets with a market value greater than book value, since those book values were based on historical cost. As a result, many of these banks' assets were dominated with weak and underperforming assets which eventually led to the banks insolvent. It was then raised that anytime assets are not held at their face value (market value) financial reports can be manipulated through the selective buying and selling of assets. Since then the FASB, has embarked on long term projects to incorporate fair value concepts in the accounting for financial assets and liabilities. ([Volha, 2010](#))

[Jones \(1988\)](#) analyzes the issues related to historical cost versus fair value in accounting for financial instruments. Where it stated that the diversity of financial instruments had grown significantly in previous years, and with that growth came valuation issues. The study pointed out that historical cost no longer faithfully represent(s) the economic realities of today's complex instruments and suggested that two fundamental issues are common to many of the divergent financial instrument transactions, namely whether transactions should be treated with sale

accounting techniques or if a borrowing treatment is more appropriate when financial assets are converted to cash, and whether certain financial liabilities should be considered settled or extinguished in certain circumstances.

When dealing with financial assets, the current model at the time provided firms the opportunity to structure and account for transactions in a way that earnings could be observed easily, managed, and yet remain in compliance with GAAP. For instance, similar transactions could be reported as a borrowing if sale accounting would show a loss, but reported as a sale if it would result in a gain (or if there was already excessive debt reported on the balance sheet). Fair value accounting could eliminate some of the motivations of managers who might take advantage of these inconsistencies. (David *et al.*, 2010).

Several issues are directly associated with fair value reporting, including recognition, relevance and measurement. With regard to recognition, the evolution in capital markets makes it possible for companies to recognize and record economic events (i.e., fair values related to financial instruments) in their financial statements.

Landsman (2007) addresses the issue of value manipulation, and notes that the requirement of relying on managerial estimates for valuation of assets and liabilities introduces the problem of information asymmetry. Information asymmetry will arise whenever managers have discretion regarding the timing or amount of non-market adjustments to amounts arising from past transactions. Such information asymmetry creates two distinct problems; moral hazard and adverse selection.

(David *et al.*, 2010) opined that historical cost accounting is not the opposite of fair value accounting, but may be more accurately viewed as its evolutionary antecedent and many of the issues raised by these authorities led to the development of fair value accounting.

FAIR VALUE ACCOUNTING

Fair value accounting was defined in financial report principles exclusively issued by Financial Accounting Standards Board as the money received by selling capital or paid by transferring debts in orderly transactions among market participants on a measurement date. Also, in the enterprise accounting principles issued by Chinese Ministry of Finance in February 2006, fair value means the amount of money for capital exchange or debt payment involving both voluntary sides familiar with the situation in fair transactions, in which both sides are enterprises conducting continuous business who have no plan to have liquidation, sharply reduce business scale or have transactions under unfavorable circumstances. (Yichao Liu, 2010). Fair value is also defined by the Canadian Institute of Chartered Accountants as the value of consideration agreed on in a fair transaction

based on both voluntary sides familiar with the situation. According to the principles for financial reports issued by British Accounting Principles Board, fair value means the amount of assets or debts involved in a fair transaction or a liquidation sale based on both voluntary sides familiar with the situation.

The Bond Market Association International Swaps & Derivatives Association Securities Industry Association of United States defines Fair Value as an estimate of the price an entity would realize if it were to sell an asset, or the price it would pay to relieve a liability (Hague, 2002). Many financial instruments, such as shares traded on an exchange, debt securities, and derivatives, are measured and reported at fair value.

In the opinion of John and Goind (2012), guidance on 'fair value' under the existing International Financial Reporting Standards (IFRS) is covered by a number of different standards. Recently, the International Accounting Standards Board (IASB) issued a new accounting standard, Fair value measurement (IFRS 13) which establishes a single source of guidance for fair value measurement where fair value is required or permitted under IFRS.

IFRS 13 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 (that is, an exit price). The definitions of fair value emphasize fair value as market-based measurement, not an entity-specific measurement. When measuring fair value, an entity uses the assumptions that market participants would use when pricing the asset or liability under current market conditions, including assumptions about risk. As a result, an entity's intention to hold an asset or to settle or otherwise fulfil a liability is not relevant when measuring fair value. (IASB, 2012)

Ting and Soo (2005) noted that under GAAP (Statement of Financial Accounting Standards No. 15), the fair value of an asset is the price of which that asset could be bought or sold in a current transaction between marketplace participants in the reference market, other than in a liquidation. On the other side of the balance sheet, the fair value of a liability is the price at which that liability could be incurred or paid to transfer a liability in a current transaction between marketplace participants in the reference market, other than in liquidation. Fair value is therefore, the value at which parties dealing at arm's length would be willing to buy or sell an asset or liability.

Doron and Stephen (2008) discussed three notions of fair value accounting, firstly, fair value variously applied as an alternative measurement in a "mixed attribute model". In this treatment, fair value is used alternatively with historical cost for the same asset or liability but at different times. The accounting is primarily historical cost accounting, but fair values are applied under certain circumstances. For instance, fair values are applied in fresh-start accounting and for initial measurement this may be in form of purchase of asset.

Secondly, Fair value continues to apply as entry value, and subsequently, assets are re-valued at their replacement cost, with current costs then recorded in the income statement and unrealized gains and losses also recognized in comprehensive income.

Thirdly, Fair value applies as exit value, where assets and liabilities are remarked each period to current exit price, with unrealized gains and losses from the remarking recorded as part of comprehensive income.

CONCEPT FRAMEWORK

IFRS 13: Fair Value Measurement

Here, reference is made to the standards which require or permit fair value measurements or disclosures about fair value measurements, and measurements, such as fair value less costs to sell, based on fair value or disclosures about those measurements and except in specified circumstances. IFRS 13 sets out in a framework for measuring fair value; and requires disclosures about fair value measurements. (IASB, 2012)

In this instance, the measurement and disclosure requirements of the IFRS do not apply to the following:

- a) share-based payment transactions within the scope of IFRS 2 Share-based Payment;
- b) leasing transactions within the scope of IAS 17 Leases; and
- c) Measurements that have some similarities to fair value but are not fair value, such as net realizable value in IAS 2 Inventories or value in use in IAS 36 Impairment of Assets.

Also, the disclosures required by the IFRS are not required for the following:

- a) plan assets measured at fair value in accordance with IAS 19 Employee Benefits;
- b) retirement benefit plan investments measured at fair value in accordance with IAS 26 Accounting and Reporting by Retirement Benefit Plans; and
- c) Assets for which recoverable amount is fair value less costs of disposal in accordance with IAS 36.

The IFRS explains that a fair value measurement requires an entity to determine the following:

- (a) The particular asset or liability being measured;
- (b) For a non-financial asset, the highest and best use of the asset and whether the asset is used in combination with other assets or on a stand-alone basis;
- (c) The market in which an orderly transaction would take place for the asset or liability; and
- (d) The appropriate valuation technique(s) to use when measuring fair value. The valuation technique(s) used should maximize the use of relevant observable inputs and minimize

unobservable inputs. Those inputs should be consistent with the inputs a market participant would use when pricing the asset or liability.

Still making reference to the technical summary paper by IASB (2012), a fair value measurement assumes that a financial or non-financial liability or an entity's own equity instrument (for example, equity interests issued as consideration in a business combination) is transferred to a market participant at the measurement date. The transfer of a liability or an entity's own equity instrument assumes the following:

- a) A liability would remain outstanding and the market participant transferee would be required to fulfill the obligation. The liability would not be settled with the counterparty or otherwise extinguished on the measurement date.
- b) An entity's own equity instrument would remain outstanding and the market participant transferee would take on the rights and responsibilities associated with the instrument. The instrument would not be cancelled or otherwise extinguished on the measurement date.

DISCLOSURE REQUIREMENTS FOR FINANCIAL AND NON-FINANCIAL

Items

To increase consistency and comparability in fair value measurements and related disclosures, the IFRS 13 establishes a fair value hierarchy that categorizes into three levels the inputs to valuation techniques. The process of valuing an instrument to its fair value depends on how easy it is to determine a price for that instrument. Since fair value is the price at which a willing buyer and seller agree to trade, finding the right price is important to valuation.

According to IASB (2012) on IFRS 13, three-level fair value hierarchy have been extensively discussed by proponents of fair value accounting. The first level inputs are fully observable such as the unadjusted quoted prices in an active market for identical assets and liabilities that the entity can access at the measurement date. This is the simplest case in which a firm can find the price or value of an instrument in a newspaper or other quotation system. These prices typically reflect the last price reported to the secondary market. The second level inputs are those other than quoted prices within first level that are directly or indirectly observable. Listed, published prices are not available, however, for all financial instruments. In this case, some estimation is often required to determine fair value. Firms use valuation models that take into account a variety of relevant data, such as current economic forecasts, general market conditions and the price of similar financial instruments. For example, corporate bonds typically trade in a well-defined range over Treasury securities of a similar maturity. Contemporaneous transaction prices in such instruments will generally be very helpful in estimating the fair value of similar securities. In most cases, some verifiable market data exists to bolster the objective determination of fair value through modeling.

At the third level, inputs are unobservable, and estimates are based on some form of valuation model that requires the use of unobservable inputs or management assumptions. Firms rely primarily on judgment only for the very complex instruments where market parameters and prices do not exist.

In the views of [John and Goind \(2012\)](#), an asset or liability is included in its entirety in one of the three levels on the basis of the lowest level input that is significant to its valuation. Disclosures based on this hierarchy are already required for financial instruments under IFRS 7, but IFRS 13 extends them to cover all assets and liabilities within its scope. Most of the companies operating in the financial services sector should be well aware of the disclosure requirements but those in the non-financial sector would probably need substantial work in this area. An entity shall disclose information that helps users of its financial statements assess:

- a) For assets and liabilities that are measured at fair value on a recurring or non-recurring basis in the statement of financial position after initial recognition, the valuation techniques and input used to develop those measurements.
- b) For recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period.

Proponents argue that fair values for assets or liabilities reflect current market conditions and hence provide timely information, thereby increasing transparency and encouraging prompt corrective actions. Few dispute that transparency is important. But the controversy rests on whether Fair Value Accounting is indeed helpful in providing transparency and whether it leads to undesirable actions on the part of banks and firms.

CONCLUSION

Today's world economy requires greater use of fair value measurements in financial reporting because it is perceived that fair measurement information is more relevant to investors than historical cost information. It is argued that moving in this direction will reduce the complexity of accounting rules and consequently increase transparency in financial reporting. The objective of fair value measurement is for firms to estimate qualitatively determine operating prices based on current information and conditions. To meet this objective, firms need to fully incorporate current information about future cash flows and current risk-adjusted discount rates into their fair value measurements.

However, the reliability of the fair value measurement depends on the availableness of an active market. For the developed countries, fair value accounting is considered as a good measure to present more reliable financial information. In the developing countries, the question of active market is a major concern.

As IFRS 13 becomes effective, the effect of the new requirements will need to recognize the effects of inactive markets in developing countries in the valuation processes. The benefits of fair value accounting there is derivable if organisations prepare financial reporting using the mixture of fair value accounting and historical value accounting. The investors want fair value information so as to better determine the true value of their investment while they also wish to see the historical cost information that provide a measure of cash flows. This indicates whether management has achieved operating results that were budgeted for.

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