The Fairness of the Fair Value Concept

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Abstract

*In recent years, international standard setters and regulators such as the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have begun to favor the use of fair value accounting over historical cost accounting in financial reporting. A key reason for this shift in methodology is to improve the relevancy of the information contained in financial reports. The general principle underlying the shift is that up-to-date information improves investors' and regulators' abilities to make informed decisions. To date, the fair value concept is applied in several IASB standards such as IAS 16*Property, Plant and Equipment*; IAS 37*Provisions, Contingent Liabilities and Contingent Assets*; IAS 38*Impairment of Assets*; IAS 39*Financial Instruments*; IAS 40*Investment Properties*; IAS 41*Agriculture*;IFRS 2*Share-basedPayment*; and IFRS 3* Business Combinations*. In principle, fair value accounting sounds attractive - surely if something is 'fair' then it must also be good? The implications for accounting practice, however, are huge and highly controversial. Amongst the questions being debated are: how reliable are fair values?; how easy is it to audit fair values?; will fair value accounting work in practice?; and what are the implications for performance measurement? Such a controversial topic is worthy of consideration by all practising accountants and the aim of this article is to discuss briefly the main issues relating to fair value accounting.*

Concept of Fair value

The use of Fair value in Accounting Standards has been increasing in the recent years. But it is first important to understand the meaning of Fair Value as a basis of measurement.

- IGAAP definition

  "Fair value of an asset is the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction."

- IFRS current definition

  "Fair Value is the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction."

- IFRS proposed definition

"Fair Value is 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."

Like the existing definition of fair value in IFRSs, the proposed definition assumes that the exchange transaction is hypothetical and is orderly (ie it is not a forced liquidation or distress sale). However, the existing definition of fair value:

- does not specify whether an entity is buying or selling the asset;
- is unclear about what is meant by 'settling' a liability because it does not refer to the creditor, but to knowledgeable, willing parties; and
- ·does not explicitly state whether the exchange or settlement takes place at the measurement date or at some other date.

The proposed definition of fair value remedies these deficiencies and highlights the following:

a. It conveys more clearly that fair value assumes an orderly transaction between market participants, and thus is a market-based measurement, not an entity-specific measurement.
b. A fair value measurement shall assume that the transaction to sell the asset or transfer the liability takes place in the *most advantageous market* to which the entity has access. The most advantageous market is the market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after considering *transaction costs and transport costs.*
   Because different entities (and businesses within those entities) with different activities enter into transactions in different markets, the most advantageous market for the same asset or liability might be different for different entities. Therefore, the most advantageous market (and thus, market participants) shall be considered from the perspective of the reporting entity. An entity need not undertake an exhaustive search of all possible markets to identify the most advantageous market. The market in which the entity would normally enter into a transaction for the asset or liability is presumed to be the most advantageous market. In the absence of evidence to the contrary, an entity may assume that the *principal market for the asset or liability is the most advantageous market*, provided that the entity can access the principal market. The principal market is the market with the greatest volume and level of activity for the asset or liability.
c. Fair value refers to the current exit price. An exit price reflects the highest and best use of an asset. When the highest and best use of an asset is 'in use' (ie the asset is used together with other assets), the fair value of the asset is the price that would be received in a current transaction to sell the asset to a market participant who holds (or could obtain) the other assets (complementary assets). Thus, for example, the exit price for specialised machinery is not the scrap value of the machinery, but the price that would be received in a sale to a market participant that would use that machinery.
d. Fair value is not liquidation value. Liquidation values imply an immediate sale in which the seller is compelled to enter into a transaction. Fair value, on the other hand, is an orderly transaction in which both the buyer and the seller are willing, but not required, to transact. It should not contain anu element of stress.

Core principles of Fair Value

- *Orderly Transaction*
    - Assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary; NOT a forced liquidation or distress sale.
    - In the absence of an actual transaction, assumes a hypothetical transaction from the perspective of a market participant that holds the asset or owes the liability.
- *Most Advantageous (or Principal) Market*
    - Assumes the transaction takes place in the most advantageous market for the entity
    - 'Most advantageous market' is the market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after considering transaction costs and transport costs
    - Fair value, however, is not adjusted for transaction costs
    - If there is no advantageous market, fair value is based on the principal market for the asset (that market with the greatest volume and level of activity for the asset or liability)
- *Market Participants*
    - Independent of the reporting entity; that is, they are not related parties.
    - Knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information
    - Able and willing to transact for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so

Need for Fair Value

Under IFRS, there is much focus on Fair value. This is because IFRS emphasizes much on the Balance Sheet approach to make it more relevant and transparent. The thought behind this is that it is the right of the user ie the shareholders and various other stake holders to have the information about the value of various assets and liabilities similar to that of the management. And, generally it is the user who has to take managerial or investment decisions for which the past cost is not much relevant and it is the present and future estimates that will help to take a prudent decision. Fair values are relevant, faithful representations of assets and liabilities, have predictive value, are timely and comparable. They are relevant because they represent the present economic conditions under which the financial statements are prepared. They have predictive value as they help predict future cash flows. Fair values are neutral because they are unbiased and comparable because they depend on the characteristics of the asset or the liability being measured.

Fair Value and Market Value / Current Value

As the term is generally used, *Fair Value* can be clearly distinguished from *Market Value*. Fair Value requires the assessment of the price that is fair between two specific parties taking into account the respective advantages or disadvantages that each will gain from the transaction. Although *Market Value* may meet these criteria, this is not necessarily always the case. *Fair Value* is frequently used when undertaking due diligence in corporate transactions, where particular synergies between the two parties may mean that the price that is fair between them is higher than the price that might be obtainable in the wider market. In other words *Special Value* may be generated. *Market Value* requires this element of *Special Value* to be disregarded, but it forms part of the assessment of *Fair Value.*

Fair value is a measure of current market value, but all current value measures do not represent fair value. In financial reporting some entity-specific current value measures are used to measure assets. For example, inventories are valued at the lower of cost and net realisable value (NRV). NRV measures the net amount that an entity expects to realise from the sale of inventory in the ordinary course of business. NRV is not fair value less costs to sell. NRV is an entity specific value. Fair value of the same inventory reflects the value for which it could be exchanged between knowledgeable and willing buyers and sellers in the market place. Similarly, in the context of impairment accounting, recoverable amount is the lower of 'value in use', which is an entity-specific current value and fair value less costs to sell. Thus, fair value is a market value, which incorporates market assumptions/perceptions. Observable prices in an active market, when the trading volume is normal, are considered to be the best estimate of fair value. When such observable prices are not available at the valuation date, an entity has to estimate the fair value taking into consideration assumptions of buyers and sellers in the market where the asset is frequently traded or the market that is most advantageous to the entity.

Valuation of Fair Value

For the purpose of valuation, there are two different approaches that need to be considered:

- Value in exchange
- Value in use

Value in exchange is what one will realize when the asset is exchanged between willing parties. This approach is considered when we want to sell the assets or pay off the liabilities.

Value in use is the benefit or inflow that is generated by the use or holding of the asset till maturity.

For eg: Incase of investment in government instrument or security or bonds, the fair value would be the amount for which the portfolio is sold to the third party in the first approach.

But ,in the case of second approach when we want to hold the asset till maturity, then the fair value would be the discounted value of the amount of interest to be received till the time of maturity.

The Fair Value Heirarchy

Whether we adopt the value in exchange approach or value in use approach, the Fair value concept emphasizes the use of market inputs in estimating the fair value for an asset or liability. Quoted prices are the most accurate measurement of fair value; however, many times an active market does not exist so other methods have to be used to estimate the fair value on an asset or liability. The assumptions used to estimate fair value should be from the perspective of an unrelated market participant. This necessitates identification of the market in which the asset or liability trades. If more than one market is available, it is better to use the "most advantageous market". Both the price and costs to do the transaction must be considered in determining which market is the most advantageous market. There is a three level fair value hierarchy to reflect the level of judgment involved in estimating fair values.

Level 1

A Fair Value measurement is classified as Level 1 in the fair value hierarchy, if the fair value is determined as the unadjusted Quoted price in the active market. (Market Value)

It is important to remember that for a Quoted price in an active market:

- There should be actual and regularly occurring market transactions.
- The prices of those transactions should be regularly and readily available.

Also, the fair value should be the unadjusted quoted price (not a measurement based on quoted rate or index) observed in the active market. Incase the quoted is adjusted to arrive at a fair value, then it is not a Level 1 measurement.

Level 2

If quoted prices are not available for identical assets or liabilities and the fair value is estimated using quoted prices of similar assets or liabilities (market equivalents) and other observable inputs that require no significant adjustments based on unobservable inputs, then the resulting fair value measurement is classified as Level 2 measurement .

Level 3

If quoted prices of identical or similar assets or liabilities are not available or not objectively determinable, fair value is estimated using valuation methods based on present value techniques of future earnings, or cash flows and valuation techniques taking into account the significant unobservable inputs. This is classified as Level 3 measurement. The "unobservable inputs" are not based on independent sources but on "the reporting entity's own assumptions about the assumptions market participants would use." The entity may only rely on internal information if the cost and effort to obtain external information is too high.

Fair value based on the judgment of future cash flows is entity-specific, which means that the same asset can be measured differently for two companies because of different borrowing rates and managerial appraisals. Thus, the reliability of fair value estimates declines with the shift from liquid markets to non-traded items.

In other words, fair value is the facility to recognize unrealized gains in the profit & loss account which can happen in financial instruments held for trading. Infact, this is a culture shock for us. This is because in accordance to the principle of conservatism (Prudence), we take into account all possible losses but ignore any gain that has not actually happened or accrued.

Fair value requirements under International Accounting Standards

IFRS 2 *Share-based Payment*: Requires the use of fair value at the grant date for all equity settled share-based payments, as well as the use of fair value for cash settled transactions, with value changes being recognised in profit and loss.

IFRS 3 *Business Combinations*: Applying the purchase method to business combinations means that the cost is viewed from the acquiror's perspective and valued at fair value plus associated costs.

IAS 19 *Employee Benefits*: Defined benefit plans (pension schemes) must be valued on the balance sheet on the basis of the actuarial estimate of the present value of the benefit obligations net of the fair value of any assets held at the balance sheet date.

IAS 36 ***Impairment of Assets***: Assets should not be carried at more than their recoverable amount, which is measured whenever the asset may be impaired, and the need to impair must be assessed at each reporting date. Recoverable amount is defined as the higher of fair value less selling costs or value in use.

IAS 38 ***Intangible Assets***: The carrying value for an intangible asset may be either cost less depreciation or fair value (where there is an active market).

IAS 16 ***PPE*** : The Assets are to be shown at their Fair Values on the date of transition. Also, companies are to follow component accounting under IFRS Where each component needs to be fair valued at the time of transition.

IAS 39 ***Financial Instruments: Recognition and Measurement***: Financial assets and liabilities are initially recognised at fair value, and if held for trading or classed as 'available for sale' then subsequent measurements are also at fair value.

IAS 40 ***Investment Property***: Entities may choose to measure investment property carrying values at either cost less depreciation or fair value (exit price) and all changes in fair value are recognised immediately in the profit and loss.

IAS 41 ***Agriculture***: Biological assets are initially recognised and have a carrying value equal to the fair value less selling costs, and changes in fair value are included in profit and loss.

Models of Fair Value Accounting

Essentially, we can distinguish between four fair value models with respect to the incorporation of realized and unrealized holding gains and losses. The key characteristics of each model — equity, mixed, income, and full fair value — are outlined below.

Models	**Unrealized Gains**	**Realized Gains**
A. Equity Approach	Equity	Equity
B. Mixed Approach	Equity	Income
C. Income Approach	Income	Income
D. Full Fair Value	Income (+ internally generated goodwill)	Income (+ internally generated goodwill)

With the equity approach, all unrealized fair value changes are admitted in a revaluation reserve. When the transaction is realized, fair value changes are disclosed in equity. Realized holding gains do not affect the income statement.IAS 16 is an example of this approach.

With the mixed approach, unrealized fair value changes are admitted in a revaluation reserve, but realized fair value changes are reflected in the income statement instead of equity. One such example is IAS 39.

With the income approach, all holding gains and losses resulting from changes in fair value will be reflected in the income statement.

In the full fair value model, all fair value changes are reflected in the income statement, including internally generated goodwill. Self-produced goodwill is the difference between the equity value of the firm (or discounted future cash flows of the firm) and the book value of equity, where fair values are used to measure separable assets and liabilities. Internal goodwill refers to the organizational efficiency of a firm and should be distinct from purchased goodwill, which is recognized on the balance sheet as an intangible asset. The measurement and capitalization of self-produced goodwill is not recognized because of a lack of reliability.

Issues Implied with Fair Value Accounting

In considering the merits or otherwise of using fair value instead of historic cost on a balance sheet it is helpful to go back to basics and consider the purpose of financial statements. The IASB's conceptual framework states that financial statements fulfill two purposes :

(a) the assessment of stewardship and
(b) the provision of information for economic decision-making

The relevance and usefulness of fair value needs to be assessed within this context. Keeping in mind the above parameters, the important implications and the various issues related to Fair Value Accounting are discussed as follows:

Relevance Versus Reliability

The debate about fair value accounting versus historical cost accounting often revolves around the divergence between relevance and reliability. Historical cost which is based on prudence brings stability. Since adequate provisions can be made, the volatility in income and profits is reduced to a great extent. This generates a feeling of reliability in the user towards the figures in the financial statements as they are considered reasonably free from error and bias. On the other hand, fair value accounting provides information about current market conditions. It contains a superior basis for expectations than outdated historical cost figures. The fair value approach is the most relevant measure for assets and liabilities.

(a) It is based on the present and future expectations. But, it generates a lot of volatility and fluctuations in the income and profits. The profits might go up high in a particular market and drastically go down in the very next year due to unrealized gains or unrealized loss which is not considered good by Indian users as our decisions are based on income approach. We believe that there should be minimum fluctuations in the profits as our thought processes have always followed a conservative approach. This requires a huge mindset change on account of preparers and users of financial statements. However, some argue that historical cost accounting is the most appropriate way to measure assets or liabilities that are held to maturity.
(b) If markets are not liquid, estimation of fair value will inevitably be subject to managerial judgment, private information, and uncertain assumptions about future values, such as future cash flows and discount rates. The role personal judgment plays in the valuation process when market prices are not available, and reliability continues to be a topic of debate. Furthermore, fair values based on internal models will also have implications for the auditors, as their verification is

dependent upon accepting the logic of the underlying valuation model. Fair value should sensibly be used in relation to items for which there are efficient markets for standard products.

The counter argument is that even if there is a degree of potential unreliability to the values, they are still very useful to decision-making because they represent the economic reality as opposed to an accounting 'fiction' in the form of amortised cost. If one holds the view that a balance sheet should represent the potential liquidation value of a company, then fair values are preferable to those based on historic cost because they offer some indication of break up value, and so a fair value based balance sheet is a more faithful representation of the net worth of its components and, hence, of a company's financial position. This would be a very strong argument if all balance sheet items were based on fair values, but when (as at present) they include a variable blend of both historic cost and fair value measurement systems it is more difficult to justify. Apples and oranges cannot sensibly be added together.

(c) Fair values also increase the risk of misunderstanding on the part of existing or potential investors. Fair value might be the realisable market value but it remains true that the net fair value from a balance sheet will not necessarily equate to the market value of the company because of the existence of internally generated goodwill in the form of intangible assets. Fair value may thus bring a balance sheet value closer to the market one, but it will never match it exactly unless non-purchased intangibles are recognised on the balance sheet. Using fair values for decision-making, therefore, remains relatively difficult but not impossible.

Firm Valuation and Fair Value

The historical cost approach is meaningless if there is no relationship between the reported financial performance of the firm and its market capitalization. Yet historical cost accounting is the benchmark treatment and a growing gap is visible between the market capitalization of firms and book values based on historical cost accounting.

The historical cost approach does not incorporate aspects of future values. However, it is highly questionable whether fair value accounting would undo the gap between market capitalization and the book value of equity, even if we measure all assets and liabilities at fair value. There will always be a divergence between the market value of a firm and the net value of its assets, especially when current accounting practice does not report internally generated goodwill and does not recognize assets such as management skills and labour force. Adding to the gap is the fact that synergies between assets are not measured because identifiable assets are measured item-by-item.

Performance Reporting

Advocates of fair value argue that income smoothing and earnings management are possible under the historical cost framework. If corporate results turn out badly, management can influence reported income under historical cost accounting through the sale of assets, as a profit is reported if the net selling price of an asset is larger than the book value based on historical costs. But, under fair value accounting, the asset is already at fair value and the result is reflected in the income statement, thereby reducing the possibility of income smoothing.

Within the fair value paradigm, more and more assets and liabilities are measured on a continuing basis that reflects market conditions at the balance sheet date. After initial recognition, a firm that chooses the fair value model will report a gain or loss arising from a change in the fair value of that asset or liability. If assets are measured on a continuing basis that reflects market conditions, depreciation costs with a regular pattern will be less common. The result may be a new development where write-offs with a regular pattern are replaced by annual impairment tests with an irregular pattern, such as goodwill. But annual impairment tests are less predictable than annual depreciation costs, and lead to more volatility in earnings and more discussion between accountants and management.

Comparability

The element of comparability is one of the underlying principles of reporting standards. But with the application of fair values, comparison between income, performance, asset valuation etc would become difficult because of wide fluctuations taking place every year.

Conclusion

The arguments for and against fair value accounting raise fundamental questions about core accounting issues, such a how performance should be measured, and the relative merits of the qualities of relevance versus reliability. Fair value accounting can be seen as a paradigm shift in the focus of financial reporting, that moves it away from a historic focus and closer to one which provides a current perspective on value. The most interesting question is how long it will take for the full range of non-financial assets, and particularly internally generated goodwill, to be measured in this way. Even if the regulators want such changes, they may face substantial opposition to their introduction from both companies and the profession itself.

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