Fair value practice: suitability in accounting

Environment, Air

Introduction

The issue of the use of fair value as a model for financial standards and reporting has been subjected to significant debate and argument since the IASB [1] Framework was first introduced in 1989. As can be seen from a number of accounting industry responses, such as that of Peter Willams (2005), the use of fair value is becoming increasing contentious and could pose difficulties for the ISAB. Some fear that if this issue is not addressed to the satisfaction of all parties, it could affect the power and influence of the ISAB.

The intention within this paper is to discuss the theoretical concept of “ fair value” and to assess its suitability of use for accounting reporting purposes. The paper will also look at the practical application of the “ fair value” measurement as determined by the IASB within their current international reporting and accounting standards.

The Concept of Fair Value

The concept of “ fair value” is to enable recognition of the reliable economic future value of certain assets and expenses, the latter of which is intended to ensure the correct level of increase or decrease of balance sheet assets or liabilities. The result of this method is to create a defined link between income and expense to reflect the movement in the value of assets and liabilities. For those who promote the concept of fair value, or what is sometimes known as fair “ market” value, it is the sale price achieved for an

asset offered on the market at the time of the statement, based upon the reasonable opinion of a professional evaluator (A. M. King 2006, 45).

Fair value at present has no specific and identifiable measurement definition within current international accounting standards. It is currently determined through an amalgamation of a number of different and diverse accounting measurements used by corporations in accounting and financial reporting, although these models all have their disadvantages.

For example, in the case of the historical cost measurement basis, fair value is deemed to be at the measured at the date of purchase, as this reflects market value at that time. Although this model is seen as one of the least volatile methods of value measurements, it is perceived to have shortcomings. The main issues are that cost dates are earlier than sale date leading to a potential for profit overstatement, and that it is not the ideal model on which to based future business decisions. In fact some commentators see that the current moves on fair value, although they may signify a move away from the less volatile performance of the previously used historical cost method, produce a measurement that is more in line with the real volatility of life and business activity generally (Mary Barth 2006, p. 324).

An alternative measurement, which uses a price index system such as the RPI [2] , and is still based on transactions, is current purchasing power. The fair value determination here is set to reflect the capital of the business in relation to the general price trends. The difficulty with this model is that it

assumes all prices move in line with the index, which is clearly not the case and thus can create an artificial monetary unit.

The replacement cost and net realisable value model (NBV) use a fair value system based upon market entry and exit costs respectively. The former has the advantage of being able to calculate current values on a realistic basis, and can therefore identify gains in operating and other business areas, thus preserving the capability of the business. However, its subjectivity is aggravated by the speed of technological development and the fact that this leads to the possibility of no similar asset being available to compare values. The NBV model is clearer as it is based upon the probable selling price of the asset. It also does away with the estimation of depreciation as that selling price already reflects this. However, NBV does not take into account that the majority of assets are not disposed of, but utilised within the business. The problem with this calculation of fair value can threaten the concept of the business being a going concern.

The ISAB intend to move towards a definitive fair value model, which supporters see as a positive action, the cost of which will not *“ be significantly higher than the cost of trying to implement the mixed measurement system”* (Langendijk et. al. 2003, p. 292). Mary Barth (2006), a member of the IASB, agrees with this statement, adding that a more definitive “ fair value” model will assist in the elimination of some of the perceived volatility presently in existence.

However, the opponents are equally vocal in their objections. A. M. King (2006, p. 45) poses the question whether *“ all assets on a balance sheet*

[should] *be shown at Fair Value?,"* continuing to comment that the ability to achieve a particular model does not necessarily mean that it should be implemented. De Vries (quoted in Langendijk et. al. 2003, p. 174) also questions whether it is a move in the right direction for financial reporting, and others fear that it will lead to less, rather than more reliance upon financial statements by investors and other stakeholders (Peter Williams, 2005).

In the author's opinion it appears that, whilst professional preparers of financial statements understand the concept of the " fair value" model being sought, those who utilize the statements as a basis for making investment and other business decisions, including stakeholders of all sizes, find difficulty equating the results with other factual information. In addition, the term fair value will only be valid at the date of preparation of the statement and, as a result, itself becomes historic from that moment. Thus, there is an argument for maintaining its use with the commonly used historical cost model.

Use of Fair Value in accounting and reporting standards

The term " fair value" is liberally spread throughout the international accounting and reporting standards. It is referred to in four of the IFRS [3] 's and at least fourteen of the international accounting standards, as shown in the summaries of the IAS (2006).

The context of fair value within IFRS relates to treatment of the initial adoption of the standards, business combinations, insurance contracts and

non-current assets and discontinued operations. In terms of the initial adoption, IFRS grants exemption of some non-current assets from the fair value model. The intention of the inclusion of fair value here is to ensure that the movement in the market value of an asset or liability, in other words the increase or decrease in value, is reflected within the financial statements at the prevailing date of those statements, identifying if this is different from actual cost. With the movements being recognised within the profit and loss, the anticipated result is to enable, a more accurate reflection of the capital (or share) value of the business at the given date (Antill and Kenneth 2005). In addition, IFRS demand that these fair value measurements be performed at each subsequent financial and accounting statement date, thus endeavouring to provide for the organisation’s Balance Sheet to reflect the impact of market conditions at all times.

The inclusion of fair value within the international accounting standards is concentrated mainly within the areas of assets and liabilities, and in relation to specific business sectors, such as banks and similar financial organisations (IAS 30), Investment property (IAS 40) and agriculture (IAS 41).

Two of the IAS’s do relate specifically to non balance sheet items. IAS 18 deals with fair value within the context of revenue. In this respect, it deals refers to the treatment of deferred income, where the fair value is achieved by the discounting of future receipts. The intention here is to take into account the change in revenue value by deferring the time of receipt, for example, how a rise in RPI [4] might influence the income in real terms. In IAS 21, which deals with foreign exchange transactions, the presenter of the

financial statement is required to determine a fair value in the foreign currency in question before converting at the exchange rate applicable at the determination date.

When dealing with the treatment of assets, impairment of assets and liabilities, as in IAS 16, 17 and 19, the fair value model intends the financial statements to include a valuation that accurately reflects the realisable worth in the marketplace of that asset or liability at the date of the valuation, notwithstanding whether the intention is to retain or dispose of that asset.

In this respect fair value differs from historical cost accounting, which records the value of such items as at the date of purchase and, in many cases applies a depreciation content to the items, irrespective of their worth to a prospective purchaser. The historical cost result is twofold. Firstly, the financial statement recognition of any gain or loss against the real market value of an item may be delayed by several years and secondly, the statements will therefore not portray an accurate and fair view of the real value of the business at the date of the statements.

The fair value model aim is to accurately align the varying fortunes of the business and its capital worth with the market forces of the date, allocating gains and losses within the period of time that they actually occur, rather than, as is the case with the historical cost model, creating an unrealistic movement in value within the space of one accounting period. A simple example of this in action is where, in the historical system, depreciation is attached to an asset at a predetermined annual rate, annually reducing the asset value. In reality, the sale of that asset would often achieve greater

value than the statements showed, leading to a sudden annual increase in profits and growth in capital. Fair value proponents’ state that, by reassessing the market value on an annual basis, the real annual growth achieved by a business entity is more accurately defined, and that this provides investors with statements from which they can make more realistic judgments and use of as comparisons against other organisations, which is of benefit in their investment decision making process.

Conclusion

The core intention in the adoption of a fair value model as the most appropriate method of measurement for financial and accounting statement is to create a balance sheet and capital value of an organisation that accurately reflects the real market position of that organisation at the date of the statement.

One difficulty and concern with this is the inherent problem in the evaluation and establishment of the fair value in respect of all of the items included within the statements. Langendijk et. al. 2003, p. 52).

At the time of this paper, the IASB has entered into further discussions with the various parties involved with, and affected by the fair value model. This is an attempt to arrive at a clearer definition of the model itself, and to seek a position on fair value, which is more acceptable for the future.

References

Antill, Nick and Lee, Kenneth (2005). Company Valuation Under IFRS: Interpreting and Forecasting Accounts Using International Financial Reporting Standards. Harriman House Publishing. UK

Barth, Mary (2006). Fair Values and Financial Statement Volatility. International Accounting Standards Board, UK.

ISAB Framework (2001). Framework for the preparation and presentation of Financial Statements. International

King, A. M (2006). Fair Value for Financial Reporting: Meeting the New FASB Requirements. John Wiley & Sons Inc., New Jersey, US.

Langendijk, Henk., Swagerman, Dirk and Verhoog, Willem (eds) (2003). Is Fair Value Fair?: Financial Reporting from an International Perspective. John Wiley and Sons Ltd. UK

Staff Team (2004). Fair Value Accounting and Financial Stability. European Central Bank. Occasional Paper Series, No. 13, April 2004. Retrieved 19 January 2007 fromhttp://www. ecb. int/pub/pdf/scpops/ecbocp13. pdf

Summary of International Accounting Standards (2006). International Accounting Standard Boards. Retrieved 20 January 2007 fromhttp://www. iasb. org/Home. htm

Williams, Peter (2005). Accounting – The next wave of convergence. Financial Director, 1 Feb 2005.

1

Footnotes

[1] International Accounting Standards Board

[2] Retail Price Index

[3] International Financial Reporting Standards

[4] Retail Price Index