FAIR VALUE IN FINANCIAL STATEMENTS – ADVANTAGES AND DISADVANTAGES

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Abstract
Nowadays, there are many demands coming from all over the world to establish or to secure the possibility of comparability of the information provided in financial statements, and to make this information as reliable and accurate as possible, and therefore making it useful and beneficial for anyone who uses them. These requests demand adjustment of the content of accounted data in every single country, which might have its own accounting standards, to international norms of accounting. Substantial form of the synchronization or unification that attempts to harmonize accounting is the International Accounting Standards / International Financial Reporting Standards (IAS/IFRS), which are mainly focusing on financial statements, and seeking the solutions for problems connected with it. Financial statements, being one of the main concerns of the IAS/IFRS that should lead to a better comparability, higher predication and also to achieve higher utility for users, is getting more and more important. One of the tools that should help achieve these demands in financial statements is called “Fair value”. Despite the intents and plans, however it is still quite difficult to establish, whether its contribution to the improvement of accounting standards is really beneficial.

Main aim of this paper is to examine and depict the advantages and disadvantages connected to the fair value, providing the reader with objective information and thorough insight into the problems and benefits of fair value.

Partial objectives of this paper are to define the concept of fair value, to provide information about theoretical background and evolution of fair value and to examine and describe the possible future development of fair value.

Keywords: Fair value, financial statement, international financial reporting standards, accounting

1. DEFINITION OF FAIR VALUE

The first definition of fair value was introduced in 1982 in a contemporary issue of IAS 20 published by the IFRS. This definition has not changed much within years and is almost identical to the most recent version, according to which Fair value is ‘the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm’s length transaction’.

The individual features of this definition are further explained in the IAS 40 that has been consistently amended to clarify the applicability of this method of
accounting to its potential users. *Knowledgeable* parties are defined as ‘reasonably informed’ about all aspects of the asset to be transferred, including its utility, form and features and the market environment and the assets value in the market environment at the time.

A *willing* buyer is defined as someone who wants to buy but is not in any way compelled to do so. Although a buyer is motivated, he is not prepared to overpay in a transaction. Also, he is not determined to pay below the asset’s value in the market. A willing buyer pays as much as the market value of the asset is at the time.

Similarly, a *willing* seller is not forced to sell below the asset’s market value but also is not trying to get an unreasonably high price for it. A willing seller wants to sell at a best reasonable price in the market conditions of the time.

An *arms-length* transaction refers to a transfer of an asset between a buyer and a seller who have no special relationship and therefore the terms of the transfer would not be affected by special mutual arrangements, such as family bonds. Both parties have to act independently and thus prevent a creation of conditions for transfer that would be atypical for market environment.

To ensure that the financial statement utilizing the fair value method of accounting indicates the most exact financial situation of a company, the IFRS specifically states that fair value excludes in its estimates costs incurred by a sale of any given asset (realizing a transaction). It also lists other ways that the estimate could be deviated from an asset’s market price to be excluded, such as atypical financing methods, concessions or leaseback arrangements.

Fair value is time-specific. Financial statements of entities that utilized the fair value method are most indicative of the entities’ financial situation at the time that this statement is finalized. Therefore, even if the entity does not make any new transfers of assets or changes to its accounts, a different market environment would deem its financial situation different.

The closest indicator of a fair value estimate is a current market price for a similar asset, in a similar location, in similar condition and under similar lease arrangement or other contract. In case this information is not available, the entity should derive the estimated price from other sources, such as the current price of different assets and factor in the differences later to get a more reliable estimate.

The *fair value* differs from a *value in use* because it does not include any specific information about an asset; it only considers general information that would be known to any ‘knowledgeable and willing’ parties. The fair value estimate therefore does not take into account any specifics regarding the asset such as for example ‘additional value derived from a creation of a portfolio of properties in different locations’ (IAS 40).

So far, the IASB has indicated the option of applying the fair value method in the financial statements in the following accounting standards:
- IAS 16 provides a fair value option for property, plant and equipment;
- IAS 36 requires asset impairments (and impairment reversals) to fair value;
- IAS 38 requires intangible asset impairments to fair value;
- IAS 38 provides for intangibles to be revalued to market price, if available;
- IAS 39 requires fair value for financial instruments other than loans and receivables that are not held for trading, securities held to maturity; and qualifying hedges (which must be near-perfect to qualify);
- IAS 40 provides a fair value option for investment property;
- IFRS 2 requires share-based payments (stock, options, etc.) to be accounted at fair value; and
- IFRS 3 provides for minority interest to be recorded at fair value.

It is very likely that the IASB shall continue to increase the applicability of the fair value in future but is mostly applied to account for the firm’s assets (IAS 16) and the investment property (IAS 40).

### 2. THEORETICAL BACKGROUND

In an effort to harmonize accounting practices, the European Union has started adopting directives as early as 1970s. In 2000 the EU made a crucial step to that end by proposing to adopt accounting standards called the International Financial Reporting Standards (IFRS) as developed by a private organization based in London UK called the International Accounting Standards Board (IASB).

The European Parliament adopted these new accounting standards in 2002 in a new legislative that came into effect 3 years later and thus led some European companies to introduce themselves to a new accounting principle known as ‘fair value’. The logic of this change is rooted in the deficiencies the Europeans perceived in their contemporary accounting system known as ‘historical cost’. Using this method, their financial statements indicated a depreciated value of their past acquisitions. This value was seen by critics as misleading, not indicative of a real wealth of a firm. The aim and the promise of a fair value accounting are thus seen in its ability to project this wealth reliably.

The fair value accounting has not become the main method of accounting in Europe and it is questionable whether it ever will. In the IFRS standards, fair value and historical cost remain methods of choice for firms and financial institutions. The IASB continues to develop the concept of fair value accounting, trying to limit the vagueness of this approach and clarify its utility and applicability. Nevertheless, fair value continues to have many critics. The reasons why this is the case will be elaborated in the next section of this paper that deals with disadvantages.
3. Advantages and Disadvantages of Fair Value in Financial Statements

It is a normative truth in the world of accounting that for a financial statement or any accounting data to be useful, the two most important characteristics have to be relevance and reliability. Taking these two features as a starting point, the following section will explore in detail how well fair value accounting stands vis-à-vis these challenges.

The pros and cons will be evaluated not only from the point of a firm - an internal view but also from an external view, from a viewpoint of a potential investor or a financial institution.

3.1 Advantages

Timely/relevant information
Since fair value accounting utilizes information specific for the time and current market conditions, it attempts to provide the most relevant estimates possible. It has a great informative value for a firm itself and encourages prompt corrective actions.

More information in the financial statements than historical cost
Fair value accounting enhances the informative power of a financial statement as opposed to the other accounting method - the historical cost.

Fair value accounting requires a firm to disclose extensive information about the methodology used, the assumption made, risk exposure, related sensitivities and other issues that result in a thorough financial statement. Inclusion of more information is possible whenever there are
- observable market prices that managers cannot materially influence due to less than perfect market liquidity; or
- independently observable, accurate estimates of liquid market prices.

Thusly produced financial statements therefore 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 its wealth.

Reliable Information
For a financial data to be reliable they ought to be verifiable and neutral. Since fair value is inferred from the market price of a given asset, this value can be checked in hindsight from available information about current and past market prices. Since it is necessary to include the methodology and disclose the information about possible deviations from a quoted price in the financial statement, this information can also be verified. Neutrality is meant to represent a value that is best explained as an objective value and therefore devoid of any factors that would cause a rise or fall in such a value, atypical of general market
conditions. For example this is a value that does not include specific information related only to the owner of a given asset. An owner of a firm is likely to seek complementary properties or assets so that a value of a single asset/property is that much higher for the firm as it not only represents its own individual value but also an additional value, as a part of a distinct and functional whole. A neutral value does not consider this asset-specific information and only makes an estimate of its value based on general publicly-known information and thus makes this estimate reliable.

3.2 Disadvantages

Pricing deviation

One of the most often quoted disadvantages of fair value accounting is the vagueness of the measurement procedure of assets for financial statements which creates loopholes for pricing deviations. There are several ways that this measurement could produce differing prices and thus result in a deviation from a desired fair value.

Misleading Information

It is possible that sometimes the observed value of an asset in the market is not indicative of the asset’s fundamental value. Market might be inefficient and not reflect in its estimates all publicly available information. There are also other factors that could cause that this market estimate to be deviated such as investor irrationality, behavioral bias or problems with arbitrage among others.

Ball (2004) also points out that market liquidity is a potentially important issue because spreads can be large enough to cause substantial uncertainty about fair value and hence introduce large overall value deviations (‘noise’) in the financial statements.

Manipulation

Manipulation of the price by the firms themselves also presents a risk in obtaining a fair value estimates because in illiquid markets, trading by firms can have an effect on both traded and quoted prices.

Absence of a market price

If a market price for a given asset is not available in the active market, fair value estimate that is supposed to provide the most reliable information is more difficult to obtain. In this case, the usual procedure is to use “mark to model” accounting. This requires creation of a more extended estimate which runs the risk of creating a deviation of price for a given asset from its price if it was to be found in the market.

Furthermore if this ‘mark to model’ method is used to simulate a market price for a given asset, it provides an opportunity for the firm to manipulate this estimate, as it is the managers of the firm that can decide on what kind of a model or a parameter would be used.
Limited reliability

It is arguable that the information available in the financial statements provided by the fair value accounting method is relevant and reliable only for a limited period. As the information included in the statements is time-specific for given market conditions, a change in the market environment could cause a major difference in the actual financial situation of a firm. For an inexperienced professional in the accounting realm, a changing market situation would thus cause confusion as to what is the actual wealth of a firm. To get reliable information this individual would have to request a new financial statement. This could become a costly business if this request is made often. On the other hand, it is likely that an experienced businessman is able to infer the changing value of a business without the need to request a new financial statement, given he understands the procedures involved in utilizing fair value method.

Volatility

The problem of volatility is closely related to the previous issue of limited reliability. If the fair value of an asset follows the development of a market environment, this means that the value of an asset changes with the market. If the market with regards to the nature of a given asset booms, the price of a given asset goes up; if it busts, the price goes down too. A volatility of the market, which is an existing possibility, therefore creates a superfluous risk and could adversely affect the investment capacity of a firm. According to the research conducted by the European Central Bank’s experts ‘for assets and liabilities held to maturity, the volatility reflected in the financial statements is artificial and can be ultimately misleading, as any deviations from cost will be gradually compensated for during the life of the financial instrument, “pulling the value to par” at maturity’.

Contribution to the procyclicality of the Financial System

Following the recent financial crisis, there has been a debate about the potential contribution of fair value accounting. Many believe that it exacerbated the effects of the crisis, through increasing the inherent procyclicality of the financial system. (Procyclicality refers to the ability to exaggerate financial or economic fluctuations.) Fair value accounting and its dependency on the development of the market situation could cause that a market that experiences a slump is closely followed by a deterioration of a firm’s financial situation that in turn causes the market to panic, bringing it closer to an outbreak of a crisis. Since financial institutions are closely related to firms and the business cycle in general, if fair values indicate a fall, losses will also be reflected on the banks’ capital. This kind of weakening of bank balance sheets has been a disconcerting event for a future development of some markets, and the state of the whole financial system. In practical terms, this potential of fair value accounting to contribute to the procyclicality of the financial system would cause that increases in bank profits would be exaggerated during upturns in the market and would encourage an ‘overextension of credit’, that would then ‘create the conditions for a deeper and more long-lasting downturn. This would then also be exacerbated by the effect that
downward adjustments in asset valuations would have on bank profits and capital, which would further restrain their lending. Moreover, another potential result would be to limit credit availability to counterparties whose credit status is more volatile, e.g. small and medium-sized enterprises (SME). Given the importance of SMEs in Europe this may have a detrimental effect on future economic developments.

4. CONCLUSION

According to the advantages and disadvantages of the concept of fair value in accounting stated in this paper in previous pages, it is quite obvious and clear that this concept is far from being perfect. It is very difficult to determine whether its contribution to the improvement of accounting is really beneficial. On the one hand there are many reasons why the users of this method are better off, but on the other hand there is also several reasons why they are worse off. In fact, many of relevant sources express their mixed views about the extent “to which IFRS are becoming imbued with the current IASB/FASB fascination with fair value accounting” (Davidson, 2010). Although the fair-value discussion seems to be far from over now, the current crisis provided an interesting setting to further explore these issues, understand them better and hopefully urge responsible institutions to fix the imperfections within the system to make it work correctly and more effectively.

References


13. [www.ifrs.org](http://www.ifrs.org)