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Changing Fair Value Accounting

The recent credit crisis has led to a discussion about how to value financial assets and liabilities on the balance sheet and in the income statement. The IASB, the accounting standards board that issues the IFRS rules, decided recently to “ease” its accounting standards w.r.t. fair value accounting by granting companies, under a limited number of circumstances, the option to value certain financial assets and liabilities at historical cost.

This paper gives a short overview of the accounting standards before and after the recent amendments. It also presents an overview of some academic research on the topic and concludes with the pros and cons of fair value accounting.

1. Introduction

Since the introduction of the International Financial Reporting Standards (IFRS) in Europe, many companies, including financial institutions, need to recognise certain balance sheet amounts at fair value, and to record the changes in these values in the income statement. For example, the International Accounting Standard (IAS) 39 *Financial Instruments: Recognition and Measurement*, developed by the International Accounting Standard Board (IASB), requires certain investment securities and derivatives to be measured at fair value.

However, the recent credit crunch triggered a heated debate on how to measure the fair value of financial instruments in the third quarter of 2008. The financial crisis and the associated decrease in fair values of many financial instruments forced financial institutions to make considerable write-downs on financial holdings, which resulted in heavy losses on the income statement. Furthermore, fair value is defined under IAS 39 as the price, at the measurement date, at which an orderly transaction would take place between market participants in an active market. However, the financial crisis has led to many forced liquidations and distress sales, and turned many markets inactive. Under these circumstances, how should one measure fair value and does one actually want to include fair values in the balance sheet and income statement?

In the US, The Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) were the first to respond to this problem by issuing a clarification on how to implement the accounting standards with respect to fair value accounting¹. This clarifying statement eases the requirement to value financial holdings at fair value if no active market exists.

In order to ensure that financial institutions using IFRS as an accounting standard were not disadvantaged in terms of accounting rules and their interpretation, the IASB has amended its accounting standards with respect to fair value accounting, too. More specifically, it has published guidance on fair value measurement in illiquid markets and has allowed companies to reclassify certain financial instruments. This reclassification makes it possible for companies to value some of their financial instruments using historical cost instead of fair value.

This paper reviews the financial accounting standards related with fair value accounting before and after the recent amendments by the IASB. It also gives a short overview of academic studies examining the effects of fair value accounting on investors and financial institutions. Finally, the paper concludes by discussing the pros and cons of fair value versus historical cost accounting.

1. FASB Press Release 2008-234.



2. Measurement of Fair Value Before the Financial Crisis

The IASB has issued a number of accounting standards related to fair value accounting. The two most important standards are IAS 32: *Financial Instruments: Disclosure and Presentation* and IAS 39: *Financial Instruments: Recognition and Measurement*. IAS 32 is primarily a disclosure standard, while IAS 39 describes how particular financial assets and liabilities are measured (*i.e.* amortised cost or fair value), and how changes in the fair values are recognised in the financial statements (*i.e.* in equity or in income). In 2005, the IASB issued IFRS 7: *Financial Instruments: Disclosures*. This standard requires disclosure of detailed information for recognised financial instruments, both those measured at fair value and those that are not².

Table 1 gives an overview of the different categories of financial assets and liabilities and how they should be measured according to IAS 39. Originally, IAS 39 distinguished four categories (categories (2) to (5)). In 2005, the IASB amended IAS 39 by describing conditions under which firms can elect to use fair value measurement for financial instruments. Under this so-called “fair value option”, companies can designate, at the time of acquisition or issuance, a financial asset or liability to be measured at fair value, with value changes recognised in income (*i.e.* category (1) in Table 1). This option is available even if the financial asset or liability would normally be measured at amortised cost, but only if the fair value can be measured reliably.

Category (2), “*Fair value through profit or loss – Held-for-trading*”, includes all financial assets and liabilities held for trading purposes. These should be measured at fair value, with the changes recorded in the income statement. Category (3), “*Held-to-maturity*”, and (5), “*Loans and receivables*”, include for instance loans, receivables and debt with a fixed maturity that the company will hold until the maturity date. These items are recorded in the balance sheet using amortised cost, *i.e.* historical cost minus any subsequent amortization, depreciation, and impairment.

Finally, in category (4), “*Available-for-sale*”, a company should classify all financial assets and liabilities that are available for sale. These are recorded at fair value, but the

changes in fair value are recognised in equity and will only affect the income statement when the item is sold.

3. Recent Amendments to Fair Value Accounting

In the light of the recent financial crisis and its effect on banks’ financial statements, the IASB has undertaken three amendments to its accounting standards. First, the IASB has amended IAS 39 to permit reclassifications of financial instruments under certain circumstances (see Table 1). Second, it has extended the disclosure requirements related to financial instruments. Finally, the IASB has published a guidance for the application of fair value in illiquid markets.

On 13 October 2008, the IASB issued amendments to IAS 39 and IFRS 7 that permit the reclassification of some financial instruments. The main reason for the amendments is to ensure that “European financial institutions are not disadvantaged vis-à-vis their international competitors in terms of accounting rules and of their interpretation.” The amendments address the desire to reduce the differences between IFRS and US GAAP.

The changes to IAS 39 permit an entity to reclassify non-derivative financial assets and liabilities out of the “*Fair value through profit or loss – held-for-trading*” (FVTPL – HFT) and “*Available-for-sale*” (AFS) categories under limited circumstances. The criteria vary, depending on whether the asset would have met the definition of “*Loans and receivables*” at initial recognition.

A debt instrument that would have met the definition of “*Loans and receivables*” may be classified out of the FVTPL – HFT or AFS category to the “*Loans and receivables*” category if the company has the intention and ability to hold the debt instrument for the foreseeable future or until maturity.

Any other debt or equity instrument may be reclassified from FVTPL – HFT to AFS, or to HTM (in case of debt instruments only) if (1) the financial asset is no longer held for the purpose of selling in the near future and (2) in “rare” circumstances. In its press release of 13 October 2008, the IASB stated that “the deterioration of the world’s financial markets’ in the third quarter of 2008 is an example of a “rare” circumstance.

2. In the US, the Financial Accounting Standards Board (FASB) has likewise issued several standards that mandate disclosure or recognition of accounting amounts using fair values. Two important disclosure standards are SFAS No. 107, *Disclosure about Fair Value of Financial Instruments* and SFAS No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*. The most significant fair value recognition standards in the US are SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* and SFAS No. 157, *Fair Value Measurements*. The accounting treatments under US GAAP and IFRS are fairly similar.

Companies may reclassify a financial asset with effect from 1 July 2008. However, reclassifications made after 1 November 2008 are only effective from the date of reclassification.

In order to increase the transparency to investors, the IASB also amended IFRS 7 in order to include more disclosures with regard to the reclassifications. For example, companies have to disclose the amount reclassified in and out of each category and details of the “rare” circumstances.

On 31 October 2008, the IASB published educational guidance on the application of fair value measurement when markets become inactive. It presents a fair value hierarchy which consists of three levels of information a company can use to arrive at the fair value of an asset.

First of all, a company should use the quoted price of an

identical asset in an active market (*Level 1 inputs*). When there is no such active market, the company should use a valuation technique in order to measure the fair value. As inputs to the valuation model, the company should give preference to observable inputs, such as quoted prices for similar assets in active markets, or for identical or similar assets in inactive markets (*Level 2 inputs*). These inputs may also include inputs that are derived from or corroborated by observable market data by correlation or other means. In other words, the company should make use of observable market data of related assets or related markets. When no such inputs are available, the company should use unobservable inputs for the asset, *e.g.* the company’s own expectations (*Level 3 inputs*).

Of course, Level 1 inputs provide the most reliable evidence of fair value and as such should be used to measure fair value whenever available.

Table 1: Classification of Financial Assets and Liabilities according to IAS 39, Before and After the Amendment

Category	Measurement	Type of security	Subsequent reclassification	
			IAS 39 (prior to amendments)	IAS 39 (with most recent amendments)
1) Fair value through profit or loss – designated	Fair value through profit or loss	Debt ¹	Not permitted	Still not permitted
		Equity		
		Loans and receivables		
2) Fair value through profit or loss – held-for-trading	Fair value through profit or loss	Debt ¹	Not permitted	Reclassify in “rare” circumstances to: – Held-to-maturity – Available-for-sale
		Equity		Reclassify in “rare” circumstances to Available-for-sale
		Loans and receivables		Reclassify to Loans and receivables
3) Held-to-maturity	Amortised cost	Debt (with fixed maturity)	Reclassify to Available-for-sale	Still allowed
4) Available-for-sale	Fair value through equity	Debt ¹	Reclassify to Held-to-maturity	Still allowed
		Equity	Not permitted	Still not permitted
		Loans and receivables	Not permitted	Reclassify to Loans and receivables
5) Loans and receivables	Amortised cost	Loans and receivables	Not permitted	Still not permitted

¹ Debt represents all interest bearing securities other than loans and receivables.
Source: KPMG.

4. Results From Studies Related to Fair Value Accounting

Related, this part of the paper gives a short overview of the academic literature on fair value accounting. A number of studies have examined the usefulness of fair value accounting for investors. These studies find overall that fair value accounting provides useful financial information to investors over and above the other accounting information (*e.g.* Bernard *et al.*, 1995; Barth *et al.*, 1996; Nelson 1996). In these studies, the usefulness of the infor-

mation is assessed by the association between share prices and accounting information. However, the degree of usefulness appears to be lower for fair value measures that are estimated by management (*e.g.* valuation methods using Level 3 inputs).

The preliminary results of a study on how the market reacts to financial institutions that reclassify financial instruments from fair value to historical cost using the amendments to IAS 39 show that investors react negatively to this reclassification (Paananen and Renders



2009). This suggests that investors apparently see through the accounting practices and that changing the accounting standards will not result in more credible financial reports.

On the other hand, a number of studies have examined the impact of fair value accounting on financial institutions. Allen and Carletti (2006) show that, in times of financial crises, fair value accounting may lead to banks becoming insolvent, whereas the use of historical cost accounting would not compromise the solvency of banks. Plantin *et al.* (2004) find that, while a historical cost regime is also not perfect and may lead to some inefficiencies, fair value accounting can lead to increased price volatility.

In sum, the literature seems to indicate that in “normal” circumstances, fair value accounting presents users of financial statements with better information, but in times of crises it may worsen the illiquidity problems of financial institutions.

5. Conclusion: Pros and Cons of Fair Value Accounting

As an answer to the recent financial crisis, both the IASB and the FASB decided to allow companies under certain circumstances to measure financial assets and liabilities using historical costs instead of fair value and gave some guidance on how to measure fair value in illiquid markets. However, it seems that the credit crisis has reopened the debate on which measurement method, fair value or historical cost, is the “best” measure and hence should be used in the future.

Historically, in Continental Europe, the national accounting standards used mainly historical cost accounting, but allowed companies to revalue or write down items based on their market value (*i.e.* mixed-attribute accounting). With the introduction of IFRS in Europe, fair value accounting became commonplace. There are a number of reasons why accounting regulators, including the IASB, have issued standards requiring fair value recognition. First, it mitigates the use of accounting-motivated transaction structures designed to exploit opportunities for earnings management created by the “mixed-attribute” accounting model. Second, fair value accounting for all financial instruments reduces the complexity of financial reporting (e.g. hedge accounting).

Third, historical cost is a very objective measure, but the value reported on the balance sheet may be far from the real (market) value of the item, and as a consequence, it has no information value for investors. Finally, derivatives often have a historical value of zero and only gain or lose value dependent on the developments in the market of the underlying item.

However, there are also drawbacks associated with the use of fair values. A key issue, one which has recently come under great scrutiny, is whether fair values of financial statement items can be measured reliably, especially for those financial instruments for which no active market exists. In these cases, management must estimate the fair value of the instruments and this may result in a lower reliability of the accounting numbers. Second, for many assets, the fair value only becomes relevant when the asset is sold.

In conclusion, fair value accounting seems to mitigate some of the concerns related with historical cost accounting. However, if fair value accounting is used, we should make sure that investors are provided with extensive disclosures about the assumptions that are made, especially for items for which no active market exists. More importantly, we should carefully select the items for which we will use fair value accounting. Hence, the recent amendments by the IASB seem to be a quick response to tackle the criticisms against fair value accounting in the light of the financial crisis. Yet, a more profound theoretical underpinning of when to apply fair value accounting seems needed.

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