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Conceptual Framework on Fair Value Accounting

KEYWORDS: Fair Value, Fair Value Accounting, IFRS, Fair Value Measurement

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ABSTRACT *The role of financial accountant is critical in providing the information to all the stakeholders of the organizations. The assets and liabilities recorded under traditional accounting system do not reflect their current value and hence the concept of fair value was introduced under IFRS to make the information provided by the financial accountant more relevant, reliable and comparable. The current study focuses on understanding the concept of fair value accounting and analyzing the benefits of implementing fair value accounting in the context of Corporate Valuation and Share valuation.*

1.1 Introduction :

The information provided by the financial accountant is vital for the efficient running of the business. A Financial Accountant records the information related to the use of resources, assets and liabilities in the business. The accounting information is required for a large number of users both within and outside the organization. The traditional system of accounting records the assets and liabilities at historical costs which do not reflect their current value. The Fair Value Accounting records the assets and liabilities at their current value thereby making the information relevant and reliable. The current study focuses on understanding the concepts of fair value accounting and analyzing the benefits of implementing fair value accounting in the context of Corporate Valuation and Share valuation.

1.2 Review of Literature

An attempt is made in this section to review the major research papers on Fair Value Accounting.

SonglanPeng and Kathryn Bewley(2010)assessed the feasibility and desirability of a major emerging economy adopting and implementing the fair value accounting(FVA) by studying the China's experience. The authors suggests that IASB standard-setting should pay attention to whether uniform fair value accounting standards are adoptable and implementable in an emerging economy such as China, where contextual factors differ considerably from developede economies.

Christian Laux and Christian Leuz(2009)assessed and examined the role of fair value accounting in the financial crisis 2008 using the descriptive data and empirical evidence. The authors concluded that fair value accounting has not added to the severity of the financial crisis 2008 in a major way.

Ashford C. Chea (2011)studied the historical development of the Statement of Financial Accounting Standards (FAS 157) and its impact on fair value accounting. The author provided recommendations to enhance the usefulness of fair value accounting and draws implications for financial reporting and users of financial statement and concluded that the implementation of fair value accounting will enhance the qualities of financial measurement and reporting namely accountability, transparency, consistency, inter-period equity and risk management.

Walid Siam and ModarAbdullatif (2011)zonducted a survey to understand the views of bankers in Jordan about the usefulness of fair value accounting and on the major obstacles in its implementation. The major obstacles in the implementation of the fair value accounting as opined by the bankers in Jordan are :

- the possibility of fraud in fair value reporting,
- the ambiguity of accounting standards on fair value application and
- the reliability of figures measured using fair value accounting, as opposed to those measured using historical cost accounting.

Pinky Dholakia (2012)carried on research to identify and evaluate the materiality of the impact of IFRS adoption on companies. The majority of the respondents opined that the international convergence into IFRS as issued by IASB is vital for economic growth. She concluded that the process of convergence of Indian Accounting Standards to IFRS should be carried out carefully and the Government of India should make sure that everybody will benefit from the adoption of a global set ofaccounting standards.

The current paper focuses on understanding the concept of fair value accounting and the benefits enjoyed by the stakeholders of the company on its implementation.

1.3 : Objectives of the Study

The major objectives of the present study are :

- To understand the International Financial Reporting Standards (IFRS) conceptual framework on Fair Value Measurement of Assets and Liabilities (IFRS 13).
- To study the benefits of Fair Value Accounting over the Traditional Accounting System.
- To analyze the benefits of implementing Fair Value Accounting in an organization in the context of Corporate Valuation.
- To examine the benefits of implementing Fair Value Accounting in an organization in the context of Valuation of shares.

1.4 Concept of Fair Value

IFRS 13 defines *"Fair value as the price that would be received to sell an asset or paid to transfer a liability in an or-*

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derly transaction between market participants at the measurement date". The definition emphasizes the following features of fair value

- The Fair Value is a current exit price on the measurement date.
- The Fair value is the exit price in the principal market.
- The Fair value is a market based measurement but not an organization specific measurement.
- The fair value is determined in the principal market where orderly transactions take place for the asset or liability.

1.5 Fair Value Hierarchy for determining Fair Value of Assets or Liabilities :
IFRS has established fair value hierarchy to increase consistency and comparability in fair value measurements and related disclosures. The fair value hierarchy is categorized into three levels of data inputs used in valuation techniques for arriving at fair value.

IFRS 13:76 defines "*Level 1 inputs are quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date".*The Level 1 data inputs represent the quoted unadjusted prices of the identical assets in the active market.

IFRS 13:81 defines*"Level 2 inputs are inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly."*The Level 2 represents the quoted prices of the similar assets and liabilities in the active market.

IFRS 13:86 defines "*Level 3 inputs are unobservable inputs for the asset or liability."The level 3 inputs are unobservable inputs used in the situations in which there is little or no information on market activity of assets or liabilities.*In the process of determining the fair value of assets and liabilities, the organizations should follow the fair value hierarchy which indicates that preference should be given for level 1 inputs and in its absence the company should use level 2 and level 3 inputs.

1.6 Valuation Techniques
The valuation techniques are used by the organizations to arrive at the fair value of the assets and liabilities. The three widely used techniques for valuation of the assets and liabilities are :

Market Approach : Under this approach, the fair value of an asset or liability is arrived based on the prices and other relevant information generated by the market transactions involving identical assets or liabilities.

Cost Approach : Under this approach, the current replacement cost of the asset is considered as the fair value of the asset.

Income Approach : Under this approach,the fair value is the discounted value of the future amounts associated with the assets.

1.7 Definition of Fair Value Accounting
Fair value accounting is defined as *"A financial reporting approach in which companies are required or permitted to measure and report on an ongoing basis the assets and liabilities at fair value"*.

The major benefits of Fair Value Accounting are :

- It helps the companies to report the amount of assets and liabilities moreaccuratly, timely and comparable than the amounts that would be reported under the traditional accounting system.
- It helps to report updated amounts of assets and liabilities on a regular and ongoing basis.
- It limits companies' ability to manipulate their net income.
- Gains and losses resulting from changes in fair value estimates indicate economic events that companies and investors may find worthy of additional disclosures.

1.8 Corporate Valuation–Benefits from Fair Value Accounting
Corporate valuation is the process of estimating the fair market value of a company. One of the approaches adopted by the companies for corporate valuation is Adjusted Book Value Approach. Under this approach, the value of a company is arrived by using the information provided in the balance sheet either by using investor claim approach or Asset-Liability approach.The Value of the company is arrived as under :

Value of the Firm = Total Assets – Current Liabilities and Provisions or

Value of the Firm = Book Value of Investor Claims

The major limitation of the Adjusted Book Value Approach is that the value arrived do not reflect the current value of the company as the valuation is done based on the value of the assets and liabilities recorded at historical costs in the balance sheet. This limitation can be eliminated if the company records the assets and liabilities at fair value.

The implementation of Fair Value Accounting by the companies will help the organization in adoption of adjusted book value approach for corporate valuation as the assets and liabilities are recorded at fair value.

1.9 Valuation of Shares – Benefits from Fair Value Accounting
In capital markets, the investors take their decisions to buy or sell shares by comparing the book value with its current market price in the stock market. The book value of the shares is calculated from the information available in the Balance Sheet. The net worth of the company per equity share outstanding gives the book value of the share. The major limitation of basing investment decisions considering book value of the share is that the assets and liabilities in the balance sheet do not reflect their current value. The implementation of Fair Value accounting by the companies will help the investors in estimating book value of the share more accurately and hence can take right investment decisions.

1.10 Conclusion
The fair value accounting also known as mark-to-market accounting is often criticized that it contributes to excess leverage in boom period and leads to excessive write downs in recession. Some financial analysts also criticized that the Fair Value Accounting is one of the major cause for the financial crisis in the year 2008. Inspite of these criticisms, implementation of the Fair Value Accounting will bring uniformity and accuracy in the financial statements provided by the companies. And this will help the investors and also the companies to compare one's performance with its competitors. Hence implementation of Fair Value Accounting is always beneficial to the companies

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and to the investors. As the Government of India is initiating the implementation of IFRS in the companies that have net worth of above 1000 crores from April 2015, the companies and the investors are certainly going to get benefited from the Fair Value Accounting procedures.

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