

FAIR VALUE MEASUREMENT: IMPLEMENTATION ISSUES AND CHALLENGES (PART 1)

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INTRODUCTION

Since the promulgation of fair value accounting by the International Accounting Standards Board (IASB), the subject matter has been hotly debated by industry players and professionals of the accounting fraternity the world over. Many problems and pitfalls have been highlighted on the "mark-to-market" premise. For example, David Gwilliam and Richard H.G. Jackson (2008) noted that Enron "was able to 'monetize' physical assets so as to bring them within the remit of mark to market accounting", suggesting misuse of fair value measurement.

Fair value is said to be superior to other forms of measurement because it is easily understood by investors and stakeholders. It is also timely, neutral, representationally faithful, reliable, relevant, comparable and consistent. Fair value reporting is deemed to be more transparent and investor-confident. However equally important is that fair value measurement is subject to constraints such as human judgment, the location and condition of the asset/liability being measured, the determination of market, the most advantageous market value as against the entity's perspective, transaction price presumption (exit price verses entry price in different markets), the bid-ask spread of financial instruments, and transportation cost exclusion, to name a few.

Brief definition of fair value:

Defined as, "The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants."

The fair value of an asset is based on the exit price (i.e., selling price) rather than the entry price (i.e., purchase price). The exit price is determined using data that market participants in the entity's principal or most advantageous market would use when determining the price of that asset or liability.

Fair value shall be determined on an individual unit basis (unit of account), but states that the unit of account should be determined using the applicable standard for that asset or liability.

The application of the exit price as a basis for determining fair value may lead to a so-called "Day one" gain or loss when the transaction price differs from the exit price.

Any gain or loss arising from a difference between the entry and the exit price at initial recognition is recognised in profit or loss under SFAS 157, even when the fair value of the asset or liability is determined to a large extent using unobservable market data.

The standard includes a three-level hierarchy for determining fair value

(Source: International Accounting Standards Board (2006), *Discussion Paper: Fair Value Measurements*)

RATIONALE FOR FAIR VALUE

The main reason put forth to support the use of fair value is that historical cost accounting method of preparing financial statements is less relevant, especially given that prices and values of assets and liabilities change frequently and in certain cases, fluctuate significantly. Financial statement prepared using fair value approach may provide more accurate information on current values of assets and liabilities in a firm.

It has also been argued that the world's economic environment has changed significantly, given the sweeping reforms and changes in regulations, sophistication of consumers and development of new valuation methods. This has in turn resulted in different ways by which values are created and in turn reported. Given this, it is necessary for reporting of performances to be based on fair values to allow for better comparison and interpretation of values of products, financial statements and performance.

With the emphasis on mark-to-market approach, fair value hence is definitely very relevant in today's business environment. Historical cost accounting fails in terms of not only in relation to reporting current values, but also in terms of projecting future values. Fair value hence allows for better investment decision to be made, based on latest fair values reported.

INDUSTRY FEEDBACK AND RESPONSE

Critics of the US banking institutions have strongly criticised and blamed fair value accounting for aggravating the credit crisis, forcing the institutions to heavily slash the value of their mortgage assets, which resulted in weakening the regulatory capital ratios. The need to mark to market the financial instruments forced many financial institutions to incur large writedowns on the balance sheets. Without the regulatory cash cushion, inter-bank and customer lending became severely hampered, thus creating a stagnant credit market. It is easy to make accounting rules the scapegoat when it comes to shifting blames. The reality is that had financial institutions adopted fair value accounting and its disclosure requirements early, they would have seen the writing on the wall.

Still, it is hard to ignore the fact that the recent financial crisis has exposed some shortcomings of fair value accounting. Reporting fair value in illiquid markets creates earnings volatility and restricts bank capital ratios. Some have contended that fair value may promote a downward spiral in asset prices (called "procyclicality") as potentially temporary losses are recorded. Banks may be forced to sell these undervalued assets into the depressed market, thus creating further downward spiral of asset values, which in turn may trigger more write downs and asset sale. When the market is stagnant, with few or no transactors, implied market value, based on estimates, is used to value the assets. A departure from fair value measurement, using alternative measurement models, will result in "creative" values which are less reliable and subjective.

Pricewaterhousecoopers¹ has advanced a proposal to refine fair value reporting as follows:

- To separate impairment charges into two components: losses related to declines in expected cash flows (or incurred credit losses) and all other changes in fair value.
- To report incurred credit losses in net income and all other impairment losses in other comprehensive income (OCI). OCI is a holding account for temporary unrealized changes in fair value of various financial assets and liabilities until they reverse themselves or result in realized gains or losses.
- To change the income statement format to provide greater visibility for the income effects of items reported at fair value; and include OCI information on the income statement below net income.

The benefits are:

- It provides greater consistency and comparability in reporting declines in the fair value of loans and securities for financial institutions.
- While reflecting only incurred losses in net income, it would disclose all changes in the fair value of debt securities on the face of the income statement.
- It provides more information about the causes of changes in fair value, including both credit and non-credit factors.
- It removes liquidity and other transitory charges from the net income of institutions with a "buy and hold" investment strategy.

¹ PricewaterhouseCoopers global network (2009), retrieved from http://www.pwc.com/images/us/eng/about/pov/PwC_PointofView_FairValue_012009.pdf on 11 July 2009.

The above proposal will not affect regulatory capital, but would promote greater transparency to investors as it acknowledges the interplay between financial and regulatory reporting.

LIABILITY ISSUES

Another major concern has been the impact of credit risk on liability measurement. It would appear that fair value accounting rules allow companies to show a reporting gain when in fact their credit rating have sunk. When a company's credit rating drops, so does the price of its debts which therefore must be re-valued to market value. The difference between the debt's carrying value and its fair value is then recorded as a debit to liabilities and a credit to income. This allows financial institutions to boost their income as they become less creditworthy. In the first quarter of 2009, Citigroup benefited from this accounting oddity by posting a \$30 million gain on its bond debt as against its downed credit rating.

IASB² argued on consistency. Accountants accept that the initial measurement of a liability incurred in an exchange for cash includes the effect of the borrower's credit risk and this consistency must be maintained. One suggestion is to use a risk-free discount rate for all liabilities in order to apply the consistent measurement rule.

IASB also noted that excluding credit risk changes may result in accounting mismatch between asset and liability measurements. Under fair value measurement, any changes in credit spreads on the assets will affect their fair value, as well as the company's profit or loss, or other comprehensive income. If liabilities does not incorporate credit-spread changes, it will also create accounting mismatch, thus distorting profit, loss or other comprehensive income.

One situation that warrants the fair value approach is when the liability offsets an asset reported at fair value. Then the accounting symmetry will reflect the underlying economics of the transaction. But this approach reduces company comparability.

EXPANDED GUIDELINES

The task of addressing the loopholes and controversies confronting fair value accounting is humongous. On May 28, 2009, IASB issued an exposure draft on *Fair Value Measurement*, providing expanded guidelines in Fair Value measurement.

² Marie Leone (2009) *The Fair-Value Deadbeat Debate Returns*. Retrieved 25 June 2009 from CFO.com (US).

On liability measurement, it is assumed that the liability is transferred to a market participant at the measurement date. If there is no observable market for the liability, then it would be measured "using the same methodology that the counterparty would use to measure the fair value of the corresponding asset"³.

If there is no corresponding asset for a liability, the entity shall estimate the price that market participants would demand to assume the liability using present value techniques, or other valuation techniques⁴.

A restriction on an entity's ability to transfer a liability to another party does not affect the fair value of the liability⁵.

If an entity initially measures an asset or liability at fair value and the transaction price differs from fair value, the difference will be recognised as gain or loss in the profit and loss unless the IFRS requires otherwise (as in IAS 39).

PROGRESS IN MALAYSIA

Companies in Malaysia of course cannot afford to rest on their laurels when it comes to fair value accounting. The stage has been set for full convergence with international financial reporting standards by 2012. Fair value ensures a fair, reliable and transparent reporting framework that keeps investors and shareholders well informed, as gains or losses are now recognized even before the financial instruments mature. This will give investors and stakeholders a good start to know the economic performance and financial conditions of their investing entities.

The deadline for implementation of fair value accounting is nearer than we thought. FRS 139 reporting period is 1 January 2010 to 31 December 2010. This means that the first quarterly financial reports in 2010 would require submission in April 2010. So, now is the time to prepare for the changeover, which is less than six months away.

In addition, public companies in Malaysia are required to prepare for detailed risk analysis disclosure in compliance with Pillar 3 of the Basel II accord. Local entities must be prepared to explore and study financial models that are relevant to financial instruments that are not exchange traded with mark-to-model provisions.

³ Deloitte Touche (2009), *IAS Plus Update: Exposure draft proposes expanded guidance on fair value measurement* (quoting reference to paragraph 26 of the IASB Exposure Draft ED/2009/5 *Fair Value Measurement*) retrieved www.deloitte.com on 30 June 2009.

⁴ Ibid. Paragraph 28 of the IASB Exposure Draft ED/2009/5 *Fair Value Measurement*

⁵ Ibid. Paragraph 31 of the IASB Exposure Draft ED/2009/5 *Fair Value Measurement*

CONCLUSION

This article discusses some of the controversies surrounding the implementation of fair value accounting and measurement. In particular, it highlights the impact of fair value accounting on the banking industry in light of recent financial crisis, which has exposed the limitations of fair value measurement and reporting. It also looks at some proposals to refine fair value accounting and reporting to enhance clarity and transparency to investors and to serve as "writings on the wall" for the reporting entities. It also highlights the credit risk issue relating to fair value measurement for liabilities. It examines briefly on the level of preparedness of Malaysian companies and financial institutions in addressing fair value accounting which has reached our shore.

Finally, it summarises the recently released Exposure Draft of IASB and highlights issues addressed by the Exposure Draft in relation to the above discussions.

This article serves as the first of a series of articles concerning fair value. Future articles shall cover:

- **Fair value definition**, in particular covering the issues behind the proposal to use exit price definition of fair value to value assets and liabilities
- **Concept of most advantageous market and market participant view**
- **Measurement assumptions.**
- **Highest and best use of an asset**
- **Assumption of transfer of a liability**
- **Day one gains/losses**
- **Valuation techniques.**

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