

Fair Value

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< EXECUTIVE SUMMARY >

◆ The concept of the 'Fair Value' has assumed significant importance in recent times due its wider acceptance by the International Standard setters in measuring the financial assets and liabilities. Both, the International Accounting Standards Committee (IASC) and the Financial Accounting Standard Board (FASB) have

accepted the usage of fair value in measuring certain financial instruments in recent times. In the article below a study is made in respect of the underlying assumptions, which prompted these accounting bodies to conclude that fair value measurement is appropriate for measuring the financial assets.

INTRODUCTION

The concept of the fair value has assumed significant importance in recent times due its wider acceptance by the international standard setters in measuring the financial assets and liabilities. Both International Accounting Standards Committee (IASC) and Financial Accounting Standards Board (FASB) United States of America have accepted the usage of fair value in measuring certain financial instruments in recent times. The introduction of International Accounting Standard 32 Financial Instruments: Disclosure and Presentation had initiated extensive disclosures regarding fair values of the financial assets and liabilities. These are part of the risk management policies of the enterprises applying these standards.

The evolution of the fair value as a tool of measurement as against the cost or lower of cost or market value

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is the result of the conscious efforts to improve the relevance of the information presented in the financial statements.

The recent standard issued by the International Accounting Standards Committee (IASC) on Financial Instruments International Accounting Standard 39: Financial Instruments Recognition and Measurement has recommended classification of the financial assets into four categories and valuation of the same either at cost, amortised cost or fair value.

The Joint Working Group which developed the basic structure upon which the exposure draft and the subsequent standard was issued, has dealt the significance and the utility of the fair value measurement at length. The Financial Accounting Standard Board at the time of issuing the Federal Accounting Standard FAS 115 on Accounting for Certain Investments in Debt and Equity Securities has dealt extensively on the utility of the fair value measurement of the financial instrument.

The direction of the world accounting bodies is clear - a definite shift from the cost based measurement to the fair value measurement is apparent. In this article a study is made in respect of the underlying assumptions, which

prompted these accounting bodies to conclude that fair value measurement is appropriate for measuring the financial assets. Further the appropriateness of such assumptions in the Indian context is also examined.

The Indian accounting standards or the statutes do not require presentation of risk management policies or fair value disclosures as part of the financial statements. Currently the Indian standard on investments recommends cost or lower of cost or market value measurement of the current investments. Long-term investments are generally valued at cost less diminution, which is other than temporary. In the light of the current developments globally, a day may not be far when the Indian standard setters may require to examine the relevance of fair value measurement and disclosure of the financial instruments. In view of the significance of the issue due to its resultant shift in the basis of measurement of the financial instruments and extensive disclosures it may require, the author is of the strong view that the underlying assumptions which have forced those bodies to introduce fair value model to certain extent in the measurement of the financial instruments in the accounting standards should be examined in great detail in the Indian context. This debate should encourage all the interested parties to participate and express their views in order to show a clear path, which is acceptable to the standard setters.

FINANCIAL INSTRUMENT AND FAIR VALUE

For the purpose of this discussion financial instrument is a contract that gives rise to a financial asset to one enterprise and financial liability to another. Financial asset or liability in general refers to the contractual right to receive or deliver cash in exchange of another financial instrument. In commercial parlance investments, trade debtors, advances, trade creditors, long-term loans and advances etc are either a financial asset or a liability.

Fair value of a financial instrument is the value, which a knowledgeable buyer is willing to exchange a financial asset or settle a financial liability with a knowledgeable seller. It takes into consideration the risk inherent in the instrument and it represents the expected future cash flows discounted at current market rate of return identical to the instrument for which fair value is determined.

JOINT WORKING GROUP OF INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE

Salient assumptions, which the JWG has considered appropriate to conclude that fair value measurement of the financial instruments is appropriate, are examined hereunder:

The two most significant qualitative characteristics of financial information presented in the financial statements are relevance and reliability. The assumptions upon which the JWG concluded have been presented under Relevance and Reliability.

RELEVANCE

Current economic conditions

JWG considered that fair value presentation of financial instruments reflects the results of current economic conditions and the latest performance indicators of the enterprise in particular and of the industry in general. The fair value also embodies the investor's or the market outlook of the performance of the financial instrument.

This assumes that fair value of any financial instrument is easily obtainable and is determined by market forces after taking into account all the relevant information. This also presupposes existence of transparent and competitive market for all kinds of financial instruments from which the fair values can be determined. These markets and their transfer price mechanism (for purchase and sale of financial instruments) should be independent of the people dealing therein to enable the market forces to determine the true fair value. These are generally the striking characters of a developed capital markets. These may be lacking in developing or evolving markets. An assessment of the Indian capital markets and their ability to reflect fair values, which would take into consideration all the relevant information, should be made before considering this as appropriate principle for measuring the financial instruments.

In the Indian context for some of the financial instruments such as futures, options, derivatives and hedge transaction the markets are still evolving and are in preliminary stages. For some of the derivative instruments the fair values or the settlement values (such as interest hedge or cash flow hedge) the fair values are determined or provided by the dealer of such instrument or such facilities. It may also be necessary to examine if

it is appropriate to reflect fair values of such kind of instruments in the financial instruments. Absence of independent market to determine the fair values may also impede such proposition.

Comparability

JWG considered that one of the shortcomings of cost based presentation- limitation in comparability - for recommending a shift in the measurement. Cost based measurement results in two different valuations in respect of a same financial instrument, by two different enterprises based on the timing of the purchase. Fair value measurement results in an unbiased measure of the financial instruments irrespective of the enterprise holding it and irrespective of the intention to hold the same. Cost based measurement results in a different measurement of the same instrument depending upon the timing of the acquisition of such an instruments. This impedes comparison of the financial statements of different enterprises having the identical financial instruments. Under cost based measurement the cost of a instrument is recorded and reflected at the cost on the date of acquisition. Same instrument acquired by two different enterprises at different times fails to bring in the effect of investment decision at different times.

Adoption of fair value model for facilitating a better comparison may have to be examined in a wider perspective. Comparison presupposes adoption and application of a number of similar or identical accounting principles or practices by enterprises within an industry or a sector. It also envisages industry specific accounting standards or practice, which may enable fruitful comparison. In India many diverse accounting practices are applied or prescribed either by statutes or standards, which impede a meaningful comparison. Hence, adoption of a new accounting practice on the consideration of comparability, other things remaining the same may not improve the relevance of the information presented in the financial statements. However, one of the foremost utilities of financial statements is comparability. Hence, in the long run standards may have to be developed to afford comparability in which fair value measurement may have to be introduced as part of it.

Market based empirical research

Market based research indicates a strong favour towards recognising fair value as the basis of measuring financial instruments particularly investments, derivatives, bank loans, long term debt held by banks and similar institutions. This strongly suggests utility and rele-

vance of this measuring technique to financial sector. In India a study with a focus to identify the sector to which a fair value measurement is ideal and relevant may have to be carried before recommending such a measure. Application of such a basis across the board to all the enterprises may not serve the purpose of improving the relevance of the information presented in the financial statements.

Survey of financial analysts

A survey of the independent consultants on behalf of association for Investment Management and Research, the FASB and the Canadian Institute of Chartered Accountants were evenly divided on application of fair value for measuring the financial instruments. Though the survey did not reveal a consensus or a majority opinion towards fair value measurement in all the sectors or industries there was a clear indication for more and better information on fair values of the financial instruments.

The disclosure and the measurement requirements as stipulated under various standards and statutes may need to be relooked in India to determine the adequacy and any improvement.

RELIABILITY

Observable market value

The JWG had countered significant concerns or difficulties in developing reliable estimates in respect of fair values for certain financial instruments. Where the market values are not easily obtainable or available, JWG felt that absence of observable market values couldn't be a deterrent factor in adopting fair value model. It is felt that fair values can be estimated with reasonable accuracy by using any of established techniques, which take, into account market pricing principles.

Liquidity risk component

JWG also disagreed with the Draft recommendation, which observed that in certain circumstances it is difficult to estimate the liquidity risk component of the fair value. In such circumstances the fair values should be estimated by excluding the liquidity risk factor from the assumption for developing the fair value of the financial instrument. JWG observed that fair value is net present value of the expected future cash flows discounted at the market rate of return after taking into account all the risk inherent in a financial instrument. Hence, a value devel-

oped by ignoring one of the significant risks cannot be considered as a representative fair value and should therefore not be excluded in estimating the fair value.

Reliability of estimates - trade off between relevance and reliability

JWG had acknowledged that determination of fair values involves certain degree of subjectivity due to which the results may not be accurate. However, it is considered that it is possible to develop reasonable estimates based on sound and relevant assumptions. A reasonable degree of variation is associated with all the techniques of estimation and is an accepted accounting practice. Further, in view of the relevance and the utility of the fair value information presented in the financial statements, a trade off had to be struck between relevance and reliability with relevance of the information presented receiving higher weightage.

Income recognition

The extension of the above principle of reflecting the fair value of the financial instruments is the concept of reflecting the fair value gains or losses in the profit and loss account. Recognition of the fair value loss (if it is permanent in case of long term investments or if it is below the cost in case of current investment) as a charge to the profit and loss account is already an accepted practice in view of the prudence associated with it under various national and international standards. However, acceptance of fair value gains, as part of the income was not part of the accepted practice in India at least till now. JWG had upheld a treatment, as it would reflect the current economic reality in the profit or loss made during the period in which the event had occurred as against on the date of realization, which has no bearing on the actual profit or loss made. Such a treatment would result in reflecting in the profit and loss account the profit, which had not realized and which may not be realized when in future when the financial instrument is sold or realized as the economic conditions which have given, rise to such gains may have changed when the instrument is sold or realized. The concept of accepting recognising gain in the period in which it had occurred may stand correct if it is certain that these gains would remain even on the date when it is sold or realized subsequently. In the absence of such certainty putting them in profit and loss account may mislead the investors expectations of future profits and performance of the entity.

Fair value scenario in Indian corporate reporting

As can be understood from the above discussion

finance industry, say companies involved in banking, corporate finance, personal finance, international trade, and mutual funds use financial instruments extensively in the daily business operations. Fair value information of these financial instruments in the annual accounts would enhance the understanding of the information and present the potent risks faced by these entities. Risk management policies as part of the annual accounts would provide a clear basis to enable the reader to understand the effectiveness or the ineffectiveness of the risk management policies of the enterprises. Annual reports of the enterprises in this sector in India are deprived of any information relating to risk management policies and fair values of their financial instruments as they are not required by the standards or statutes governing them. Many Indian investors may not be using aware of the significance of this information or may not be information of this nature in their decisions to buy or hold investments in these enterprises. However, the fair value information is extensively used by other stakeholders such as peer bankers, international clientele', and a knowledgeable investor. Educating the importance of the utility of this kind of information is also a social obligation of the accounting profession. Hence, there is a definite case for fair value information in the financial statements in India in general and in the enterprises operating within the finance sector in particular. However, extreme caution should be exercised to decide the extent to which fair value should be applied in the preparation and presentation in the financial statements.

CONCLUSION

The time is ripe for a debate on the utility of fair value as a measuring tool of financial instruments and as a disclosure in the financial statements. In view of the wider significance and the extent of the reporting entities being effected by such information, a debate which involves all the sections may result in development of a standard which is suitable to Indian necessities and may also prove to be trend setter to the International standard setters.

'Acknowledgments and sources

The author expresses his acknowledgments for the summary of the recommendations made by the Joint Working Group.

The full text of the Joint working Group recommendations can be downloaded from the official web site of the International Accounting Standards Committee.