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Fair value measurement in the prospective orientation of contemporary financial reporting – Who needs it?

Abstract. *The purpose of this paper is to analyze the role of fair value measurement in contemporary financial reporting, the consequences it has for the quality of financial information, and to examine the real economy impact of the fair value option. In the first part of the paper, the author conducts theoretical studies of the elements of the prospective orientation of financial reporting and the role the fair value measurement plays in the realization of the financial reporting purpose. Reference to the traditional historical cost approach is made. In the second part, the author examines the consequences of the fair value option (FVO) for the real economy. In the author's opinion, it is likely that FVO implementation may force managers to more aggressive market behavior, which ultimately is not in favor of any stakeholder and, on the global scale, may easily destabilize markets.*

Keywords: *fair value, historical cost, financial reporting, fair value option, financial crisis*

Introduction

Introduction of fair value into the global practices of contemporary financial reporting triggered the reorientation of it from being retrospective to being prospective. It was a revolutionary change for market participants in all continental countries. At the initial stage of fair value measurement implementation the main stream of discussions among practitioners and accounting science representatives

regarded the methods of fair value measurement. Subsequently the impact of subjectivity within the fair value measurement was emphasized as a potential problem for faithful representation in accounting. However, in the author's opinion, the most significant problem resulting from the fair value implementation into financial reporting practices in a global perspective may arise from the impact it has over the real economy. There is little reference to it among researchers.

Prospective financial reporting addresses the informational needs of stakeholders, but on the other hand injects additional uncertainties to presented financial reporting, especially in the range of performance reporting. The purpose of this paper is to analyze how fair value implemented into measurement of assets and liabilities responds to variety of informational needs of stakeholders, what are the side effects of implementation of fair value option and makes an attempt to answer the question: who really needs fair value accounting?

1. Purpose and functions of financial reporting

The purpose of this paper is not to analyze variety of perspectives presented by different authors about the goals and roles of accounting in contemporary economic society. Hereby the author limits himself to the conclusion that the basic purpose of accounting is to provide to the wide range of stakeholders information they will find useful for making economic decisions.

Thus, the perspective of external stakeholders is taken in this paper. Going further, financial statement components provide information about **the risk and reward mix** specific for given reporting entity. This mix is presented in dedicated financial statement components in which information on **financial position** (balance sheet) and **performance** (profit and loss account and/or (comprehensive) income statement, statement of cash flow) is presented.

This general purpose can be broken down to several more detailed functions accounting fulfils from perspectives of specific stakeholders. The author focuses on two major functions accounting fulfils in a business entity which is perceived from the perspective of the contractual model of the business entity. The idea of the contractual model of business entity is pictured in Figure 1.

In this model different stakeholders are providing the business entity with resources required for its operation, and managers in response provide stakeholders with contractual rewards (like: price, interest, and other payments incl. dividend) and information on possible execution of these rewards whenever they are postponed in time (i.e. not payable in reasonably short time). Information plays a key role in this arrangement, as stakeholders are exposed to risk of not getting any benefits or getting them with delays. Financial information allows them to understand what benefits they can expect (shareholders) and what the credit

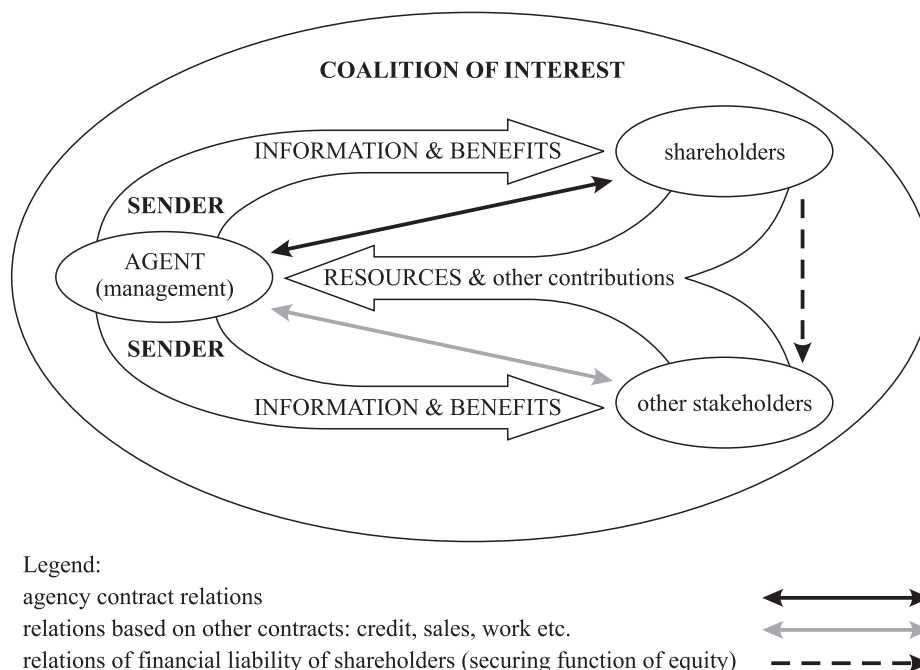


Figure 1. Contractual model of a business entity

Source: own study.

risk is, i.e. not being paid on time (other stakeholders). It represents the reward-risk mix specific for the reporting entity.

Both functions this paper is focusing on are based on performance reporting, thus are focused on “reward” part of financial information:

- settling accounts between entity and its shareholders through calculation of net financial result and distribution of dividends,
- analytical assessment of company performance performed by most of stakeholders, not only shareholders.

2. Retrospective orientation & historical cost concept

In traditional, continental accounting the reward-risk mix is perceived in the following way:

- performance representing reward – is measured on the basis and limited to achievements already accomplished with reservation of accrual accounting impact in which cash collection is not required to consider achievement done,

– financial position representing risk – is considering and limited to current status quo, where current means that only facts should be incorporated in financial information.

In retrospective accounting financial information is limited to facts which have one important characteristic: they belong to the past. Any judgment on future is to some degree a speculation which simply is not a fact. The dominating measurement concept is historical cost which is subsequently challenged by prudence principle. It doesn't change the fact that these judgements rely on historical facts only. Measurement of assets and performance is not influenced by gains resulting from favorable changes of assets market prices until they are realized, i.e. materialized in concluded transaction. Thus performance reporting is also limited to facts. Accrual basis of accounting could be considered a small exception from this fact oriented approach as the credit risk is clearly incorporated in reported performance. As a result performance is influenced only when market risk is fully transferred to counterparty in a transaction and contractual payment is going to be done with reasonable certainty. But it is not a subject of market risk anymore.

This approach is described as the transaction theory which stays in opposition to the value theory [Helin, Szymański 2001: 66-69], according to which market values and their positive changes are influencing performance of an entity and can be reflected in assets measurement. Value theory gives a ground to a wide use of fair value measurement.

3. Prospective orientation & fair value concept

Domination of capital markets as a main source of funding for business entities in Anglo-Saxon world had in a natural way resulted in prioritization of capital market participants as addressees of financial information ahead of other stakeholders. Consequently, the chase after any information that could potentially explain future performance begun. The turn into prospective financial reporting is noticeable directly in numerous obligatory positions of financial report. Among them the most important is wide use of fair value in assets (and liabilities) measurement. Although there are also other areas of prospective orientation of contemporary financial reporting, for instance:

- measurement of debt instruments at amortized cost using effective interest rate,
- high dependency of impairment measurement on future cash flows estimations,

- discounting of nominal values of long term receivables and liabilities, including provisions, down to present values,
- reporting on contingencies,
- wide range of qualitative, descriptive information disclosed in notes to financial statement, which are focused on future determinants of performance and financial position.

Thus, prospectively oriented financial reports focus on future performance which is a starting point for capital market games. These games are about incorporating expected future performance into current market valuation of company's shares. Market valuation of a company is hugely influenced by market's participants group perception of expected performance of companies. The historical data is important basically because it is a basis for formulated expectations as for the future (reward-risk mix) of these companies.

Most important element of prospective financial reports is an extensive use of fair value measurement. The intrinsic feature of fair value concept¹ is an assumption that the exchange price set by relevant method will be realized. Thus it puts another uncertainty element of assets measurement in the top of accrual accounting concept. Accrual accounting requires assumption that the price realized in a concluded transaction will be collected with reasonable certainty. The level of this certainty is subsequently challenged by prudence. With a fair value measurement adoption we put more uncertainty into reported performance, as it can be potentially disrupted not only by credit risk,² as it is in traditional accounting, but also by market risk, i.e. probability that actual transaction will be concluded at lower price that assumed in fair value. It must be noted that it is hard to determine the level of market risk incorporated in fair value, as it will differ depending on the actual methods used in this measurement. Thus, when market value is observed on active markets, the market risk is limited to probability of subsequent changes of market prices due to future circumstances. However, if market value is not observable on an active market, fair value is based on the assumptions on a potential transaction price, where in fact there is no transaction we could refer to. Fair value is then more a guess than a fact. Market risk is significantly increased in these circumstances, as not only the market can change, but our estimation as for the market price can be potentially incorrect.

Addressee of financial statements have very limited abilities to fairly assess and understand the level of market risk in fair value measures, as this risk is mitigated only by obligatory disclosures of fair value levels³ adopted by a company

¹ Fair value is not a single measurement method but rather a measurement concept representing the mix of methods among which the most relevant is chosen depending on availability of data.

² Credit risk refers to risk of not collecting payment due.

³ I.e. fair value hierarchy.

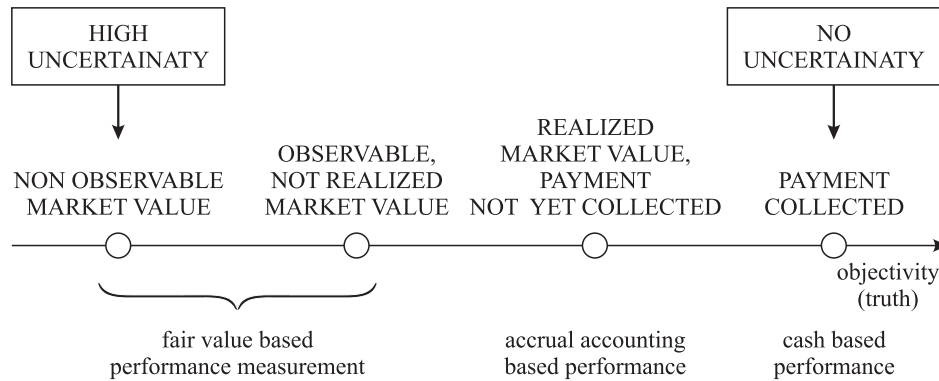


Figure 2. Level of objectivity in performance reporting under competitive accounting concepts

Source: own study.

into assets and liabilities measurement. And stakeholders have in practice limited abilities to incorporate all available information into their judgments. Influence of these concepts on performance reporting is illustrated by Figure 2.

Fair value measurement adoption into financial statements results in a reporting of potential performance, instead of factual, which is exposed not only to a credit risk, as in historical cost based and accrual accounting, but also to a market risk. In this reporting, the assumption is being made that the both risks are insignificant and both: market price and cash payment will be achieved with reasonable certainty.

It leads us to conclusion **that contemporary, prospectively oriented financial statements focus on future consequences of past management's decisions, whereas retrospective financial statements that used to be prepared under traditional continental accounting were focused on up to date consequences (facts) of management's past decisions.**

Contemporary global practice of financial reporting seems to be addicted to fair value. It is hard to imagine presentation of true and fair view of financial position and performance with limitations of historical cost today. Fair value is clearly a fruit of Anglo-Saxon accounting, where its impact over financial reporting practices was gradually increasing over the 2nd half of 20th century up the beginning of 21st century. Although current price based measurement of assets was present in the past of continental accounting as well, however it should be treated more like incident in a long history of historical cost [see Gawart 2012: 32].

4. Fair value option – value added for whom?

In 2005 International Accounting Standards Board (IASB) included FVO into IAS 39 allowing companies to elect any financial asset or liability to be measured at its fair value with the effects of revaluations to be reported directly in profit and loss account. The purpose of FVO was to limit volatility of reported earnings caused by mismatch of measurement methods of related financial assets and financial liabilities. In 2006 the first comprehensive and consistent regulation on the acceptable range of fair value measurement methods was set in the USA.⁴ Shortly after the FVO appeared in USA practice,⁵ and subsequently IASB issued its own regulation on fair value measurement which had a direct impact over European reporting practice.⁶ Since then the use of fair value is similarly extensive under both regulations: US Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS).

There is some evidence from practice confirming that FVO may fulfill its role as it was intended by standard setters [Fiechter 2011: 85-108]. It is considered relevant for financial institutions where the real mismatch appears and in which implementing the extensive hedge accounting rules⁷ seem to be not practical. On the other hand companies outside the financial sector do not involve fair value into measurement of assets other than financial or tangible investments. Thus companies representing non-financial sectors do not use it in significant scale and consequently it has not significant impact on the reward–risk mix information [see Hasik 2012: 65]. Whatsoever, we must assume that at least part of shareholders and probably most of other stakeholders present higher aversion to risk and as a consequence they are unlikely to accept additional risk resulting from fair value option adoption [see Mućko 2012: 92].

The timing of FVO introduction firstly into IFRSs and subsequently into US GAAPs is correlated with doubling of activity on global over-the-counter (OTC) derivative market. The total value of outstanding OTC derivative contracts has increased by 235% between 2007 and 2004, and gross value respectively by 174%. The growing tendency was maintained in subsequent years although the dynamic was much slower what is illustrated by Table 1.

⁴ Statement of Financial Accounting Standards (SFAS) No. 157, “Fair Value Measurements,” issued by FASB in September 2006.

⁵ SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities,” issued by FASB in February 2007.

⁶ IFRS 13, “Fair Value Measurement,” issued by IASB in May 2011.

⁷ Hedge accounting is the basic way to avoid mentioned mismatch of measurement methods of related financial assets and liabilities alternative to FVO.

Table 1. Historical statistics of global OTC derivative market between end-June 2004 and end-June 2014

[USD billion]	H1 2004	H1 2007	H2 2011	H2 2012	H1 2014
OTC foreign exchange contracts					
Notional amounts outstanding	31 500	57 604	63 381	67 358	74 782
Gross market value	1116	1612	2582	2313	1722
OTC commodity contracts					
Notional amounts outstanding	1354	8255	3091	2587	2206
Gross market value	176	690	481	347	269
Total OTC derivative contracts					
Notional amounts outstanding	220 070	516 411	647 811	635 685	691 492
Gross market value	6 391	11 145	27 307	24 953	17 423

Source: BIS, www.bis.org/statistics/derstats.htm [2.05.2015].

Noticeably, the gross value of outstanding commodity OTC derivatives jumped up 6 times over 2004 and 2007 to its historical peak, to deteriorate by 63% over next 3 years. The correlation with introduction of FVO and subsequent global financial crisis of 2008 is clear. The scale of these numbers becomes meaningful when put in the context global economy. It is pictorially depicted by comparison of global GDP, i.e. USD 74,7 trillion in 2013,⁸ to total gross value of OTC derivatives contracts outstanding⁹ stood at USD 18,8 trillion [BIS 2014], that is app. 25% of global GDP. Please note, that gross value of those contracts outstanding represent the market value of these contracts, which for the financial reporting purposes is carried into financial statement at fair values under both IFRS and US GAAP.

When the existing investment markets became too shallow for the global wealth searching for new investment opportunities, it turned into alternative profit making potentials: speculative transactions on both basic and derivative markets for basic commodities. Speculative capital involved in OTC markets became an important price driver of basic instruments, like commodities, including: oil, soya,

⁸ *World Economic Outlook Database*, International Monetary Fund, October 2014, <https://www.imf.org/external/pubs/ft/weo/2014/02/weodata/index.aspx> [1.05.2015].

⁹ Gross value of OTC contracts means its MtM valuation, not the nominal value of the contracts, which stood at USD 710 trillion as of year-end 2013, i.e. 9,1 times the global GDP: "The gross market value is calculated as the sum of the absolute value of gross positive market values and gross negative market values. The gross positive market value is the gain to derivatives dealers – and the gross negative market value the loss – if the dealers were to sell their outstanding contracts at market prices prevailing on the reporting date."

rapeseed, wheat, corn etc., responsible for increasing fluctuations of these commodities' prices in a short run and continuing growing tendency in a medium and long run [see Dybowski 2013: 19; Wysoczańska 2015]. It turned out to be very visible in 2008 when FAO global food price index nearly doubled within three years [Dybowski 2013: 18]. These are the basic goods responsible for cost of living of an average European citizen.

Obviously, the price drivers are multiple and complex. But it seems that introduction of fair value measurement and FVO into global financial reporting practice pushed financial institutions to more aggressive engagement in the multiple global markets, as the reward for both institutions and their managers was instant: the increase of market prices of assets held was on day-by-day basis reported in profit and loss account. Consequently shareholders were benefited with increases of share prices and managers with bonuses, which in turn pushed them for even more aggressive behavior. Instant reward from fair value measurement which appears before the sales transaction is concluded is potentially shortening the distance to speculative bubble creation. It was observed in 2008 when the financial crisis was announced as a consequence of too high risk acceptance and splash of speculative bubbles on several financial and non-financial markets. The only difference was, that this time financial institutions responsible for the financial crisis of 2008 refused to accept the consequences of their actions and pushed regulatory body for a change of rules when the game was on. The abolition implemented by IASB into IAS 39 in October 2008 allowed the holders of troublesome assets to reclassify them into available-for-sale category without any consequences and this way to save their profit and loss accounts their managers to save their bonuses.

Conclusions

Wide adoption of fair value measurement into financial reporting is clearly driven by strong influences of financial institutions. The use of it by companies operating outside of financial markets is marginal. It is one of the most important evidence of prospective orientation of contemporary financial reporting. Stakeholders gain useful prospective information, but on the other hand they could be easily misled by it, as the reported performance is subject to significant market risk. The implementation of FVO into contemporary financial reporting may potentially trigger more aggressive market behavior of managers, as they get the instant reward for their decisions even if consequences are not yet known. That, along with more loose relation of reported information to facts can potentially bring negative consequences to all stakeholders, including shareholders.

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Wycena wartości godziwej w kontekście prospektywnej orientacji współczesnej sprawozdawczości finansowej – komu jest ona potrzebna?

Streszczenie. Celem artykułu jest analiza roli pełnionej przez wycenę w wartości godziwej we współczesnej sprawozdawczości finansowej, wpływu wyceny w wartości godziwej na jakość informacji finansowej oraz wpływu opcji wyceny w wartości godziwej (*Fair Value Option*) na realną ekonomię. W pierwszej części artykułu zaprezentowana jest teoretyczna analiza elementów prospektywnej orientacji sprawozdawczości finansowej oraz roli wartości godziwej w realizacji celów sprawozdania finansowego. Analiza została przeprowadzona w odniesieniu do dwóch przeciwstawianych sobie koncepcji rachunkowości: tradycji rachunkowości kontynentalnej opartej na koszcie historycznym oraz tradycji rachunkowości anglosaskiej zorientowanej na wyceny bieżące, w szczególności według wartości godziwej. W drugiej części artykułu podjęto próbę analizy wpływu opcji wyceny w wartości godziwej na realną ekonomię. Istnieje duże prawdopodobieństwo, że przyjęcie opcji wyceny w wartości godziwej będzie skłaniało menadżerów instytucji finansowych

do podejmowania bardziej agresywnych decyzji finansowych, które nie są zgodne z interesem interesariuszy. Zachowania te mogą w skali globalnej gospodarki w istotny sposób przyczyniać się do destabilizacji rynków. Są przesłanki do stwierdzenia, że przyjęcie wartości godziwej przyczyniło się w pewien sposób do powstania kryzysu finansowego w roku 2008.

Słowa kluczowe: *wartość godziwa, koszt historyczny, sprawozdawczość finansowa, opcja wyceny w wartości godziwej, kryzys finansowy*