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A Study of Challenges and Prospects of Fair Value Accounting In India

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Abstract

Accounting data with high quality is an important symbol for actual reflection of accounting. For the past two decades, fair-value accounting—the practice of measuring assets and liabilities at estimates of their current values—has been on the ascent. This marks a major departure from the centuries-old tradition of keeping books at historical cost. It also has implications across the world of business, because the accounting basis—whether fair value or historical cost—affects investment choices and management decisions, with consequences for aggregate economic activity. Fair-value accounting is just the messenger and it wouldn't be wise to "shoot it down" just because the message it is bringing today is unpleasant. The purpose of this paper is to identify the meaning and need of fair value accounting. The paper holds importance as there is little awareness of the topic in Indian Context and this research will lead to awareness regarding the importance of fair value accounting. Therefore, this study has been taken with a view to examine the concept and importance of fair value accounting along with an overall objective of highlighting the challenges and future prospects of Fair Value Accounting in India.

Keywords: Fair Value, Market Value, FVA, FASB, Historical Cost, IFRS.

Introduction

Just as the independence of auditing is soul of auditing, the quality of accounting data is soul of accounting. Accounting data with high quality is an important symbol for actual reflection of accounting. There have been various opinions on whether introduction of fair value measurement in accounting practice can generate accounting data with high quality. Those who hold a supportive opinion believe that, as an artificial accounting information system, estimation and hypothesis are intrinsic in accounting, so measurement of fair value does not affect its reliability.

Reliability is just an issue of degree, and there does not exist any measurement attribute that is unexceptionable in terms of reliability. Those who oppose to the above opinion believe that, it is really extremely difficult for fair value to realize “fairness” since fair value is affected by external environment and artificial estimation. Especially, since 2008 when the financial crisis broke out, fair value has been faced up with unprecedented challenges. Those from banking and political circles hold the view in succession that fair value accounting standards are the “accomplice” of this crisis, and fair value measurement standards deteriorate the credit crisis. In the process of disputes, it can be said that attitudes towards fair value have been full of twists and turns. New Accounting Standards for Business Enterprises released on February 15, 2006, have almost made their last pitches, and we should boldly use fair value measurement to improve quality of accounting data.

History

In the 1800s in the U.S. marking to market was the usual practice of bookkeepers. This has been blamed for contributing to the frequent recessions up to the Great Depression and for the collapse of banks. The Securities and Exchange Commission told President Franklin Roosevelt that he should get rid of it, which he did in 1938. But in the 1980s the practice spread to major banks and corporations, and beginning in the 1990s mark-to-market accounting began to result in scandals.

As the practice of marking to market became more used by corporations and banks, some of them seem to have discovered that this was a tempting way to commit accounting fraud, especially when the market price could not be determined objectively (because there was no real day-to-day market available or the asset value was derived from other

traded commodities, such as crude oil futures), so assets were being "marked to model" in a hypothetical or synthetic manner using estimated valuations derived from financial modeling, and sometimes marked in a manipulative manner to achieve spurious valuations. The most infamous use of mark-to-market in this way was the Enron scandal.

After the Enron scandal, changes were made to the mark to market method by the Sarbanes–Oxley Act during 2002. The Act affected mark to market by forcing companies to implement stricter accounting standards. The stricter standards included more explicit financial reporting, stronger internal controls to prevent and identify fraud, and auditor independence. In addition, the Public Company Accounting Oversight Board (PCAOB) was created by the Securities and Exchange Commission (SEC) for the purpose of overseeing audits. The Sarbanes-Oxley Act also implemented harsher penalties for fraud, such as enhanced prison sentences and fines for committing fraud. Although the law was created to restore investor confidence, the cost of implementing the regulations caused many companies to avoid registering on stock exchanges in the United States.

Recently, IASB came out with IFRS 13, which suggests a uniform method of calculating Fair Value. FASB had also developed SFAS 157 which deals with Fair Value. In SFAS 157, FASB has provided single definition of Fair Value and prescribes a framework for performing fair value measurement using a three tiered hierarchy of inputs. IASB, working on its convergence programme, followed similar manner of defining and measuring Fair Value as provided in SFAS 157 and announce IFRS 13. IFRS 13 follows similar hierarchical structure in categorizing the inputs used in measurement of fair value. This is significant to note that India had converged its accounting standards with IAS/IFRS and will follow the same Accounting standards as prescribed by IASB. The three level hierarchical structures are as follows (IASB, 2013):

1. Level 1 input are Quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date.
2. Inputs other than quoted market prices included within level 1, that are still observable for the asset or liability, either directly or indirectly.
3. Unobservable inputs for the asset or liability – These are used to measure fair value to the extent that relevant observable inputs are not available.

Review of Literature

This paper relies on the literature review of current relevant articles focusing on accounting for fair value. A summary of some of the studies is given below:

Sun (2010) article decodes fair value measurement again from four aspects respectively. Fair value measurement attribute is for asset measurement in the end, a kind of initiative measurement from master-slave relationship. As a matter of fact, fair value measurement is a measurement process.

Swamy (2012) in the article highlights the areas in which Indian banking industry is required to focus before and after the implementation of Fair Value Accounting and their consequences on the financial statements of the Bank.

Ramanna (2013) article discusses the role of investment banking and investment management Industry veterans on the Financial Accounting Standards Board in the growth of fair-value accounting. It raises the possibility of special-interest capture of accounting regulation by segments of the financial-services industry.

Jain (2013) examines the degree of adoptability of Fair Value concept (as codified in IFRS) in Ind AS. It also provides insight on factors that can hinder the process of International Accounting Practices convergence in accounting practices followed in emerging economies with special reference to India.

Gunawardhana and Gunawardane (2014) in the research were aimed to analyze Challenges and Barriers of Adopting Fair Value Accounting for Real Estate Assets Valuation in Sri Lanka Public Listed Companies. To accomplish this purpose, three objectives were developed and to achieve the objectives eighteen (18) hypotheses were developed and tested.

Salwalqa (2016) the paper offers some creative suggestions that standard-setters (e.g. FASB and IASB), regulators, practitioners and academics should globally adopt to ensure a brighter future for fair value accounting. In addition, the paper provides a set of the necessary future research avenues in fair value and the related accounting standards.

Research Methodology

The present paper is of conceptual nature and purely based on information from secondary sources. For this purpose various articles on forensic accounting at national and international level, working papers, e-papers, and reports on newspapers are reviewed careful.

Objectives of the Study

With rapid development of Indian economy, whether accounting reflection corresponds to outside demands has gradually become a much-talked-about topic in the circle of accounting theory and practice. The central issue of accounting reflection rests with the quality of accounting data generated through accounting measurement. Therefore, this study has been taken with a view to examine the concept of fair value accounting along with an overall objective of highlighting the problems and prospects of Fair Value accounting in India. In view, the objectives of the paper are:

1. To examine the concept and significance of fair value as a tool accounting in India.
2. To address the challenges and prospects of fair value accounting.
3. To find out the measures a firm should take to address the challenges.

Fair Value Accounting

The idea of fair value accounting is not a new one and comes mainly to overcome the limitations of historical cost accounting. A long-

standing criticism of historical-cost accounting (HCA) is that, while it may provide good information about things that already have happened, it may not tell us much about what has happened in the recent past or what is likely to happen in the future. For the past two decades, fair value accounting—the practice of measuring assets and liabilities at estimates of their current value—has been on the ascent. This marks a major departure from the centuries-old tradition of keeping books at historical cost. It also has implications across the world of business, because the accounting basis—whether fair value or historical cost—affects investment choices and management decisions, with consequences for aggregate economic activity. The main purpose of fair value accounting is to identify the actual market value of an asset or liability at the measurement date and to overcome the limitations of historical cost accounting in measuring the actual value of an asset or liability subsequent to acquisition date, especially in case of impairment. That is, fair value accounting comes to give a fair value to entity under current market conditions.

The argument for fair value accounting is that it makes accounting information more relevant. However, historical cost accounting is considered more conservative and reliable. Fair value accounting was blamed for some dubious practices in the period leading up to the Wall Street crash of 1929, and was virtually banned by the U.S. Securities and Exchange Commission from the 1930s through the 1970s. The 2008 financial crisis brought it under fire again. Some scholars and practitioners have connected its proliferation in accounting-based performance metrics to the actions of bankers and other managers during the run-up to the crisis. Specifically, as asset prices rose through 2008, the fair value gains on certain securitized assets held by financial institutions were recognized as net income, and thus sometimes used to calculate executive bonuses. And after asset prices began falling, many financial executives blamed fair value markdowns for accelerating the decline.

Thus, it can be argued that fair value accounting is now an important dominant system used to a considerable extent by listed companies in all over the world and created a lot of controversy and debate among interested parties due to existence of some difficulties in its implementation process, especially as a balance sheet measure and due to its supposed role in the international financial crisis of 2007-2009.

Yet both Generally Accepted Accounting Principles in the United States and International Financial Reporting Standards, adopted by nearly 100 countries worldwide, continue to use fair value extensively—for example, in accounts concerning derivatives and hedges, employee stock options, financial assets, and goodwill impairment testing. One explanation for the rise of fair value accounting is that finance theory—in particular, the idea that financial markets are efficient and their prevailing prices are reliable measures of value—permeated academic accounting research in the 1980s and 1990s, thus changing opinions on the relative merits of historical cost and fair value. In accounting and in most Schools of economic thought, fair value is a rational and unbiased estimate of the potential market price of a good, service, or asset.

Fair Value Vs Market Value

The latest edition of International Valuation Standards (IVS 2017), clearly distinguishes between fair value (now referred to as "equitable value"), as defined in the IVS, and market value, as defined in the IVS:

So as the term is generally used, Fair Value can be clearly distinguished from Market Value. It requires the assessment of the price that is fair between two specific parties taking into account the respective advantages or disadvantages that each will gain from the transaction. Although Market Value may meet these criteria, this is not necessarily always the case. Fair Value is frequently used when undertaking due diligence in corporate transactions, where particular synergies between the two parties may mean that the price that is fair between them is higher than the price that might be obtainable on the wider market. In other words Special Value may be generated. Market Value requires this element of Special Value to be disregarded, but it forms part of the assessment of Fair Value.

Fair Value Accounting Pros and Cons

There are a few different financial reporting approaches that a businessman can choose today. One of them is the fair value accounting method. It allows for the measurement and reporting of liabilities and assets on their estimated or actual fair market price. As there are changes to asset liability over time, so there can be unrealized gains or losses in assets that are held by a businessman. Fai Value Accounting method can help to measure and chart those gains. The move toward fair value accounting has engendered intense debate. Both supporters and detractors of fair value accounting have been equally vocal in airing their views. The major advantages of fair value accounting are as follows:

Advantages of Fair Value Accounting

Reflects Current Information

Fair value accounting reflects current information regarding the value of assets and liabilities on the balance sheet. This method of accounting helps to provide more accuracy when it comes to current valuations. If prices are expected to increase or decrease, then the valuation can do the same. The current market prices allow individuals or businesses to know exactly where they stand. By reflecting more current information, fair value accounting is argued to be more relevant for decision making.

Consistent Standard of Accounting

Instead of the historical cost value that isn't always accurate after a long period of time, fair value accounting accurately tracks all types of assets. At present, financial accounting follows a mish-mash of approaches that is termed the mixed attribute model. For example, fixed assets such as land and building are measured using historical cost, but financial assets such as marketable securities are recorded at current market prices. Even for the same item, inconsistent criteria are used because of

conservatism. Under fair value accounting, it is hoped that all assets and liabilities will be measured using a consistent and conceptually appealing criterion.

Comparability

Because of consistency in the manner in which assets and liabilities are measured, it is argued that fair value accounting will improve comparability. It will help in making a comparison of financial statements of different firms.

No Conservative Bias

Fair value accounting helps in eliminating the conservative bias that currently exists in accounting. By eliminating conservatism the reliability is expected to improve because of neutrality, which is, reporting information without any bias.

Measurement of True Income

Under fair value accounting method, there is less opportunity to manipulate accounting data. Instead of using the sale of assets to affect gains or losses, the price changes are simply tracked based on the actual or estimated value. The changes to income happen with the changes to the asset value.

Survival in a difficult economy

In the traditional method, the same value goes of an asset on the budget line every year. When there's a difficult economy and prices are reduced, it become a cumbersome financial burden. Fair value accounting allows for asset reductions within that market so that a businessman can have a fighting chance.

Disadvantages of Fair Value Accounting

Large swings of value

In volatile markets, an item's value can change quite frequently. This leads to major swings in a company's value and earnings. So it can be concluded that there are some businesses that do not benefit from this method of accounting at all. These businesses typically have assets that fluctuate in value in large amounts frequently throughout the year. Additionally, the potential for inaccurate valuations can lead to audit problems.

Less Reliable

The major criticism against fair value accounting is that it is less reliable because it often lacks objectivity. This issue is crucially linked to the type of inputs that are used. While nobody can question the objectivity of Level 1 inputs, the same cannot be said about Level 3 inputs. Level 3 inputs are unobservable and based on assumptions made by managers. Many fear that the extensive use of Level 3 inputs will lower the reliability of financial statement information.

Frequent changes in Book Value

Historically, a company's book value changed when a company purchased new assets and/or disposed of old assets. Fair value accounting now changes a company's book value for seemingly arbitrary issues. Businesses with specialized assets or investment packages may find it difficult to value these items on the open market.

Reduce Investor's Satisfaction

There are many academics and practitioners who prefer conservative accounting. The two main advantages of conservatism are:

1. It naturally offsets the optimistic bias on the part of management to report higher income or higher net assets.
2. It is important for credit analysis and debt contracting because creditors prefer financial statements that highlight downside risk.

The fair value model which purports to be unbiased will cause financial statements to be prepared aggressively, therefore reducing its usefulness to creditors, who are one of the most important set of users of financial information.

Excessive Income Volatility

One of the most serious concerns from adopting the fair value model is that of excessive income volatility. As we noted earlier, under the fair value accounting model income is simply the net change in value of assets and liabilities. Changes in fair values of assets can cause reported income to become excessively volatile. Much of this volatility is attributable to swings in the fair value of assets and liabilities rather than changes in the underlying profitability of the business's operations, so it is feared that income will become less useful for analysis.

Loses the Historical Perspective

Although current accounting is important to measure, there must also be a general sense of what has happened historically for accuracy in tracking results. If market price for a given asset is not available in the active market, fair value estimate that is supposed to provide the most reliable information is more difficult to obtain.

Susceptibility to Manipulation

It is possible that sometimes the observed value of an asset in the market is not indicative of the asset's fundamental value. Market might be inefficient and not reflect in its estimates all publicly available information. There are also other factors that could cause that this market estimate to be deviated such as investor irrationality, behavioral bias or problems with arbitrage among others. This would considerably increase the ability of managers to manipulate financial statements. Again, this issue is closely linked to the use of Level 3 inputs because Level 3 inputs are less objective.

The fair value accounting pros and cons show that for the most part, businesses can have a transparent and accurate method of tracking profit and loss. As long as investors are kept in the loop and know what is going on, the benefits will typically outweigh the risks in this matter.

Recommendations

Despite all the above mentioned limitations, the fair value accounting could be a promising system. In order to provide more relevant information to financial statement users, fair value information should be reported for all financial assets and liabilities. It has been noted from the above discussion that only level 1 of fair value hierarchy can measure the fair value of the asset or liability in a reliable way. Thus, most of the limitations of fair value accounting are centered in level 2 and particularly in level 3. Based on this fact, the current study offers following recommendation:

1. Firstly, the accounting authority should revise the accounting law and accounting standards to complement and update the contents of regulations and standards related to fair value.
2. The transparency of accounting information need to be enhanced by disclosing any uncertainty in the accuracy of the fair value of an element along with all procedures that have employed to validate such value, whether from the entity itself or by the auditors, especially in case of level 3 of fair value hierarchy
3. To work in close co-operation with users and preparers of financial statements to further consider the practicality of the proposals and to demonstrate or refute the relative merits of fair value and historic cost based reporting of financial statements for users' analysis purposes.
4. The global business environment should be improved to make it more appropriate for the active market. This can be achieved by helping emerging markets to rearrange their markets to be more liberal.
5. The current international accounting standards should be amended to make them easier for implementation. This will remove the current ambiguity in some standards where fair value accounting becomes an integral part of these standards.
6. Fair value accounting should be taken as a core course in all universities in all over the world with international accounting standard (IFRS/IAS) as a prerequisite course for it.
7. There is a need to offer all the necessary training needs in fair value accounting and the related standards to all the interested parties (e.g. accountants and auditors). This mission can be arranged and performed by standard-setters, who have the ability to offer and explain any ambiguous issues in different standards.
8. It is also feared in the Indian Corporate sector that adoption of concept of Fair Value may reduce the value of assets held by these firms. An awareness programme should be carried by the Standard setters to remove this misunderstanding.

Summarily, infrastructure to support understanding, provide oversight, enforcing proper application of the concept, providing training & awareness programme are some of the essential elements for successful implementation of Fair Value Accounting.

Conclusion

The concept of Fair Value is here to stay. Despite all its cons, the standards setters and practitioners are embracing the concept. There may be valid arguments coming from those opposed to fair value accounting, but the reality is that fair value reporting is here to stay in one form or another, and will be further expanded. The FASB is to moving incrementally toward fair market value, if for no other reason than to enhance comparability with international standards. As the difference between U.S. GAAP and international standards continues to narrow, the use of fair value is likely to continue its expansion.

The issues surrounding fair value accounting are numerous and many powerful forces are opposed to its implementation. It is quite obvious and clear that this concept is far from being perfect. It is very difficult to determine whether its contribution to the improvement of accounting is really beneficial. On the one hand there are many reasons why the users of this method are better off, but on the other hand there are also several reasons why they are worse off. In fact, both extreme positions are wide of the mark. FVA is neither perfect nor pernicious in its own right. There are many difficult conceptual and practical issues surrounding FVA that remain to be resolved. In the meantime, all concerned parties should learn more about FVA and work toward a more effective implementation. Fair-value accounting is just the messenger and it wouldn't be wise to "shoot it down" just because the message it is bringing today is unpleasant.

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