Fair Value Accounting – Relevance, Reliability and Progress in Malaysia

Ting Yieng Sing,
University College Sedaya International

&

Soo Choon Meng,
Alan Yoon Associates, Chartered Accountants

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Abstract

The primary qualities of accounting information are relevance and reliability, the two criteria to enhance the usefulness of financial report. Fair Value Accounting (FVA), thus, fair value measurements have placed greater function in financial statements because this information is perceived as more relevant to investors and creditors than historical cost information. However, the difficult question for implementing FVA is the reliability of fair-value estimates. Reliability concerns are particularly serious for instruments that are not market traded, since the management is the one that evaluate them. Malaysia has adopted FRS 139 Financial Instruments – Recognition and Measurements in the progress of these arguments.

***Key words**:* relevance, reliability, fair value measurements.

1. Introduction

For many-many years, companies have firmly established the practice of "closing" company ledgers each year and producing annual balance sheets and income statements according to accounting periodicity. In conventional accounting, accountants learn the concept of historical cost accounting, the traditional system that based on double-entry book-keeping and reporting transactions at the amount paid or liable. Accountants only recognized gains and losses when actually realized. The matching principle underlies the historical cost method, where expenses are offset against the revenues they support. This strong accounting principle held the faith of accountants for decades. Today, investors, financial analysts, shareholders, creditors, employees, and communities, nevertheless, believe that historical cost financial statements have lost their value relevance and a good way out may be Fair Vale Accounting (FVA),

2. Fair Value

The purpose of financial statements is to report useful information to the users. But how greatly is the basic usefulness of the financial statements can move with the rapid growth of a dynamic economy? For how long the users of corporate financial information have to wait for the accounting standards to completely emerge with a good fair value assessment to evaluate the performance or the creditworthiness of a company?

Under GAAP[1], the fair value of an asset is the price of which that asset could be bought or sold in a current transaction between marketplace participants in the reference market, other than in a liquidation. On the other side of the balance sheet, the fair value of a liability is the price at which that liability could be incurred or paid to transfer a liability in a current transaction between marketplace participants in the reference market, other than in liquidation.

If available, a referenced market price in an active market is the best confirmation of fair value and should be used as the basis for the measurement. Unfortunately, in many circumstances, referenced market prices are unavailable. As such, difficulties occur when making estimates of fair value. The defect is whether an estimate of fair value is or is not using the best information available in the circumstances.

The guidance of fair value measurements that currently exists has evolved piecemeal over time. The guidance is dispersed among the many pronouncements that required fair value measurements, and differences in the guidance have probably created inconsistencies and added complexity to the GAAP.

[1] Fair Value Measurements, Statement of Financial Accounting Standards No. 15X, Financial Accounting Series, October 21, 2005 Working Draft, Financial Accounting Standards Board of the Financial Accounting Foundation

3. Why continue to argue and using fair value accounting now?

We are all well aware of the many instances where derivatives trading have contributed to the severe losses incurred by large and established companies, much to the horror and surprise of investors and other users of financial statements. In 1994, example Procter & Gamble lost USD157 million resulting from their unsuccessful use of swaptions i.e. options that relate to interest rate swaps. The company recognized the losses and disclosed the facts only when the transaction was closed.

According to Lynn Brewer, the whistle-blower of Enron's case, the US Securities and Exchange Commission (SEC) currently receives some 400,000 whistle-blowing reports every month. Numerous happenings exist that have created an urgent need for better guidance on estimating fair values and auditing those estimates, including:

- The economy has become more high-tech and service oriented and, thus, the need for reliable fair value amounts is becoming progressively more important;
- The practitioners and certain other regulators have seen and continue to see problems that are attached to unreliable estimates of fair value;
- Over the years, standard setters have required measuring assets and liabilities at fair value without providing detailed "how to" valuation and auditing guidance for estimating those fair values; and,
- various accounting projects are underway that would require more assets and liabilities to be measured at fair value.

In light of these conditions, there is no time like the present to quicker execute more guidelines for fair value measurements instead of keep standing at the step of "moving forward".

Robert H. Herz, chairman of the Financial Accounting Standards Board has strong opinions about what is wrong with accounting and financial reporting in the United States. "Accounting has historically not defined income as change in wealth, or change in net worth or value," he explains. "It has defined it by thousands and thousands of conventions that measure allocations of historical costs." In other words, accounting hasn't really defined income." These "pure accounting fantasies," Herz declares, have helped create "a basic schism in U.S. industry" between company management and investors. He believes CFOs and CEOs--and current accounting methods focus on meeting annual budgets and reporting those financial metrics that they control and for which they are held accountable.

Is there anything wrong with that practice? Unfortunately, that is a very imperfect application for people who invest in companies. Investors also want to know what the impacts of external events on companies' value are. Without doubt, the concept of fair value is far from problem-free. While any accounting board has long believed in fair value, years will pass before that belief becomes practice. As long as they have a strong advocate of fair value at its helm, it is high time the process was accelerated.

3. Relevance and Reliability

Is fair value relevant? In today's dynamic and volatile markets, whether it is to buy or sell, what people want to know is what an asset is worth today. Fair value measurements provide more transparency than historical cost based measurements. Maybe, if companies had measured all financial instruments at fair value, regulators, shareholder, and investors could have achieved greater regulatory and market discipline and avoided some of the losses that investors and taxpayers have had to pay during previous downturns in the economy.

Accountants presently use a wide array of accrual and deferral methods in preparing financial statements. Those methods are essentially mathematical calculation even to a minute cent to get the precision. Nevertheless, Robert R. Sterling notes: Accountants who continue to seek more precision are to be admired and encouraged. However, those who seek absolute precision might be instructed by considering what has been learned in the so-called "exact" sciences. Einstein…drew a sharp and clear distinction between the certainty of calculation and the uncertainty of representations of phenomena: "As far as the laws of mathematics refer to reality, they are not certain; and as far as they are certain, they do not refer to reality." The same is true for accounting: as far as mathematical methods used in accounting refer to reality, they are not certain; as far as they are certain, they do not refer to reality.[2]

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[2] Robert R. Sterling, *An Essay on Recognition* (1985), p.28. Depreciation accounting is an example. But would those measures faithfully represent the economic importance of the asset and its depreciation during the period? Such precision in the depreciation accounting is not open to question (reliability does not imply precision), but the relevance and reliability of those measures is open to question.

Preparers must be concentrating on adjustment of overall economic value when measuring economic growth and productivity. In practical terms, that generally means reporting the fair value of –or marking to market—assets and liabilities whenever it can be reliably determined. Due to the whole attraction of market value accounting, many balance sheets items already are carried at fair value, and some, such as property, plant, and equipment, probably should be. It is hard to argue with the theoretical qualities of fair value as the most relevant measurement attribute. But to those who say that accounting should better reflect true economic essence, fair value, rather than historical cost, would generally seem to be the better measure.

The relevance and reliability of fair value also defending by criticizing that historic cost numbers "are reliable and relevant only on the day they are recorded." Bear in mind that in the fair-value debate, each side agrees both qualities are important, but fair-value supporters emphasize relevance, while historical-cost supporters place greater weight on reliability. Reliability is as important as relevance because relevant information that is not reliable is useless to an investor. Reliability, therefore, should not be the dominant characteristics of financial statement and at least have an equal standing with relevance.

Nonetheless, relevance and reliability of fair value measures is often held back with difficulty for publicly traded companies whereby some might require to disclosing hundreds, if not thousands, of valuation assumptions and how they were derived. In addition, there is also a trouble in the possibility of underlining total company value at the expense of measuring management performance.

The other unspoken argument against fair value is that regularly measuring the effect of market movements on a company's assets and liabilities can introduce huge volatility into financial statements. Fair-value proponents, by contrast, believe volatility may be the price of investor confidence.

In order to create fair value accounting to have reliable information for decision-making, markets has to be transparent for all assets and liabilities. However, because many assets and liabilities do not have an active market, the methods for estimating their fair value are more subjective and, therefore, the valuations less reliable. If this is the case, the concept, measurement and interpretation of fair value accounting will remain highly discussed till to-date but poorly understood on how the measurement can be set.

Another issue that adds to our concerns about reliability is the management integrity in the judgment of the valuation process. Management bias, whether intentional or unintentional, may result in inappropriate fair value measurements and misstatements of earnings and equity capital. The possibility for management bias exists today. We continue to see news stories about how management communicates with shareholders by obscuring the facts instead of demonstrating the full transparency, even under the historical cost accounting framework. Ultimately, without reliable fair value estimates, the potential for misstatements in financial statements prepared using fair value measurements will be even greater.

4. Fair Value Measurements and its Caveats

Do investors want financial instruments to be measured based on fair value or historical cost? Many accounting papers or standard setters have investigated the survey and the results were to use mixture of both. The investors want fair value information so as to better determine the true value of their investment. At the same time, they also wish to see the historical results that provide a measure of cash flows and indicate whether management has achieved operating results that were budgeted or predicted. This kind of thinking in other common circumstances always create a dilemma and desirous to keep all preference, and at the same time left the accounting professionals to bother the rest. We believed that investors fancy fair value information, but not necessarily at the cost of abandoning historical cost information. If this is the case, investors need to be educated on what measuring instruments at fair value means in the context of financial reporting.

Following the footsteps of the Financial Accounting Standard Board and the International Accounting Standard Board, the CICA's Canadian Accounting Standard Board recently proposed new recognition and measurement rules for financial instruments (proposed sections 3855 and 3865 of the CICA Handbook).[3]

[3] Internet: http://www.acsbcanada.org/index.cfm/ci_id/1580/la_id/1.htm stated that on April 1, 2005, the Accounting Standards Board (AcSB) issued the following new Handbook Sections:

- Section 3855, Financial Instruments – Recognition and Measurement; and
- Section 3865, Hedges

While the proposed standards will maintain historical cost accounting for some securities held-to-maturity securities, loans and receivables and most financial liabilities, it will impose measurement for securities held for trading speculative purposes, securities that are deemed "available-for-sale," and all derivatives.

The measurement of financial instruments has attracted extensive interest from the academic community, especially its reliability for purposes of financial reporting and its relevance for investors. Evidence from earlier research suggests that reliable and relevant measures can be obtained, but important caveats do apply. We now review such evidence.

Value relevance jointly involves both relevance for investor's decision-making and reliability of measurement. However, to assess value relevance, one must first determine how accounting information records, or is reflected, in stock prices. A widely used valuation model, the balance-sheet valuation model, is based on the accounting equation. In this model, the market value of a stock equity is assumed to be explained by the sum of the book values of the firm's individual assets and liabilities. The model can be expressed algebraically.

$$\textbf{Market Value Equity}_t = \__1\textbf{book value assets}_t - \__2\textbf{book value liabilities}_t + \__t$$

$$\textbf{MV}_t = \__1\boldsymbol{BV}\textbf{ financial instruments}_t + \__2\boldsymbol{BV}\textbf{ other assets} - \__3\boldsymbol{BV}\textbf{ other liab}_t + \__4\boldsymbol{FV}\textbf{ financial instruments} + \__t$$

Where,

MV_t = market value of shareholders' equity in year t

BV financial instruments$_t$ = book value of financial instruments in year t

BV other assets = book value of other assets

BV other liab$_t$ = book value of other liabilities in year t

FV financial instruments = fair value of financial instruments

In this model, e is the portion of firm value that is not explained by the model, often akin to goodwill. When examining research questions concerned with supplementary fair-value disclosures, the model is transformed to isolate the book value of financial instruments from the book value of other assets and liabilities. Supplementary fair-value disclosure variables are also added to the model.

The fair value of financial instruments shows incremental value relevance, over and above their recorded book value, if ß4 is different from zero in the second equation. For example, assume that a firm' financial instruments have a book value of $0 but a fair value of $1,000. If investors rely on fair-value disclosure on a one-to-one basis, we then expect ß4 to be equal to one. That implies that $1,000 worth of financial instruments translates into $1,000 of stock market valuation for the firm. This model ignores income statement information, which is hardly consistent with real-life observations. Combining both balance sheet and income statement numbers in the valuation model captures both the current value of the firm i.e. information from balance sheet and its growth prospects i.e. information from income statement.

After statistically estimating a valuation model similar to the second equation, researchers usually interpret the failure to provide evidence of value relevance as a lack of reliability. The lack of relevance could also be due to the use of an inappropriate valuation model for the company, to several statistical issues presenting a challenge when estimating valuation models on data, or to the oversight of other relevant variables from the valuation model.

Having augur well that fair-value estimates of financial instruments obtained or computed by management are value relevant, does this directly imply that standard-setters should adopt fair-value measurement, thus FVA?

The first shortcoming of FVA relates to the lack of conclusion with respect to the connection of a cause-effect relationship. Did the market use accounting information released to calculate company value or did it use information from other sources? If the accounting information reflects the information used by the market in valuing the company, both the market data and the accounting information may appear correlated, even though market participants may not have used the accounting information at all. If there are alternate sources for this information, should company report information again that is already reflected in prices? These questions are the purpose of much debate between academics. After all, it is pretty clear that the world is looking beyond the balance sheet.

The second shortcoming relates to the ad-hoc kind of the valuation models used whereby no valuation model is perfectly representative of an investors' valuation model. All are at best an approximation of an investor's true model, and their performance will vary depending on the empirical setting examined. Moreover, the models hold under any accounting policies chosen by the company, somewhat reducing their usefulness in sorting out accounting alternatives. As long as the accounting policies chosen by the company produce numbers that can be systematically related to the market value of equity, the valuation models' parameters i.e. the regression coefficients will adjust upward or downward as needed. This greatly complicates the interpretation of any regression results about the relevance of accounting numbers. While recognizing the limitations imposed, researchers and standard-setters alike are aware of these limitations and properly control for them when interpreting their results.

Third, value relevance research ignores other potential users of financial statements, such as lenders, employees, suppliers, etc. Financial statements are prepared for a general purpose audience, and should debatably serve all users. There is currently little proof with respect to the relevance of fair values to other groups of users. Still, equity investors are important users of financial statements, and while their needs should probably not be the only concern of the standard setters, they also cannot be ignored.

5. Fair Value Era and the Progress in Malaysia

According to Financial Accounting Standards Board (FASB), some 800 public companies in US already use fair value. However, for years beginning after June 15, 2005, all public companies--other than small businesses--must do so. And all other public and private companies will use fair value for years beginning after Dec. 15, 2005.

Many accounting papers have investigated the empirical relationship between stock market values and particular accounting numbers over the last decade. However, most of the studies have focused on the Western and developed countries. There are also some findings[4] related to value relevance research in Malaysia.

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[4] Research: Muhd Kamil Ibrahim, Raudah Danila, Haslinda Yuoff nd Normahiran Yatim (2001), *Investors, Market Value and Accounting Numbers*, e-Jurnal & Artikel, 7 Nov 2005, UiTM Muhd Kamil Ibrahim, Mahasuria Idris, Khairul Anuar Kamarudin and Wan Adibah Wan Ismail (2004a), *Terrorist Attacks and Wars: Responsiveness of Accounting Numbers*, IRDC Research Report, Universiti Tecknologi MARA, Shah Alam, Selangor D.E.

Those researches examined the association between the book value of equity and the value placed on the firm by the stock market in Malaysia based on the premise that a primary focus of financial statements is equity investment. The primary purpose for conducting tests of value relevance is to extend our knowledge regarding the relevance and reliability of accounting numbers as reflected in equity values. Further, given the regulatory changes now under way in Malaysia, the findings of these researches should be important for those involve in the setting and monitoring of standards as well as the accounting conceptual framework.

As a way forward, the Malaysian market cannot afford to ignore these developments in financial reporting. If we ignore fair value accounting it would mean that Malaysia is moving backwards in financial reporting. "For many accountants, some of the new standards are completely alien to them such as the fair value concepts. Often participants in the MASB working groups are themselves just learning about the standards and cannot therefore fully participate with feedback on possible implementation issues. Only when you implement a standard do you understand the full implication." Says Faiz Azmi, Partner, PricewaterhouseCoopers in his interview with *Accountants Today* in March 2005.

It is very pleased to note that the Malaysian Accounting Standards Board (MASB) and the accounting profession are examining these issues and have taken a pragmatic approach in recognizing that there are issues to be resolved and have, therefore, wisely elected to adopt fair value accounting in phases. After a lengthy deliberation, Malaysia has finally adopted the financial instruments IAS 39, one of the most complex standards issued to date by the world body, the International Accounting Standards Board (IASB).

The adoption follows the approval recently by the MASB on August 2005 of IAS 39, known as FRS 139 in Malaysia. MASB Chairman, Dato' Zainal Abidin Putih, says FRS 139 is likely to change the way companies account for financial instruments and will involve changes to systems, processes and documentation. For instance, classification of assets required under the standard will determine how companies value an asset, whether at fair value or other measurement. MASB encourages companies to get ready for FRS 139's implementation on 1 January 2006. Under the new disclosure requirement of fair value reports, management will have to communicate to investors the judgments of their assessments.

The next hierarchy challenge, whether like it or not, would be the need to train staff and develop the necessary in-house skills to implement the standard in order to reassess current strategies and transactions against international financial reporting requirements. This is certainly not an easy route, like on-size-fits-all governance, convergence will drives up costs since systems need to be modified and people adequately trained for full implementation.

While the standard setters pushes forward with its framework, perhaps also challenge the investors to get involve, as their voices are the one that counts. Other than that, efforts to educate the preparers, auditors, and users of financial statements on fair value estimates are important too. Instead of waiting the members of profession to be in practice, educational curriculum need to be modified to more effectively teach valuation techniques, the meaning of fair value, and how financial instruments work.

6. Conclusions

The current economy has required greater use of fair value measurements in financial statements because it perceives that information as more relevant to investors than historical cost information. Relevance and reliability should carry the same weight for financial statement measures. Such measures better reflect the present financial status of reporting companies and better facilitate assessing the past performance and future prospects of the companies. In that regard, the view that reliability should outweigh relevance for financial statement measures should not be accept.

As a summary, only one model should exist for measuring financial instruments. That model refers to fair value. Measuring financial instruments at fair value does not necessarily mean abandoning historical cost information. Fair value measurements should be reliable and worked out in a manner that is faithful to the causal economics of the transaction.

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The fair value is more relevant, but is not necessarily reliable. Selling the same item at different auctions will lead to a wide range of winning bids for the same item, and even professional appraisers will value an asset at a range of prices instead of a set value.Â The reliability vs. relevance debate centers on one of the key issues in financial reporting and one of the major transitions currently underway in GAAP: the transition from historical cost to fair value accounting. Currently accountants in the U.S. are not allowed to write up the value of an asset to the market or fair value, but accountants are required to write down an asset when an asset is materially impaired in any way. The application of fair value accounting causes a lot of controversy related to the relevance and reliability of fair value information. It is believed that the extent to which fair value measurement is used reflects attitudes of financial statement preparers about the usefulness of this model at its best. The findings of this study suggest that most companies in Bosnia and Herzegovina do not have tendency to apply fair value accounting. It is found that half of the companies in the sample do not use fair value accounting at all. Almost half of the companies that use fair value accounting use We directly test the reliability and relevance of investee fair values reported by listed private equity funds (LPEs). In our setting, disaggregated fair value measurements are observable for fundsâ€™ investees; and investee accounting fundamentals are also publicly disclosed. We find that LPE fair value measurements reflect equity book value and net income in a manner consistent with stock market pricing of listed companies. Most studies of fair value accounting focus on the financial industry (banks, insurance companies, and other financial institutions) because fair value assets are more prevalent and important there. According to data obtained from the Standard & Poorâ€™s Compustat database, the proportion of fair value assets to total assets of exchange-listed firms grew from 18.8% in 2008 to 20.3% in 2013.Â In addition, given the highly leveraged situation of financial institutions, the size of level 3 assets relative to their common equity is quite large. This ratio is 10.5% for financial companies, which implies that the gains and losses from fair value changes in level 3 assets (hereafter, â€œlevel 3 gainsâ€) are likely to have a significant effect on net earnings. The relevance and reliability of fair value also defending by criticizing that historic cost numbers â€œare reliable and relevant only on the day they are recorded.â€ Bear in mind that in the fair-value debate, each side agrees both qualities are important, but fair-value supporters emphasize relevance, while historical-cost supporters place greater weight on reliability. Reliability is as important as relevance because relevant information that is not reliable is useless to an investor.Â 5. Fair Value Era and the Progress in Malaysia. According to Financial Accounting Standards Board (FASB), some 800 public companies in US already use fair value. However, for years beginning after June 15, 2005, all public companies--other than small businesses--must do so.