

Fair Value Accounting: Its Impacts on Financial Reporting and How It Can Be Enhanced to Provide More Clarity and Reliability of Information for Users of Financial Statements

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Abstract

The author begins the paper with a brief historical development of the Statement of Financial Accounting Standards (FAS 157) and its impact on fair value accounting. This is followed by the methodology employed in the research. Next, he reviews the literature on major issues in fair value accounting and financial reporting, and presents his findings from the study. The researcher ends the paper with recommendations to enhance the usefulness of fair value accounting and draws implications for financial reporting and users of financial statements.

Keywords: Fair Value, Measurement, Financial Instruments, Market

1. INTRODUCTION

In December of 2001, accounting standard-setters around the world published a consultation paper (Financial instruments and similar items) that proposes fundamental changes to the way financial instruments are reported in the accounts of companies. In particular, the paper proposes, *inter alia*, that all financial instruments should be measured at fair value. The banking sector has long argued that such an approach is not appropriate for banks and that, to the extent that there are weaknesses in the way that banks currently account for their financial instruments, those ills are better addressed through incremental, than fundamental, change (Ebling, 2001). The Financial Instruments Joint Working Party of standard setters (JWP) main proposal are that: (a) all types of entity should measure all their financial instruments at fair value, and should recognize all changes in those fair values immediately in the profit and loss account; (b) the fair value of an instrument should be its estimated market exit price; (c) no exceptions should be made for financial instruments used in hedging arrangements (i.e. there should be no hedge accounting for financial instruments (Bies, 2005)).

In other words, a financial asset for which an active market exists should be carried in the balance sheet at its market bid price and changes in that bid price should be recognized immediately in the profit and loss account. This would be the case regardless of the reason why the instrument is being held—for example, even if it is being held as a hedging instrument or being held until it matures—and regardless of the cause or nature of the market price change involved (Ebling, 2001). FAS 157 – Statement of Financial Accounting Standards No. 157, Fair Value Measurements—defines fair value and establishes a frame work for measuring fair value in generally accepted accounting principles (GAAP). While previous pronouncements involving valuation focused on what to measure at fair value, FAS 157—issued by the Financial Accounting Standards Board (FASB) on September 15, 2006—focuses on how to measure fair value (Sinnott, 2007).

What is fair value? FAS 157 are quite prescriptive, defining it as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between participants at the measurement dates (Chambers, 2008). FAS 157 put in place a framework for fair value measurement and disclosure. Perhaps the most important feature in FAS 157 is the requirement to set out financial statements in three levels that describe the reliability of the inputs used to establish fair value. Fitch describes it as the fair value hierarchy. So Level 1 is quite straightforward, as the price used are identical to the input and discovered in something like a public exchange. It gets quite complicated for Level 2 assets and liabilities, because the prices used might be inferred from an index or another security with similar attributes to the one being measured. Fair value measurement in Level 3 assets are purely model-driven, consisting of unobservable inputs, and have understandably swollen as markets have grown increasingly illiquid and disorderly (Chambers, 2008). For many years, users of financial statements have sought relevant and timely information about financial instruments and off-balance sheet items and activities. It is believe that fair value measurements and recognition of these values in the financial statements, along with adequate disclosures, will provide necessary information to evaluate properly an enterprise's exposures to financial risks, as well as rewards (Anonymous, 2002).

This is because fair value reporting reflects the economic reality by showing the volatility inherent in the values of financial instruments given changes in market conditions and operations of the enterprise. Historic cost-based accounting smoothes these effects, thus, obscuring this volatility and masking the economic impact of various positions held in financial instruments (Anonymous, 2007).

2. METHODOLOGY

This paper relies on the literature review of current relevant articles focusing on accounting for fair value. Except where a source was needed specifically for its perspective on broad issues relating to fair value accounting, the author screened by “fair value accounting” and by numerous variants of keywords, focusing specifically on fair value accounting and financial reporting in firms. Source papers included refereed research studies, empirical reports, and articles from professional journals. Since the literature relating to fair value accounting is voluminous, the author used several decision rules in choosing articles. First, because the accounting profession is changing fast in today’s environment, especially for financial instruments, the author used mostly sources published 2002-2010, except where papers were needed specifically for their historical perspectives. Second, given the author’s aim to provide a practical understanding of the main issues in fair value accounting, he included, in order of priority: refereed empirical research papers, reports, and other relevant literature on current firms’ fair value reporting practices. To get some perspective on the current state of fair value accounting, the author begins with a literature review of some of the most important issues relating to the concept.

3. LITERATURE REVIEW

3.1. Statement of Financial Accounting Standards (FAS 157)

FAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This definition abandons a long-standing practice of using the transaction price for an asset or liability as its initial fair value. In other words, fair value will no longer be based on what you pay for something; it will now be based on what you can sell it for, also known as its “exit price.” Just as important, this definition emphasizes that fair value is market based—requiring the consideration of what other market participants might pay for something—and is no longer entity-specific. Valuation will now be determined by a skeptical, rather than optimistic, buyer. In turn, the level of data available to measure fair value will determine how the valuation of an asset or liability is determined. Common valuation techniques identified by FAS 157 are the market approach, income approach and/or cost approach. These models require inputs that reflect assumptions that market participants would use for pricing an asset or liability. Observable inputs would be based on market data obtained from independent sources, such as stock exchange prices. Meanwhile, in the absence of an active market for an asset or liability, unobservable inputs reflect the reporting entity’s own assumptions. The standard provides a fair value hierarchy that gives highest priority to quoted prices in active markets (defined as level 1) and lowest priority to unobservable inputs (level 3) (Sinnott, 2007).

3.2. Mark to Market

Mark-to-market accounting refers to the accounting standards of assigning a value to a position held in a financial instrument based on the current fair market price, rather than its original cost or book value, for the instrument or similar instruments. Fair value has been part of U.S. generally accepted accounting principles (GAAP) since the early 1990s. Investors demand the use of fair value when estimating the value of assets and liabilities. This has been influenced by investors’ desire for a more realistic appraisal of an institution’s or a company’s current financial position. Mark to market is a measure of the fair value of accounts that can change over time, such as assets and liabilities. For example, financial instruments traded on a futures exchange, such as commodity contracts, are marked to market on a daily basis at the market close (Metzger, 2010). When banks mark to market, they follow two steps. First, they estimate the net realizable value of their portfolio of asset-backed securities. This involves discounting the cash flows of these assets. Then under fair value accounting, they have to take a haircut on these values that takes into account the price at which they could sell the assets. When the market is not functioning, of course, this haircut is very large. This is important because it suggests that the huge decline in the value of bank assets is not due to a decline that has certainly occurred—but rather to the market’s judgment about the risk of resale by a purchaser. It is this risks that—when combined with fair value accounting—has forced the write-downs in bank assets (Wallison, 2009).

3.3. Relevance

The debate of fair value accounting basically revolves around the issues of relevance and reliability. Before discussing the issues of relevance of fair value, the author looks briefly at how fair value and relevance are generally defined. Fair value is defined in the FASB's Preliminary View documents as an estimate of the price an entity would realized if it has sold an asset or paid if it had been relieved of a liability on the reporting date in an arm's –length exchange motivated by normal business consideration. Relevance is defined in the glossary of the FASB Statement of Financial Accounting Concepts No.2 as the capacity of information to make a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct expectation (Poon, 2004).

3.4. Reliability and Measurements

Reliability is defined in the glossary to the FASB Statement of Financial Accounting Concepts No. 2 as the quality of information that assures that information is reasonably free from error and bias and faithfully represented what it purports to represent. Fair value as an estimate of exit value under normal market condition is well defined and noncontroversial when there are well-established liquid markets. What if there is no liquid market? This is the situation in which an estimation of fair value will inevitably involve prediction of future cash flows and selection of appropriate discount rates. These estimates depend on management's assumptions and measurement error. This has the potential to mask deliberate miscalculation and manipulation of the numbers. Both the FASB and the JWG acknowledge that some significant measurement issues must be resolved and they are working on developing more guidance regarding estimating fair value and establishing appropriate controls. However, it should be noted that the use of estimate is an essential part of preparation of financial statements, e.g. the ubiquitous use of estimates in pension accounting (Poon, 2004). If markets were liquid and transparent for all assets and liabilities, fair value accounting clearly would be reliable information useful in the decision-making process. However, because many assets and liabilities do not have an active market, the inputs and methods for estimating their fair value are more subjective and, therefore, the valuations less reliable (Bies, 2005).

3.5. Verification

As the variety and complexity of financial instruments increases, so does the need for independent verification of fair value estimates. However, verification of valuations that are not based on observable market prices is very challenging. Many of the values will be on inputs and methods selected by management. Estimates based on these judgments will likely be difficult to verify. Both auditors and users of financial statements, including credit portfolio managers, will need to place greater emphasis on understanding how assets and liabilities are measured and how reliable these valuations are when making decision based on them (Bies, 2005).

3.6. Disclosure

The FASB states that the proposed update would change the wording used to describe the principles and requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. Specifically, the proposed update would include amendments to (a) clarify FASB intent about fair value application of existing fair value measurement and disclosure requirements, and (b) change a particular principle or requirement for measuring fair value or disclosing information about fair value measurements (Elifoglu et al. 2010).

3.7. Financial Instruments

Financial instruments versus nonfinancial instruments—many see fundamental inconsistency between measuring financial instruments at fair value and nonfinancial items largely on historic cost basis. Standard-setters recognize that whenever a boundary is drawn between financial statement items with different measurement attributes some inconsistencies and complexities often results. It is argued that there is economic logic in drawing a line between financial instruments and nonfinancial items, and more so than drawing a line including some financial instruments but not others (Hague, 2002). Conceptually, the periodic returns on financial instruments can be separated into three components with distinct sustainability or certainty. The first two components—amortized cost interest and the difference between fair value interest and amortized cost interest-sum to fair value interest. It is useful to distinguish these two components of fair value interest because amortized cost interest is both sustainable and certain, whereas the difference between fair value interest and amortized cost interest is sustainable but uncertain. The difference between fair value interest and amortized cost interest is sustainable because unexpected changes in interest rates and the resulting unexpected changes in fair values affect fair value interest calculations throughout the remaining lives of financial instruments.

For example, an unexpected gain on a financial asset due to a decrease in interest rates in the current period reduces expected fair value interest revenue on the asset throughout its remaining life. This third component of the periodic returns to financial instruments is the unexpected change in their fair values during the period. Unexpected changes in the fair values of financial instruments are both unsustainable and uncertain (Ryan & et, al., 2002).

3.8. Financial Reporting

The reporting of financial assets and liabilities is an election on a contract-by-contract basis and not mandatory. Therefore, not all instruments will necessarily be reported at fair value. In order to distinguish instruments that are reported at fair value from those that employ some other measurement, firms will have one of two reporting options on the statement of financial position. A firm may display the two classifications, fair-value and non-fair-value carrying amounts, as separate line items on the statement of financial position. The second option for reporting is parenthetical disclosure where the firm presents the aggregate of the two classifications and discloses the amount of the fair value parenthetically (Schneider & McCarthy, 2007).

3.9. Critics of Fair Value

Critics argue that fair value accounting has created a false short-term visibility in the case of pension funding and hastened the demise of defined benefit schemes. More generally, critics argue that the financial crisis demonstrates the pro-cyclicality of fair values when accounting is tightly coupled to prudential regulatory systems, and the unreliability of marking to model in less than liquid asset markets, especially for assets which are being held for the long term (Power, 2010). They also add that the impact of fair value accounting (FVA) is likely to be more restrictive lending policies, and more demanding loan covenants, than are necessary for sound risk management, together with pricing which will be higher than is economically necessary (Allatt, 2001). Moreover, several commentators remarked on the fictional and imaginary nature of fair value and bemoaned their subjectivity and potential for manipulation and bias. Regardless of whether these criticisms have substance, it is also the case that if enough people believe in fictions, then they can play a role in constituting markets (Power, 2010).

Many are comfortable with historic cost/realization accounting on the grounds that it is familiar and provide a more stable basis for prediction of future accounting than fair values. They argue that fair value based earnings cannot be predicted in the same way because of the effects of uncertain future events and see this as a significant drawback in being able to prepare budgets, forecasts, etc. and to manage analysts' expectations (Hague, 2002). Nevertheless, many critics of the subjectivity of fair value miss the real point. The very idea of reliability is being reconstructed in front of their eyes by shifting the focus from transactions to economic valuation methods, and by giving these methods a firmer institutional footing. Deep down the fair value debate seems to hinge on fundamentally different conceptions of the basis for reliability in accounting, making it less of a technical dispute and more of the politics of acceptability (Power, 2010).

3.10. Proponents of Fair Value

Few will question the relevance of information based on market prices as historical cost information is based on market prices at which assets were initially acquired and liabilities were initially incurred whereas fair value are based on current market prices. Fair value reflects the effects of changes in market conditions and changes in fair value reflect the effect of changes in market conditions when they take place. In contrast, historical cost information reflects only the effects of conditions that existed when the transaction took place, and the effects of price changes are reflected only when they are realized. As fair value incorporate current information about current market conditions and expectations, they are expected to provide a superior basis for prediction than outdated cost figures can since these outdated cost figures reflect an outdated market conditions and expectations (Poon, 2004). Proponents of fair value in accounting often appeal to notions of telling things as they are and of improving transparency. They point to areas such as pension accounting or the savings and loans industry in North America where fair values would have made problems (deficits, poor performing loans) visible much earlier, thereby enabling corrective action. An often heard trope is that one should not shoot the messenger of poor asset quality (Ebling, 2001).

4. FINDINGS

While there is a large number of assets and liabilities reported or disclosed in financial statements, the percentage of these items and the dollar impact on earnings may not have been exorbitant for most companies, except for financial institutions.

In 2008, only 27% of the total assets of the S&P 500 companies that had adopted FAS 157 were actually reported at fair value (Zion et al., 2009). While this represents about \$6.6 trillion in assets, it is still a relatively small percentage of the assets. Because of the mixed attribute model used in U.S. Generally Accepted Accounting Principles (GAAP), some assets are measured using fair value while others—even very similar assets are measured at cost, or amortized cost, or by some other measure. The nature of the assets held by these companies determined, to a large extent, their exposure to risk in the credit crisis. Companies in the financial sector had a much larger number of fair valued assets (39%) than did, for instance, companies in consumer staples (2%). Even within the financial sector, investment banks and insurance companies, most of whose assets are reported at fair value, were impacted more than commercial banks, whose largest assets is generally loans, which are not reported at fair value (Casabona & Shoaf, 2010). In addition, there is ample empirical evidence to support the relevance of fair value information of financial instruments. For example, Barth (2006) finds that fair valuation of investment securities influences the share price indicating that it provides extra information to investors. Additional discussion of findings of research on accounting for fair value of financial instruments can be found in FASC 1998 study (Poon, 2004).

5. ANALYSIS AND DISCUSSION

While most people agree that fair values are the most relevant measure for financial assets and liabilities that an entity actively trades, some (most notably, those in the banking industry) argue that historical cost is the more appropriate measure if management intends to hold an asset or to owe a liability until maturity. The rationale for accounting on a historical cost basis is that it better reflects the economic substance of the transactions and the actual cash flow over time. They argue that fair value information, on the other hand, would reflect the effects of transactions and events in which the entity would not participate and thus is often irrelevant. The question here is whether management's decision to hold assets or to continue to owe liabilities in light of changed market condition is relevant in evaluating the entity's financial position and performance (Poon, 2004).

Some also argue that the outcome of fair value accounting on entity's financial liabilities is counterintuitive if its credit risks changes. The fair value of a financial liability will decrease when the issuing entity's credit risk deteriorates because the interest rate on the initial issue date would now be lower than what it would be if the liability was issued today. Conversely, if an entity's credit rating improves, an increase in the fair value of its financial liability will result. However, as explained in Barth and Landsman (1995), changes in the credit rating represent wealth transfers between creditors and stockholders. It is not counterintuitive to see a decrease (an increase) in the value of a financial liability when there is a wealth transfer from creditor (stockholders) to stockholders (creditors) corresponding to the deterioration (improvement) of the credit rating of the issuing entity. Therefore, the outcome of fair value accounting is not readily counterintuitive. But as illustrated in Lipe (2002), financial statement users must be better educated about the impact of fair value accounting on financial liabilities. In particular, a decrease (an increase) in the fair value of financial liabilities should not be interpreted as positive (negative) if it is due to deteriorating (improving) credit quality. In addition, loan covenants have to be revised and financial ratios involving financial liabilities have to be analyzed accordingly (Lipe, 2002).

Still another argument against fair value accounting is the induced volatility of earnings if changes in fair values are reported in earnings. Some believe that this volatility of earnings may not correlate to management's performance and that this would make it more difficult for users to predict future performance. First, this is not a reliability issue since fair values can be reliably measured but still vary a great deal from one period to another. Second, the requirement of fair value reporting does not have to go hand in hand with the requirement of recognizing changes in fair values in reporting earnings (Poon, 2004). For this reason changes in fair value should be separately reported based on causes such as the passage of time, changes in market conditions, changes in the entity's financial health, changes in estimate, and changes in valuation techniques. Requiring fair value information as supplemental disclosures instead of financial statement recognition also addresses some of the concerns (e.g., volatility of reported assets, liabilities, and earnings) of the opponents of fair value accounting. In addition, this will allow financial statement users to decide on their own how much reliance they will put on and how to use fair value information (Poon, 2004). FSP FAS 175-4 provides application guidance to assess whether the volume and level of activity for asset or liability have significantly decreased when compared with normal market conditions. However, this assessment should consider whether there are factors present that indicate that the market for the asset is not active at the measurement date, such as : (a) there are few recent transactions based on volume and level of activity in the market, (b) price quotations are not based on current information ,

(c) price quotations vary significantly either over time or among market makers, (d) there is a significant increase in implied liquidity risk premiums, yields, or performance indicators (such as delinquency rates or loss severities) (e) There is a significant decline or absence of a market for new issuances (Casabona & Shoaf, 2010). Research by Federal Reserve staff shows that fair value estimates for bank loan can vary greatly, depending on the valuation inputs and methodology used. For example, observed market rates for corporate bonds and syndicated loans with lower-rated categories have varied by much as 200 to 500 basis points. Such wide ranges occur even in the case of senior bonds and loans when obligors are matched. Moreover, the FASB statement on the proposed fair value standards that reliability can be significantly enhanced if market inputs are used in valuation. However, because management uses significant judgment in selecting market inputs when market prices are not available, reliability will continue to be an issue (Bies, 2005)

6. RECOMMENDATIONS

In order to provide more relevant information to financial statement users, fair value information should be reported for all financial assets and liabilities. Given that there are still some important conceptual and practical issues relating to the reliable determination of fair value, it is better to first require full fair value disclosures before contemplating a shift to full fair value recognition in financial statements. That would enable investors, creditor, preparer, auditors, and regulators to learn from experience. When the issues relating to the reliable determination of fair values are resolved, they will be ready for full fair value recognition in financial statements (Poon, 2004). The author concurs with the SEC recommendations, which are expected to impact the FASB's future activities, including (a) improve fair value accounting standards (b) improve the application of existing fair value requirements (c) readdress the accounting for financial asset impairments (d) establish formal measures to address the operation of existing accounting standards in practice (e) implement further guidance to foster the use of sound judgment of practitioners (f) address the need to simplify the accounting for investments in financial asset (Casabona & Shoaf, 2010).

The first priority seems to be 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. Such work should involve rigorous testing to consider how fair value information would be used in decision models, as well as to stimulate the preparation of fair value information to understand better the extent of many of the practical concerns (Hague, 2002).

Second, implementation of the proposals would provide more useful, relevant and transparent information about an enterprise's use of financial instruments than is available today. The full benefits, however, will only be understood with careful study and education about how to use the new information. A somewhat different mindset and base of expertise (from that appropriate to traditional recognition and historical cost-based accounting for financial instruments) is also necessary. This includes integrating knowledge of certain finance and capital-markets concepts and practices with financial accounting objectives and concepts (Hague, 2001).

Third, financial instruments should be grouped and displayed on the balance sheet based on the underlying characteristics of the instruments, such as unconditional rights to receive or obligations to deliver, and by major classes within these groups. Detailed, descriptive information about the nature and terms of these financial instruments, as well as management's policies pertaining to them, should be disclosed in the notes to the financial statements in a manner consistent with the balance sheet (Anonymous, 2002).

Fourth, fair values reflect point estimates and by themselves do not result in transparent financial statements. Hence, additional disclosures are necessary to bring meaning to these fair value estimates. FASB's proposal take a first step toward enhancing fair value disclosures related to the reliability of fair value estimates. Additional types of disclosures should be considered to give users of financial statements a better understanding of the relative reliability of fair value estimates. These disclosures might include key drivers affecting valuations, fair-value-range estimates, and confidence level (Yonetani & Katsuo, 1998).

Finally, another important disclosure consideration relates to changes in fair value amounts. For example, changes in fair value of securities portfolio can arise from movements in interest rates, foreign-currency rates, and credit quality, as well as purchases and sales from the portfolio. For users to understand fair value estimates, they must be given adequate disclosures about what factors caused the changes in fair value (Bies, 2005).

7. IMPLICATIONS FOR FINANCIAL REPORTING AND MANAGERIAL DECISION-MAKING

Several implications are drawn from this paper.

First, standard-setters and regulators would be required to provide more specific guidance on how to determine fair value for financial statements. Perhaps, they can list some common valuation techniques and indicate their appropriateness in various circumstances. Disclosure requirements would include disclosure of fair value of all financial instruments along with method adopted to determine fair values, any significant assumptions used in their estimation, some indications of the sensitivity of the estimated fair value to these assumptions, and discussion of risk exposure and issues associated with the estimation of fair value (Poon, 2004).

Second, the role of external financial reporting is to portray an enterprise as if seen through the eyes of management—that is, that financial reporting should be consistent with internal management practices. It is, obviously, desirable that there be as much compatibility between the two as possible. However, it is difficult to see how accounting that is driven by the manner in which an enterprise chooses to manage its financial instruments and risks can provide information to financial statement users that are consistent and comparable between enterprises (Hague, 2002).

Third, the objectives of financial analysis are to discern and assess the effects to an enterprise's performance and financial condition, including those that result from its risk management policies and decisions that involve financial instruments. In addition, financial statement users want to assess how well an enterprise effectively applies these policies in managing the risks of the enterprise. Therefore accounting and disclosure requirements related to financial instruments must be designed to explain (a) risks inherent in a given business (b) hedging strategies employed and (c) outcome(s) of such hedging activities. In other words, financial and nonfinancial disclosures should provide sufficient information for users of this information to discern and answer question, such as these: (a) what are management's policies and procedures for using certain financial instruments? (b) How extensively does the enterprise use these financial instruments as part of its risk management? (c) What are the timing and the magnitude of the effects of the instruments on fair values in the balance sheet and changes in these values reflected in the income statement? (d) How effective, or ineffective, are the position in these financial instruments as hedges in managing the risk exposure of the enterprise? And (e) what portion of the gains and losses reported in the balance sheet and income statement is realized and unrealized? (Anonymous, 2002).

Fourth, the fact that management use significant judgment in the valuation process, particularly for level 3 estimates, add to the concern about reliability. Management bias, whether intentional or unintentional, may result in inappropriate fair value measurements and misstatements of earnings and equity capital. This was the case in the overvaluation of certain residual tranches in securitizations in recent years, when there was no active market for these assets. Significant write-downs of overstated asset valuations have resulted in the failure of a number of finance companies and depository institutions. Similar problems have occurred due to overvaluations in nonbank trading portfolios that resulted in overstatements of income and equity. The possibility of management bias exists today. There continue to be new stories about charges of earnings manipulation, even under the historical cost accounting framework. It is believe that, without reliable fair value estimates, the potential for misstatements in financial statements prepared using fair value measurements will be even greater (Bies, 2005).

Fifth, three fundamental goals of accounting that are likely to have influenced the choice of fair value accounting for all financial firms. One of these objectives is to minimize what is called management bias. Management has an obvious incentive to inflate the value of a company's assets, and many ways to do it. Marking a company's assets to market is an effective way of taking this element of financial statement manipulation out of management's hands (Wallison, 2009).

Finally, the option to use fair value for certain assets and liabilities will provide more relevant information to the users of financial statements. However, since the fair value usage can be elected for some financial assets and financial liabilities and avoided for others, there is a loss of consistency in the financial statements between entities and even within a single entity. Also the new standard imposes additional disclosure requirements (Schneider & McCarthy, 2007).

8. CONCLUDING REMARKS

Current methods of accounting for financial instruments have been of concern to accounting standard-setters around the world for some time now. These concerns about financial instruments start from the observation that markets now exists for either the instruments themselves or the various financial risks that arise from the instruments, and the availability of those markets enables entities to actively manage the financial risks and, thereby, to realize some or all of the market value of their financial instruments with ease. (Ebling, 2001).

It has been argued that different conceptions of what is for an accounting estimate to be reliable underlie the fair value debate as it has taken shape in the last decade. The language of subjectivity and objectivity is unhelpful in characterizing what is at stake; it is more useful to focus on the question of how certain valuation technologies do or don't become institutionally accepted as producing facts (Power, 2010). However, the shift in accounting principles will not come without some additional effort by all capital market participants, including preparers, auditors, regulators, and users of this information. It is realized that accounting and reporting based on fair value principles, in comparison with historical cost-based principles, require more extensive and detailed analysis of the methods and assumptions used to determine values recognized in the financial statements. This in turn, will require market participants to redesign the current financial reporting model and to educate themselves in the application of these new principles. Nonetheless, transparency of the true economic consequences, i.e. risks and rewards, resulting from the use of financial instruments justifies the movement to a fair value based model for financial reporting (Anonymous, 2002).

Certainly, mark-to-market reporting has its drawbacks, especially for derivatives. First, fair value based on market prices can be difficult to determine for complex and lightly traded instruments. These types of derivatives are the level 3 type mentioned above. These derivatives are usually measured using a mark-to-model process, which can be arbitrary at best and fraudulent at worst. Next, there is the theoretical issue, as banks successfully argued, as to whether market price does indeed represent fair value. Also, the relevance of market prices can be challenged with respect to intent. Some observers challenge the relevance of market prices because they believe that, if government officials do not intend to trade derivatives but rather hold them to maturity, as is usually the case with derivatives used for hedging, then the time and expense of determining fair value may not be worthwhile. Still, using fair value accounting is proper for derivative reporting because it enhances the following qualities or objectives of financial measurement and reporting: accountability, transparency, consistency, inter-period equity, and risk management (Metzger, 2010).

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