The Origin Of Fair Value Accounting And How It Has Affected The Economics

Abstract

Fair value accounting is a financial reporting approach through which organizations ought to evaluate and provide information on a regular basis regarding specific assets and liabilities. From a general perspective the given assets can be termed as financial instruments and the measure is in terms of the prices they can get fro the sale of the given assets or being relieved from their liabilities. Although fair values has had part in U.S. generally accepted accounting Principles (GAAP) for a little over five decades, accounting standards that need or allow fair value accounting have been on the rise in the recent past. However, there are issues that have been linked to fair value accounting that have led to numerous debates. For instance, the global financial crisis of 2007-2008 is linked to the concept of fair value accounting. This has not limited the use of fair value accounting rather it has brought it to the lime light and is becoming a requirement for investments.

Introduction

Accounting is at times perceived as just a cover and in turn does not highlight the economic fundamentals that are vital as they are not directly affected. The basic idea of having a market that is perfect without any friction, where there is trade of assets in fully liquid markets, creates a sense that accounting would be immaterial. This is largely based on the idea that there would be reliable market prices readily available to all interested parties. However, this is not the case and therefore, the basic idea of accounting and the development of accounting standards is very important in our modern world as it is not perfect. In recent years, there has been a rise in the number of cases linked to accounting and this is considered as one of the primary drivers that have strengthened the proposal and enforcement of fair value accounting. This is in the sense that fair value accounting acts as a light to some of the unfair prices and accounting practices that are employed by managers in an effort to hide their mischievous actions to the outside world of observers. Hence, from a general point of view fair value accounting and good corporate governance are perceived as two sides of the same coin (Plantin, Sapra & Shin 2008).

History of fair value accounting

For a long time there has been the issue of standard setters coming up or developing a working system that would deal with the challenges linked to accounting for financial instruments. This is in particular to decisions that are directly linked to the type of valuation technique and process that should be applied. This is based on the idea that coming up with the decisions has been hard and controversial in given situations. Back in the mid 1990s, Financial Accounting Standards (FAS) 115 was set up into U.S. Generally Accepted Accounting Principles (GAAP) as a probable solution to the challenges. Although, fair values had been part of the accounting system in the U.S for sometime, the introduction of FAS 115 was seen as a first step in the right direction for fair value accounting for many of the investments taking place at the time (Ryan

2008).

In early 2000, FAS 133 was set up as foundation for the improvement of the accounting form for derivative by requiring fair value measurement. In 2007, FAS 157 introduced a universal meaning of fair value. This was shortly followed by the introduction of FAS 159 that widened the ability of organizations to elect fair values as their measurement form for given financial liabilities and financial assets. In the case where market prices for similar positions are available, FAS 157 generally requires organizations to apply these prices in estimating fair values. The underlying principle for this requirement is that market prices should act as a mirror to all publicly available information regarding future cash flows, including investors' private information that is exposed through their trading. This is also in addition to current risk-adjusted discount rates. In a situation where fair values are estimated through the use of unadjusted or adjusted market prices, they are termed as mark-to-market values. If market prices for similar positions do not exist, then companies have to approximate fair values using valuation models. In relation to FAS 157 the given models have to be employed through observable market inputs such as interest rates and yield curves that are evident at frequently quoted intervals. In the case where the models are present and unobservable firm-supplied inputs such as projected cash flows established through the company's own information are to be employed (Song, Chang, Wayne, and HanYi 2009).

The primary goal of fair value measurement is for organizations to approximate to the best of their ability the prices at which the positions they hold at the moment would change hands in well planned transactions founded on current information and conditions. In their effort to attain this goal, companies have to fully incorporate their current information about future cash flows and current discount rates which are adjusted into their fair value measurements.

Impact of Fair Value Accounting

Fair value accounting presupposes that the market can make cash flow evaluation accurately. According to Christian and Leuz (2009) FASB expressed the view that "fair value portrays the market's estimate of the present value of the net future cash flows" on assets held by banks. This has in turn given rise to the question how could the market know this? However, the truth is that there is no possibility of the market knowing these predictions. It is quite evident that the market does not have necessary information on what the cash flows are to precise portfolios of mortgage-backed securities held by banks. Market participants might have the know-how that the cash flows are not what they ought to be; that the losses are larger than expected; but they cannot value these securities in a more complicated manner. There is speculation that in the recent crisis it is the market's unawareness in particular to cash flows on given portfolios that is perceived as one of the primary sources of the crisis and of the losses that the banks registered. During that period after it was apparent that there were bigger losses on mortgage-backed securities than their triple-A ratings disguised the market for these and other asset-backed securities in turn, collapsed at least one and a half years.

Although a greater number of people agree that fair value comes up with a more relevant evaluation than historical cost, it is far from perfect. For instance, there are two issues that are linked to fair value measurements today:

(1) the use of fair value accounting in illiquid markets, and (2) how and when modeling ought to

be applied as the method of determining fair value (Penman and Stephen 2007). Recent credit market situations have led to large write-downs through the use of fair value measurements. Most of the charges have happened inside the banking and broker-dealer industries.

It is quite evident that firms providing credit protection through credit default changes on the under lying asset, in place of insurance contracts, have been affected by fair value measurements. Regardless of the fact that the non-payment that would activate protection may not have taken place, companies are required to take into account unrealized losses on the contract when the fair value of the underlying assets has considerably decreased. In addition to this, some corporations with investments in auction rate securities have also been affected and have which experienced declines.

The underlying principles for the application of use fair value measurements have been criticized for leading to erroneous results in the unusual market conditions recently experienced. Moreover, the given outcomes have had negative impacts on most companies in the long run. In the case where an organization is required to record losses in such an environment, critics argue that it is an indication of bad news to investors that may lead to misleading information. They also argue that it is better to record only realized gains and losses. Taking into account this critical issue, it is vital to be aware of accounting principles such as fair value are established with the objective of providing information that will best serve the interests of investors, enterprises and policy makers in the long run (Ryan 2008).

In response to the concerns regarding fair value measurements that have risen in relation to the recent market illiquidity and volatility, there has been proposals made that fair value accounting should be suspended or changed for certain financial instruments. Moreover, as a counter measure also business enterprises should be given the opportunity or allowed to put into use their own models, which may present a less volatile long-term state of affairs. The current market is perceived as an anomaly and is contended a situation that should not be the case. However, in particular to the issues raised, there has to be a balance against investors' requests to know the current values of given assets (Wallison and Peter 2008).

In balancing the factors, fair value still stands for the most effective method to show the economic realities of market conditions. In the event that fair value were suspended or reinstated with a different method based on historical cost, investors would be given the opportunity to determine the current value of these instruments through the use of their tools. This would be less a reliable tool and might limit any market recovery. There is agreement that those arguing in favor of the market being an anomaly might be correct. Moreover, if this is the case there is a high likelihood that the market might realize this and return to normal (Nissim and Penman 2008).

Although investors in general believe that fair value is suitable for measuring financial instruments, they and companies are focused on the use of fair value when it is not clear how to determine market pricing. Fair value measures require (a) using market prices regardless of how erratic the market may be, or (b) referring to prices of similar securities. If neither of these alternatives exists, firms use models to determine fair value. Earnings volatility might take place when markets become illiquid and market prices are not available. If either of the methods named above are applied, the effect on earnings may be as unpredictable as the market. The impact of fair value measurements on long-term value is another concern.

Conclusion

The critical issue with fair value accounting is whether companies can and evaluate fair values accurately and without discretion. When similar positions trade in liquid markets that offer unadjusted mark-to-market values, fair value from a general perspective is the most precise and least discretionary probable evaluation tool. This is regardless of the fact that at times even liquid markets get values wrong. Fair values usually are less accurate and more discretionary when they are either adjusted mark-to-market values or mark-to-model values. In regulating mark-to-market values, firms might be required to make adjustments for market illiquidity or for the variation of the position being fair valued from the position observed in relation to market price. The given adjustments can be great and critical in some situations. On the other hand, in estimating mark-to-model values, firms typically have options regarding which valuation models to apply and which inputs to use in employing the chosen models. All valuation models are restricted, and different models apply the value-relevant elements of positions differently.