

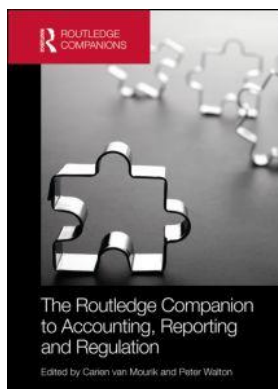
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Fair Value and Financial Reporting

David Cairns

The chapter deals with the role of fair value measurement in the context of financial reporting under International Financial Reporting Standards (IFRS). Many commentators see IFRS as fair value-based standards and some believe that IFRS require many assets and liabilities to be measured at fair value at each reporting date. This chapter addresses these issues. In doing so, it distinguishes between the use of fair value measurement at each reporting date (the fair value model) and other uses of fair value measurement, a distinction which some commentators do not make.

Section 1 considers measurement in IFRS financial statements from the standpoint of the IASB's Conceptual Framework. It notes that the balance sheet approach that underlies the Framework is equally applicable for different measurement models and, in so doing, refutes the widespread myth that the approach requires fair value measurement for all assets and liabilities.

Section 2 describes the measurement models in IFRS, in particular the fair value model, the historical cost model and the present value model. These three models feature strongly and to varying degrees in IFRS financial statements. Other measurement models used in IFRS financial statements and discussed in professional and academic literature, including the equity method and the current or replacement cost model, are beyond the scope of the chapter.

Section 3 explains how the different measurement models affect the measurement of profit. Changes in the measurements usually meet the definition of income and expenses in the Framework but some changes are excluded from profit. In the past, these exclusions were limited mainly to capital maintenance adjustments. More recently, the exclusions have been extended to the effects of some volatility arising from the use of particular measurement models and have led to the emergence of separate notions of profit, comprehensive income and other comprehensive income.

Section 4 discusses why IFRS require or permit the use of the fair value model for some financial assets and financial liabilities, investment property and biological assets. It explains that, contrary to a widely held belief, the cost model is used for many financial assets and financial liabilities as well as many other assets and liabilities. In both IFRS and IFRS financial statements, the use of the fair value model is quite limited.

Section 5 discusses why the use of the fair value model has been contentious before, during and after the financial crisis which started in 2007. It notes that concerns focus on both the use and consequences of the fair value model and the measurement of fair value. Many of these concerns have been expressed for many years and considered by both the IASC and the IASB as part of their due process. Nevertheless, the financial crisis reinforced those concerns.

Section 6 deals with the IASB's responses to the concerns about the use and consequences of the fair value model and the measurement of fair value. IFRS 13 *Fair Value Measurement* will alleviate some of, but not all, the concerns about the measurement of fair value. It is, however, unlikely that the IASB will significantly reduce the requirements or options to use the fair value model.

1. Measurement and the IASB's framework

1.1 *The elements of financial statements*

Financial reports provide information about, among other things, the reporting entity's financial position and its financial performance. Financial position consists of the entity's assets, liabilities and equity. Financial performance reported in terms of accrual accounting consists of income, expenses and profit. Financial performance is also reported in terms of cash flows but cash flows are not affected by fair value measurement and, therefore, are not dealt with further in this chapter.

The Framework defines assets and liabilities and specifies when those assets and liabilities are recognised on the statement of financial position. Equity is defined as the difference between assets and liabilities recognized in the statement of financial position. Income and expenses are defined as changes in assets and liabilities that result in changes in equity other than changes resulting from contributions from or distributions to equity participants. Profit is the difference between income and expenses. However, as explained in **section 3**, some items of income and expense are excluded from profit under certain concepts of capital maintenance and, more recently, through the distinction between profit and other comprehensive income.

The fact that income and expenses are defined as changes in assets and liabilities is sometimes referred to as the balance sheet approach. Some argue that the primacy given to the definitions of assets and liabilities means that the IASB believes that financial position is more important than financial performance. This is not the case. The balance sheet approach is simply the only way in which the IASB (and some national standard setters) have found to define income and expenses.

Some also argue that income and expenses have traditionally been defined in their own right without first defining assets and liabilities. This is not the case. Accountants have always found it necessary to get assets and liabilities right first, however defined and measured, before determining income and expenses. For example, the need to get inventories, receivables and payables right before determining revenue, costs of sales and profit is long established. Similarly, the need to confirm the existence and recoverability of receivables has played a key part in determining both revenue and bad debt expense. The practice of looking for the existence of future economic benefits before recognizing expenditure as an asset is also well established. Of course, there have been, and are, exceptions to this approach in IFRS and national GAAPs as well as in practice but the exceptions do not hide the fact the balance sheet approach has dominated accounting practices and accounting standards for many years.

Some also believe that the balance sheet approach requires the fair value measurement of assets and liabilities at each reporting date. This is also not the case. The Framework acknowledges

that the balance sheet approach is applicable to a range of accounting models and the use of different measurement bases and that financial statements are most commonly prepared in accordance with the cost model, something which is obvious to anybody who has prepared, audited or studied IFRS financial statements.

1.2 Measurement

Measurement is the process of determining the monetary amounts at which assets, liabilities, income and expenses are carried in the balance sheet and income statement (IASB, 2010: Par. 4.54). This involves the selection of the particular basis of measurement. The Framework lists and defines four measurement bases:

- historical cost;
- current cost;
- realizable or settlement value; and
- present value.

These four bases were commonly used in the late 1980s when the measurement section of the Framework was written. Fair value was not used by the IASC as a measurement basis until after the Framework was written and is, therefore, not listed as a measurement base.¹ This deficiency will undoubtedly be addressed in the IASB's Conceptual Framework project.

While the Framework does not define or explain what it means by measurement basis, it clearly intends the measurement bases to be used in measurement models which are specified at standards level (see Section 2). The Framework acknowledges that the balance sheet approach is applicable to a range of accounting models and the use of different measurement bases (IASB, 2010: Introduction). It explains that IFRS financial statements are most commonly prepared in accordance with the cost model (IASB, 2010: Introduction and Par. 4.56). It recognizes that other measurement models may be more appropriate in order to meet the objective of providing information that is useful for making economic decisions. It does not express a preference for a particular model or for the circumstances in which particular models are appropriate. The IASB has, however, expressed preferences at standards level.

Prior to developing and issuing the Framework, the IASC gave extensive consideration to the appropriateness of a current cost (or replacement cost) model for tangible assets (property, plant and equipment and inventories). Those considerations led to the issue of IAS 6 *Accounting Responses to Changing Prices* and its replacement IAS 15 *Information Reflecting the Effects of Changing Prices* but did not result in an international consensus with the result that compliance with IAS 15 became non-mandatory in 1989 (Camfferman & Zeff, 2007: 106–10). The IASC and the IASB have subsequently given little consideration to the appropriateness of the current cost (or replacement cost) model.

Also prior to developing and issuing the Framework, the IASC decided that the present value model, in particular an actuarial model, was the most appropriate model for some post-employment benefit obligations. This decision explains why present value is listed in the Framework as one of the measurement bases. In this case, international consensus has been achieved with the result that the present value model not only continues to be used but has been refined and strengthened in successive versions of IAS 19 *Employee Benefits*.

More significantly, the IASC and then the IASB decided that the fair value model was the most appropriate model for some financial assets and financial liabilities, investment property and

biological assets (see Section 4). This step began about the time that the Framework was being developed but too late and with insufficient commitment to persuade the IASC to include fair value as a measurement basis in the Framework. As with the present value model in IAS 19, so the use of the fair value model has been refined and strengthened over the ensuing 20 years.

As part of its conceptual framework project, the IASB is likely to seek to strengthen the measurement chapter by, among other things, specifying the circumstances in which different measurement models are appropriate in order to meet the objective of providing information that is useful for making economic decisions. While the outcome of those efforts is uncertain, it seems likely that the IASB will retain a mixed measurement approach under which the cost model, the fair value model and other models are appropriate in specific circumstances.

2. Measurement models in IFRS

Three measurement models are used extensively in IFRS: the fair value model; the cost model; the present value model. Each model uses one of the measurement bases as the starting point for the measurement of assets and liabilities but may adjust the resulting amount to reflect events since the measurement date. This is particularly the case for the cost model where the measurement date for historical cost usually precedes the reporting date (in some cases by many years) and the asset or liability may have changed between the measurement date and the reporting date (in some cases to a very significant extent). It is less the case for the fair value model and the present value model because the measurements usually reflect circumstances at the reporting date.

2.1 *The fair value model*

2.1.1 Fair value

In IFRS, fair value is a measure of the current value of an asset, liability or equity instrument. Fair value has no natural meaning but is, instead, defined in IFRS.² Immediately prior to the issuance of IFRS 13 *Fair Value Measurement*, fair value was defined as:

The amount for which an asset could be exchanged, a liability settled or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction.

IFRS 13 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.

The definitions have much in common, most notably that:

- fair value is a current value of the asset, liability or equity instrument at the measurement date; and
- fair value is the market value for assets, liabilities and equity instruments traded in an active market.

The IFRS 13 definition also confirms that fair value is the exit price for the asset or liability in a transaction with market participants at the measurement date.

2.1.2 Fair value model

Under the fair value model, assets and liabilities are measured at fair value at each reporting date and changes in fair values are reported in each period as income or expenses. Section 4 deals with whether the resulting changes in fair value are included in the measurement of profit or other comprehensive income.

In IFRS financial statements for 2013, the use of the fair value model is:

- required for held-for-trading financial assets and financial liabilities and available-for-sale financial assets;
- permitted, but rarely used, for other financial assets and financial liabilities;
- required for most biological assets;
- permitted and frequently used for investment property; and
- permitted in certain circumstances, but rarely used, for most other assets and liabilities (see for example Cairns *et al*, 2011).

2.1.3 Other uses of fair value measurement

In IFRS, fair value measurement is also used as part of both the fair value model and the cost model³ for:

- the measurement of assets, liabilities and equity instruments on their initial recognition in the financial statements;
- the measurement of the consideration given or received for assets, liabilities and equity instruments; and
- the allocation of the initial amount at which a transaction or other event is recognized among its constituent parts.

The use of fair value measurement in these ways does not imply, let alone require, the subsequent use of the fair value model. In fact, the fair value measurements in each case are most frequently used as the historical costs of the relevant assets, liabilities or equity instruments in the application of the cost model.

Fair value measurement is also used as an essential part of the cost model for the measurement of the recoverable amount of assets. Under the cost model, the carrying amount of an asset must not exceed the amount that the entity expects to obtain from the sale, use or other means of recovery of the asset.⁴ Fair value measurement is used to determine any impairment losses for some assets which the entity can recover through sale, for example property, plant and equipment and intangible assets.

The separate measurement of recoverable amount is largely irrelevant to the fair value model as fair value reflects the condition of the asset at reporting date and there is rarely, if ever, any justification for reducing the carrying amount of an asset below its fair value.

2.2 The cost model

2.2.1 Historical cost

The historical cost of an asset is defined in the Framework as the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire the asset at the time of its acquisition. The historical cost of a liability is defined as the amount of proceeds received in

exchange for the obligation or the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Historical cost is, therefore, the entry price for the asset or liability. Historical cost often coincides with fair value of the asset or liability at the date that the asset or liability is acquired or assumed. It rarely coincides with fair value at any other date.

2.2.2 The cost model

Under the cost model, assets and liabilities are measured at each reporting date by reference to their historical costs. The historical cost is adjusted for some changes in the asset or liability since the measurement date. For example, the historical costs of assets are adjusted by means of depreciation, amortization and impairment write-downs to reflect the consumption or loss of economic benefits embodied in the asset. The historical costs of liabilities are adjusted for changes in the estimates of the amounts of cash or cash equivalents expected to be paid to satisfy them. The historical costs of financial assets and financial liabilities are also adjusted for the amortization of premiums and discounts.

Under the cost model, adjustments are not made for changes in the fair values of the assets or liabilities. In fact, the adjusted amounts rarely, if ever, coincide with fair values of the assets or liabilities. However, the carrying amount of an impaired asset will coincide with the asset's fair value at the date at which the impairment loss is recognized and if fair value measurement is used to determine the impairment loss.

The adjustments made to the historical costs of assets and liabilities under the cost model give rise to income or expenses which are included in the measurement of profit.

2.3 *The present value model*

2.3.1 Present value

The present value of an asset is defined in the Framework as the present discounted value of the future net cash inflows that the asset is expected to generate in the normal course of business. The present value of a liability is the present discounted value of the future net cash outflows that are expected to be required to settle the liability in the normal course of business. Present value is, therefore, an exit price for the asset or liability.

As the assumptions required by IFRS to measure present value differ from the assumptions used to measure fair value, present value rarely coincides with fair value. In particular, present value is usually measured using entity-specific assumptions while fair value should be measured using market participant assumptions.

Present value is included among the measurement bases in the Framework and is used as a measurement basis in IAS 19 *Employee Benefits* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

2.3.2 Present value model

Under the present value model, assets and liabilities are measured at present value at each reporting date and changes in present values are reported in each period as income or expenses which are usually included in the determination of profit. However, under IAS 19, some changes in present values of defined benefit obligations are included in other comprehensive income.

2.3.3 Other uses of present value

Present value is also used as an essential part of the cost model for the measurement of the recoverable amount of assets which the entity can recover through use, for example property, plant and equipment and intangible assets.

3. Fair value measurement and the measurement of profit

The Framework defines profit as the difference between income and expenses. As income and expenses are defined as changes in assets and liabilities, the measurement of assets and liabilities affects income and expenses and, therefore profit. If the fair value model is used for assets and liabilities, changes in fair values meet the definitions of income and expenses and, therefore affect the measurement of profit. However, both the Framework and current IFRS exclude some items of income and expenses from the measurement of profit, in particular some income and expenses arising from the remeasurement of some assets and liabilities.

3.1 Capital maintenance adjustments

The Framework reflects its 1980s origins by taking a capital maintenance approach. It excludes from profit those items of income and expenses arising from the remeasurement of assets and liabilities that are capital maintenance adjustments (IASB, 2010: Par. 4.36). Capital maintenance considerations are among the reasons why changes in the fair values of property, plant and equipment accounted for under the fair value model in IAS 16 *Property, Plant and Equipment* are excluded from profit. However, little or no consideration has subsequently been given to concepts of capital and capital maintenance by the IASC or the IASB. In particular, the consideration of capital maintenance issues has played no part in IASC or IASB decisions about whether other changes in fair values arising from the use of the fair value model should, or should not, be included in profit.

3.2 Other remeasurements

In IFRS effective from 2013, the following remeasurements are excluded from IFRS profit:

- changes in the fair values of property, plant and equipment accounted for using the fair value model (see [Section 3.1](#));
- exchange differences arising on the translation of an entity's net assets from functional currency to presentation currency;
- changes in the fair values of available-for-sale financial assets; and
- remeasurements arising on the net liability for post-employment benefits.

In addition, from 2015, IFRS 9 *Financial Instruments* will replace the requirements for available-for-sale financial assets and introduce a new requirement to exclude from profit the effects of own credit risk on financial liabilities accounted for using the fair value model.

One of the current driving forces for the exclusion of some remeasurements from the measurement of profit is the desire to remove some volatility from the measurement of profit. While there is widespread agreement that volatility arising from the underlying business operations of an entity, for example in the levels of its sales or operating costs, must be included

in the measurement of profit, there is much less agreement about volatility arising from the remeasurement of assets and liabilities, in particular those remeasurements arising from changes in fair values.

This concern about volatility arising from remeasurements first arose in the early 1980s with the end of fixed currency exchange rates. Some national standard setters, together with the IASC, concluded that foreign exchange differences arising on the translation of a foreign entity's net assets from functional currency to presentation currency should be excluded from profit. The original version of IAS 21 *The Effects of Changes in Foreign Exchange Rates* issued in 1983 explained that such differences are excluded from profit because, among other things, the 'inclusion of such differences would distort the income statement'.⁵

The emergence of the fair value model for financial assets and financial liabilities (see [Section 4](#)) had added considerable impetus to the exclusion of the effects of some remeasurements from profit. Under IAS 25 *Accounting for Investments* (issued before the Framework was developed), changes in the measurement of long-term investments were excluded from profit; there was also an option to exclude changes in the measurement of current investments from profit. Possible volatility in profit was one reason for the exclusions. Others were the fact that changes in fair values might be unrealized or not distributable as dividends to shareholders.

IAS 39 *Financial Instruments: Recognition and Measurement* was based on US GAAP and, therefore, imported the notion of available-for-sale financial assets which are measured at fair value at each reporting date but with most changes in fair values excluded from profit. The incorporation of this approach into US GAAP was clearly influenced by the desire of US entities, in particular US banks, to keep the volatility arising from changes in fair values of such investments out of profit. Its inclusion in IAS 39 was driven solely by the need to use US GAAP as the basis for the new standard.⁶

IFRS 9 *Financial Instruments* retains the IAS 39 approach but restricts its use to investments in equity instruments that are not held for trading. The IASB justifies the approach on the basis that the inclusion of changes in fair values in profit 'may not be indicative of the performance of the entity' (IFRS 9.BC5.22) and that users of financial statements differentiate between fair value changes arising from 'equity investments held for purposes other than generating investment returns' and 'equity investments held for trading' (IFRS 9.BC5.23). While there is no mention of seeking to exclude some volatility from profit, it is hard to find a more substantive principle supporting the exclusions from profit.

IFRS 9 also introduces a further exclusion from profit: the effects of own credit risk on the changes in the fair values of some financial liabilities. In this case, volatility in profit is not the major concern. Commentators are far more concerned that the use of the fair value model for financial liabilities will allow an entity to report lower liabilities and income as a result of deteriorating credit risk, something which commentators find not useful and difficult to explain (IFRS 9.BCZ5.30). Many commentators suggested that the effect of the entity's own credit risk should be excluded from the fair value measurement or, if it is included, any resulting gains should be excluded from profit. The IASB has rejected the first suggestion but acceded to the second (IFRS 9.5.5.1c and BC5.31 to BC5.64).

The revised IAS 19 *Employee Benefits* issued in 2011 requires that the effects of remeasuring defined benefit obligations and plan assets should be excluded from profit. While the potential volatility arising from the inclusion of such remeasurements in profit was a concern of many preparers of IFRS financial statements, the IASB justifies its approach by the need to distinguish remeasurements from service cost and net interest in the most informative way given their different predictive values (IAS 19.BC88 and 90). In reaching this decision, the IASB acknowledged that the Framework does not describe a principle that would identify the items that would be treated in such a way.

3.3 *Comprehensive income, other comprehensive income and profit*

Until 2006, the income and expenses excluded from profit were included in equity and disclosed in the statement of changes in equity. The IASB subsequently decided that greater prominence should be given to these items and that a total should be presented for all income and expenses irrespective of whether or not they are included in profit. The outcome was the reporting of total comprehensive income, other comprehensive income and profit:

- total comprehensive income is the difference between all income and all expenses;
- other comprehensive income consists of income and expenses that are excluded from profit in accordance with specific requirements of IFRS; and
- profit is the difference between total comprehensive income and other comprehensive income.

As there is no concept or principle underpinning what is included or excluded from profit, there is no concept or principle underpinning other comprehensive income. For the most part the items are the result of compromises made by national standard setters, primarily in the UK or the USA, to win support for some current measurements in the statement of financial position.⁷ The IASC, IASB and some other national standard setters have accepted the same compromises. More recently, the IASB has made its own decisions about what should be included or excluded from profit.

Many of the items included in other comprehensive income result from the remeasurements of assets and liabilities. However, not all remeasurements are included in other comprehensive income. In particular, the dividing line between those changes in fair values that are included in profit and those which are excluded from profit is based on compromises on individual IFRS. However, the introduction of total comprehensive income and the statement of comprehensive income has, perhaps, made the IASB's job a little easier. Before 2006, exclusions from profit were hidden in equity or the statement of change in equity. Now they are given greater prominence so they are more visible.

4. Measurement in IFRS

This section discusses why the IASB has required or permitted the use of the fair value model in the IFRS on financial assets and financial liabilities, investment property and biological assets. It also discusses briefly the options to use the fair value model for other assets and liabilities.

4.1 *Financial assets and financial liabilities*

The fair value model has emerged in the past 30 years as the appropriate way of accounting for financial assets and financial liabilities. The evolution of the model and the need for its use were accelerated by the explosion of new financial instruments in the late 1980s and were made possible by changes in attitudes of securities and prudential regulators.

IAS 25 and IAS 26 were small, but important, steps in the emergence of the fair value model in IFRS. IAS 25 *Accounting for Investments* permitted the use of market value for current investments that were readily realizable and could be sold without effort. It also allowed the use of the cost model, because it avoided recognizing unrealized gains and the effects of fortuitous swings in stock market prices notwithstanding that it allowed management to recognize income at its discretion. The choice reflected different opinions which were prevalent at the time and are clearly still prevalent (see [Section 5](#)). IAS 25 was later replaced by IAS 39 and IAS 40.

IAS 26 *Accounting and Reporting by Retirement Benefit Plans* requires fair value measurement for the investments of retirement benefit plans. It explains that fair value is market value for marketable securities (IAS 26.35). It argues that fair value measurement is the most useful measure of the investments at the reporting date and the investment performance of the period. IAS 26 remains in effect.

Both IAS 25 and IAS 26 were relatively limited in scope and were written before the explosion of new financial instruments in the latter half of the 1980s led to calls for a much broader project. The IASC and the Canadian Accounting Standards Board responded by setting up a joint financial instruments project which, from the outset, was intended to apply to all types of financial instruments and all businesses.⁸

The use of the fair value model was a key issue throughout the project. The IASC issued two exposure drafts (E40 *Financial Instruments* and E48 *Financial Instruments*) in the early 1990s which proposed the retention of a mixed measurement model under which:

- the fair value model should be used for financial assets and financial liabilities resulting from operating activities; and
- the cost model should be used for financial assets and financial liabilities resulting from investing and financing activities.

The choice of measurement model was based on managements' intentions with respect to the financial assets and financial liabilities. Operating activities included transactions undertaken as part of an active programme of buying and selling financial instruments with a view to short term gain. Therefore E40 and E48 proposed the use of the fair value model. There was no option to use the cost model for such assets and liabilities.

Investing activities were defined as transactions that result in the acquisition of financial assets that are intended to be held for the long-term or until maturity. Financing activities were defined as transactions that result in the assumption of financial liabilities that are intended to be held for the long term or to maturity. The IASB believed that the use of the cost model would 'avoid volatility in reported earning that may be misunderstood and an undue emphasis on short-term fluctuations in value that may tend to reverse over time'. It suggested that carrying amounts under the cost model were reliable and avoided the need to estimate fair values in circumstances in which such values may not be determinable on a sufficiently precise and accurate basis. The cost model also incorporated 'a reasonable degree of prudence' by not permitting the recognition of unrealized increases in fair values unless it was probable that they will be realized (E40.135). Lastly, the IASC believed that cost model was used in many countries and was, therefore, well known and supported and relatively easy for entities to adopt and apply and users to understand.

Notwithstanding the support for the cost model, both E40 and E48 proposed an option to use the fair value model for financial assets and financial liabilities resulting from investing and financing activities. The option acknowledged that fair value measurement was routinely used in financial markets and more closely reflected the present value of the reporting entity's expected future cash flows. The fair value model minimized the application of judgement by management in determining carrying amounts and required the same accounting for assets and liabilities having the same economic characteristics. The fair value model was also seen as the long-term goal for financial reporting.

In 1994, the IASC decided not to proceed with the measurement proposals in E40 and E48 partly because of concerns raised by some national standard setting bodies that some aspects of the proposals were a step backwards. In particular, US GAAP had started to move towards the

use of the fair value model for investments in equity and debt securities and derivatives, a step which had been made possible only with a change of attitude by the Securities and Exchange Commission, a long-time supporter of the cost model.

In 1997, the IASC and the Canadian Accounting Standards Board published a discussion paper that proposed that all financial assets and financial liabilities should be accounted for using the fair value model. All changes in fair value, except some hedging gains and losses, would be included in profit. The discussion paper argued that the historical cost of financial assets and financial liabilities had little relevance to financial risk management decisions and that a mixed measurement system provided opportunities for abuse and would inevitably lead to accounting mismatches when linked transactions are measured using different models. It argued that the successful management of financial risks required information on the nature and value of financial instruments, financial risk and exposures, liquidity and the effects of changes in the value of financial instruments.

Many responses to the discussion paper argued that the IASC had gone too far, in particular by proposing the use of the fair value model for traditional banking activities. Rather than proceed with the proposals in the discussion paper, the IASC took the pragmatic decision to develop an interim standard based on US GAAP requirements for financial instruments.⁹ The outcome of this decision was IAS 39 *Financial Instruments: Recognition and Measurement* which was completed within a year and with scant due process. It introduced several significant parts of US GAAP into IFRS including the use of the fair value model for all derivatives, held for trading financial assets and financial liabilities, and available-for-sale financial assets. It required that changes in the fair values of available-for-sale financial assets should be excluded from profit, a compromise made by the FASB to accommodate the wishes of US banks. It incorporated detailed requirements on hedge accounting which were significantly different from the proposals in E40 and E48. It retained the cost model for loans and receivables, held to maturity investments and non-derivative liabilities but with some new restrictions on the model's use and much more implementation guidance.

Unlike the proposals in E40 and E48, IAS 39 did not include an option to use the fair value model for assets and liabilities measured using the cost model. The IASB subsequently added a fair value option in 2004 and the FASB followed suit. However, prudential supervisors of banks, securities companies and insurers expressed concern that the fair value option might be applied to financial assets or financial liabilities whose fair values were not verifiable, lead to increased volatility in profit or loss and result in the recognition of gains or losses associated with changes in an entity's own creditworthiness (see [Section 5](#)).

Notwithstanding the issuance of a revised IAS 39 in 2004, the IASB made no secret of its disdain for IAS 39. It proposed first that the complexity of IAS 39 could be reduced by requiring that all financial assets and financial liabilities should be accounted for using the fair value model but, again, this lacked support. IFRS 9 *Financial Instruments*, the eventual replacement for IAS 39, retains the mixed measurement approach with many financial assets and financial liabilities measured using the same measurement model as under IAS 39. IFRS 9 retains the fair value option but makes some changes to that option.

4.2 Investment property

The fair value model has also emerged as an appropriate way of accounting for investment property. IAS 25 permitted the use of the fair value model for investment property¹⁰ but with changes in fair values excluded from profit. In this case, the move was heavily influenced by requirements

in the United Kingdom where property investment companies had resisted national, EU and international requirements for the depreciation of property. UK property companies believed that changes in the fair values of investment properties were more important than depreciation.

When IAS 25 was superseded by IAS 39, the IASC developed a separate standard for investment property. The exposure draft proposed that all investment property should be accounted for using the fair value model with changes in fair value included in profit. The IASC argued (IAS 40.B44 and 45):

- fair value measurement give users of financial statements more useful information than other measures, such as depreciated cost;
- rental income and changes in fair value are inextricably linked as integral components of the financial performance of an investment property; and
- an investment property generates cash flows largely independently of the other assets held by an entity which makes a fair value model more appropriate for investment property than for owner-occupied property.

The responses to the exposure draft identified significant conceptual and practical reasons that precluded the mandatory use of the fair value model (IAS 40.B47). Therefore, the IASC decided that it was impracticable to require the use of the fair value model. It believed that it was desirable to permit the use of the fair value model in order to allow preparers and users to gain greater experience working with the model and allow time for certain property markets to achieve greater maturity (IAS 40.48). Therefore IAS 40 allows a free choice between the fair value model and the cost model.

4.3 Biological assets

The IASC also concluded that the fair value model is the appropriate way of accounting for biological assets and harvested agricultural produce. As a result, IAS 41 *Agriculture* requires that the fair value model should be used for all biological assets (with limited exceptions) and all harvested agricultural produce (with no exceptions). Changes in fair values are included in profit.

The IASB concluded that the fair value model should be used 'because of the unique nature and characteristics of agricultural activity' (IAS 41.B19). It rejected an option to use the cost model 'because of the greater comparability and understandability achieved by a mandatory fair value approach in the presence of active markets' (IAS 41.B21). In reaching these conclusions, the IASC rejected counter-arguments that market prices are often volatile and cyclical, active markets may not exist for harvested agricultural produce in some countries and fair value measurement results in the recognition of unrealized gains and contradicts the principles on revenue recognition.

4.4 Other assets

IAS 16 *Property, Plant and Equipment* allows a choice between the cost model and the fair value model for property, plant and equipment but, in practice the fair value model is rarely used.¹¹ The choice reflects the practices in the United Kingdom, the Netherlands, Australia, New Zealand, South Africa and some other British Commonwealth countries. The same choice is included as a member state option in the EC Fourth Directive, again as a result of the influence of the United Kingdom, Ireland and the Netherlands.

With effect from 1995, IAS 16 has required those entities using the fair value model to revalue the assets to fair value; and keep the revaluations up to date. The practical effect of these restrictions was a reduction in the number of companies using the fair value model. The UK incorporated the same restriction in its national standard with the same effect. Therefore, very few companies now use the revaluation model.

IAS 38 *Intangible Assets* allows a choice between the cost model and the fair value model for intangible assets but the fair value model may be used only when there is an active market for relevant assets. Therefore, in practice, the fair value model is never used.

5. Why is the fair value model contentious?

The choice of an appropriate measurement model that is appropriate in order to meet the objective of providing information that is useful for making economic decisions requires judgment. There is no single right answer shared by preparers and users of financial statements, standard setters and regulators. This lack of agreement is clearly evident whether seeking the appropriate model for the whole financial statements of a reporting entity or for part of those financial statements. The experiences of the IASC and the IASB on investments and financial assets show that there is even not agreement for a portfolio of marketable equity securities which are held with the express purpose earning income and capital appreciation.

Some, but far from all, of the objections to the use of the fair value model result from using a different objective for financial statements, for example providing information that can be used to monitor the adequacy of capital or the solvency of a bank or determining taxable or distributable profits. While there is no right answer to the choice of measurement model to be used to meet such objectives, there may be a greater consensus that the cost model is appropriate. However, these objectives are not those that the IASC had, or the IASB has, in mind when developing accounting standards.

So what are the objections to the use of the fair value model in financial statements that are intended to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity? At its simplest level, there is a strong body of opinion that believes that the use of the cost model can provide such information for all assets and liabilities including those that are held for investment purposes. Some base their support for this model on its reliance on information derived from transactions undertaken by the reporting entity. Others use arguments based on notions of prudence under which the carrying amounts of assets should never exceed the amounts measured under the cost model.

A similar objection to the use of the fair value model focuses on the role of management in measuring fair values. These objectors believe that the financial statements should report what management has done using objective evidence derived from the transactions management has carried out. Beyond this, management should not be able to influence, let alone determine, the monetary amounts that are reported in the financial statements.

Many objectors to the use of the fair value model question the measurements of fair values, in particular when those fair values are not measured from transactions or quotations in active markets. They question the reliability of purported fair values obtained from inactive markets and the use of models to measure such fair values.

The financial crisis which started in 2007 has also brought to light concerns that the ability to use the fair value model may influence the behaviour of management. In particular, some have asserted that managements may take more risks by buying assets if they can use the fair

value model when accounting for those assets. This argument leads to the suggestion that the use of the fair value model is pro-cyclical – in a rising market, entities buy more assets so pushing the values of those assets even higher – in a falling market, entities are forced to sell so pushing the values even lower.

Some objectors to the use of the fair value model focus on its use for particular types of assets and liabilities. Many would probably object to the use of the fair value model for operating assets (property, plant and equipment, and inventories). Many in the banking industry and many banking regulators oppose strongly the use of the fair value model for banking book assets and liabilities, in other words the customer loans, advances and deposits of banks. However, many bankers also object to the use of the fair value model for investment securities, hence the notion of available-for-sale financial assets in IAS 39 and US GAAP under which changes in fair values are excluded from profit.

There is extensive literature setting out the arguments against the use of the fair value model. Some of this literature is summarised in IASB discussion papers and the bases for conclusions in IFRS. One of the best and most balanced summaries of the arguments for and against the use of the fair value model was published by the European Central Bank (2004) (*Fair Value Accounting and Financial Stability*) at the time the Bank and bankers were objecting to the introduction of a fair value option in IAS 39.

6. The IASB'S responses to concerns about the use of the fair value model

As [Section 5](#) explains, two major concerns have been raised about the use of the fair value model: the requirement or permission to use the fair value model; the measurement of fair value. The IASB has dealt with the former concerns during the development of new and revised IFRS, in particular IFRS 9 *Financial Instruments*. It has dealt with the latter concerns in IFRS 13 *Fair Value Measurement*.

6.1 *The use of the fair value model*

Requirements about the use of the fair value model are included in IFRS dealing with specific assets and liabilities. As explained in [Section 4](#), the standards on financial assets and financial liabilities (financial instruments) require the use of the fair value model for some financial assets and financial liabilities and allow its use for many other financial assets and financial liabilities. The IASB has remained committed to this approach and there are no signs that it will reduce, to any measurable extent, the use of the fair value model. It may, in fact, wish to extend its use but has, so far, found strong opposition to any significant extension.

The retention in IFRS 9 of the fair value model for some financial assets and financial liabilities seeks to help users to understand the financial reporting of financial assets by aligning their measurement with the way that the entity manages its financial assets (business model) and their contractual cash flow characteristics, thus providing relevant and useful information to users for their assessment of the amounts, timing and certainty of the entity's future cash flows. However, the discussion in the basis for conclusions focuses entirely on the circumstances in which financial assets should be measured at amortised cost rather than on the need for any financial assets to be measured at fair value. In other words, the basis for conclusions in IFRS 9 reflects the IASB's preference for measuring financial assets at fair value.

IFRS 9 reduces the measurement categories in IAS 39 from four to two but the practical effect of these changes is likely to be that those financial assets that were measured at fair value under IAS 39 will also be measured at fair value under IFRS 9. In other words, IFRS 9 does

not reduce the requirements to use the fair value model. In contrast, IFRS 9 increases the use of the fair value model in certain limited circumstances, in particular for investments in unquoted equity securities and for financial assets which include embedded derivatives.

The IASB's support for the use of the fair value model for financial assets and financial liabilities was clear in its 2008 discussion paper *Reducing Complexity in Reporting Financial Instruments*. This discussion paper responded to concerns that the then requirements for reporting financial instruments were complex and that one of the main causes of complexity was the many ways of measuring financial instruments and the associated rules with those measurements. The discussion paper suggested that a long term solution was to measure in the same way all types of financial instruments within the scope of a standard for financial instruments. It observed: 'fair value seems to be the only measure that is appropriate for all types of financial instruments'. It noted that many documents previously published by the IASB expressed this view. The paper argued that the use of the cost model for all types of financial instruments was not a feasible alternative and that, for example, the use of the cost model for derivative financial instruments did not provide users of financial statements with information about future cash flow prospects for the instruments.

Against this background, it is not surprising that the IASB has continued to favour the fair value model as the appropriate measurement model for some financial assets and financial liabilities.

6.2 Fair value measurement

IFRS 13 *Fair Value Measurement* deals only with how fair value should be measured when other IFRS require or allow the use of fair value measurement. It does not change when fair value measurement is required. Instead IFRS 13 seeks to ensure that fair value is measured consistently for any asset, liability or equity instrument irrespective of whether they have market values or are quoted or traded in an active market.¹²

IFRS 13 will not satisfy those who object to the use of the fair value model or to the use of fair values that are not derived from active markets. It may satisfy some, including some regulators, who have been concerned about the way some entities have measured fair values.

Notes

- 1 The IASC had required or proposed the use of other current value measurements, in particular current cost and market value, as alternatives to the use of historical cost based amounts.
- 2 The evolution of the definition of fair value and definitions in different IFRS are dealt with in Cairns (2006).
- 3 Some national accounting requirements may permit or require the use of some amount other than fair value to deal with such issues. For example, they may permit the use of the carrying amounts in the acquiree's financial statements when accounting for business combinations. They may also permit or require the use of the carrying amount of the non-cash asset given up as the initial amount for the non-cash asset received.
- 4 Impairment requirements are generally unnecessary under the fair value model because there is no need to reduce the carrying amount of an asset below its fair value. However, it is sometimes necessary to consider whether negative changes in the fair value of an asset accounted for under the fair value model are impairment losses.
- 5 The text referring to the distortion of the income statement was included in paragraph 17 of the original version of IAS 21 issued in 1983. The text was removed in the 1993 version of IAS 21. The current version of IAS 21 retains only the notion that the changes in exchange rates have little or no effect on the present or future cash flows from operations (see IAS 21.41).

- 6 However, IAS 25 had permitted a similar treatment.
- 7 There is one important difference between the UK and US compromises which has found its way into IFRS. Those items of other comprehensive income that originated in UK GAAP, principally revaluation surpluses on property, plant and equipment and actuarial gains and losses on defined benefit plans, are not recycled out of other comprehensive income into profit at some later date. Those items that originated in the USA, principally gains and losses on the translation of foreign operations from functional currency to presentation currency, gains or losses on available-for-sale financial assets and gains or losses on hedging instruments in a cash flow hedge, are recycled out of other comprehensive income into profit at some later date.
- 8 For more details of the project, see Cairns (2002), pp. 364–7.
- 9 This decision was influenced by the IASC's commitment to the International Organisation of Securities Commissions (IOSCO) to develop, by 1999, a set of core standards for the purpose of cross-border capital raising and listing in all global markets. That set of standards had to include a standard on the recognition and measurement of financial instruments.
- 10 IAS 25.24, 25 and 45. The standard referred to 'revalued amount' but the explanation referred to 'fair value which is usually market value'. The treatment was consistent with the treatment for other long-term investments. IAS 25 also allowed investment property to be accounted for as property in accordance with IAS 16 *Property, Plant and Equipment* which allowed measurement under either the cost model or the fair value model.
- 11 See, for example, Cairns *et al.* (2011) and Christensen and Nikolaev (2008).
- 12 The evolution of the term fair value and its definition in IFRS are dealt with in Cairns (2007).

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