How Fair is Fair Value Measurement?

CA Rajkumar S Adukia
B.Com (Hons), FCA, ACS, ACWA, LLB, DIPR, DLL &LP, IFRS(UK), MBA
email id: rajkumarradukia@caaa.in
Mob: 09820061049/09323061049

To receive regular updates kindly send test email to : rajkumarfca-subscribe@yahoogroups.com & rajkumarfca+subscribe@googlegroups.com

The Fair Value Definition

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. .

Market Participants

Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

(a) They are independent of each other, ie they are not related parties as defined in IAS 24, although the price in a related party transaction may be used as an input to a fair value measurement if the entity has evidence that the transaction was entered into at market terms.

Market Participants

(b) They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary.

(c) They are able to enter into a transaction for the asset or liability.

(d) They are willing to enter into a transaction for the asset or liability, ie they are motivated but not forced or otherwise compelled to do so.

REMEMBER THIS…

“Fair value is an art, not a science.”

Marking to Market
or
Fair Value Accounting

Panacea or Pandora's Box?

Case for Marking to Market

- Market price reflects current terms of trade between willing parties

- Market price gives better indication of current risk profile
  - Market discipline
  - Informs investors, better allocation of resources

Mark to Market (MTM) Accounting

- In other words Fair Value Accounting is nothing but a simple accounting rule that relies on the use of the current market price of your financial assets to arrive at their fair value
- But some believe that this MTM or FVA rule does not reflect the effect of market forces on the correct price

Mark to Market (MTM) Accounting

- MTM Accounting or the Fair Value Accounting has the potential to become the best friend of our financial market, barring extreme cases

Example of MTM or FV A/cing

- Say you are holding a stock that is currently trading at Rs.100, then as per MTM or FV Accounting rule the FV of your stock is Rs.100
- In this case inspite of the fact that you have actually spent Rs. 200 to acquire the same and expect that in future the same stock will fetch you more money

MTM or FV Accounting Rule

- Under MTM or FV Accounting rule future expectations do not play a role.
- The worth of your asset is always determined by the price at which you can currently sell it in the market
- No need for statistics on future earning, growth potential or any other fact or assumption
- The current market price is the yard stick

Objections

- But some opine that it sounds all good in theory, in reality the free play of market forces may not always reflect the current picture of a financial asset
- Sometime the market prices may sway from one extreme to the other making it extremely difficult to account for.

Examples - Shortcomings of MTM or FV Accounting Rule

- A case of Distress Sale – Assets are not sold at right prices
- A case of Subprime Crisis – Financial markets freeze and you are left with assets for which there are absolutely no takers

  In such cases MTM or FV Accounting rule becomes a bane, while your financial assets are generating some income

Example for Duress Sale

- Say you own a house in the neighborhood where all the houses are priced at around $300,000.Your neighbor owns his house free and clear.
- Unfortunately he falls ill and needs urgent cash. Now because he is under duress, he must sell the house for $200,000 in order to get the cash he needs right away, even though his house is worth more.


Your House
BEFORE neighbor sells
Home Value: $300k


Your House
AFTER neighbor sells
Home Value: $200k
Loss of $100k!

What is the conclusion?

Does it mean your house is now worth the same $200,000, the price for which your neighbor has sold????

No Of course Not! The sale was made under duress or your new neighbor has made a great deal..

What does it mean?

- Should we get away with MTM or FV Accounting rule when the market is in distress
- The question here is about striking a balance between completely discarding and absolutely adopting MTM or FV Accounting Rule
- Not to forget MTM or FV Accounting rule compels us to look at the real picture

Top Property Sale in Mumbai

- **2007 –** An NCPA Apartment at Nariman Point in 2007, a flat measuring 3,475 sq ft (super built-up) was bought by a London-based NRI at a rate of Rs 97,842 a sq ft (Rs 34 crore).
- **April 2010** - National record in property transactions, with a duplex in the prime Samudra Mahal building at Worli fetching in excess of **Rs 36 crore** in an auction
- **October 2011** – Real Estate Expo at BKC – Ranged from a two-bedroom flat for Rs 1.5 crore in Kandivli (E) to a Rs 35 lakh- terrace flat in Virar, builders displayed their projects at the four-day Maharashtra Chamber of Housing Industry (MCHI) Property 2011 exhibition that opened on Thursday.

MTM in a world of market inefficiency

- We are told that mark to market is the right way to value assets
- Thus from July 2006 to July 2007 this rule told accountants that the massive asset price increases corresponded to real profits that should be recorded in the books.
- These profits, however, did not correspond to something that had happened in the real economy
- They were the result of “animal spirits”

MTM in a world of market inefficiency

- As a result mark to market rules exacerbated the sense of euphoria and intensified the bubble
- Now the reverse is happening
- Mark to market rules force massive write downs correcting for the massive overvaluations introduced just a year earlier
- intensifying the sense of gloom and the economic downturn

The Result

- Bankers now complain about mark to market rules now that the market goes down
- They did not complain during the upturn
- As a result, their credibility is weak

Marking to Market is Superior when Asset is

- Liquid
  - minimise feedback through strategic complementarily
- Junior
  - limited downside potential, large upside (e.g. stocks)
- Short-lived
  - minimise effect of horizon mismatch

Damage from Marking to Market is Large when Asset is

- Illiquid
  - Stronger strategic effects
- Senior
  - limited upwide, large downside (e.g. loans, insurance liabilities)
- Long-lived
  - Greater horizon mismatch

Other Basis of Measurement

- Historical cost
- Current cost
- Net realizable value
- Present value of future cash flows

Predominant usage of FV

- Under both U.S. GAAP and IFRS, fair value is most prevalently used to measure “financial” assets and liabilities as opposed to “non-financial” assets and liabilities, such as property or intangible assets.

Two kinds of Fair Value Measurements

- There are two kinds of FVM they are
  - Recurring FVM (Quarterly basis or each reporting period)
- Non Recurring FVM (Testing for Impairment)

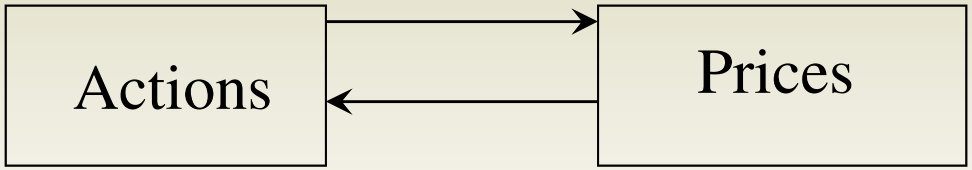
Volatility?

- If the fundamentals are volatile, then so be it.
- Market price is volatile
- Again it simply reflects the volatility of the fundamentals

“Artificial” Volatility

- Dual role of market price
  - Reflection of fundamentals
  - Influences actions

- *Reliance* on market prices *distorts* market prices



The Valuation Policy

- The valuation policy should be a priority
- The policy should be well documented
- The valuation process should be open and transparent
- The policy is a working document
- A sound valuation policy is critical and it pays dividends

A Uniform Framework

On

How to Measure Fair Value for entities around the world was created by

International Accounting Standards Board (IASB)

and

US Financial Accounting Standards Board (FASB)

The Emergency Economic Stabilization Act of 2008

- The Emergency Economic Stabilization Act of 2008 was introduced was signed into law on October 3, 2008. This legislation requires the SEC to conduct a study of mark-to-market accounting that must be completed by January 2, 2009
- A paper on Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting was issued by SEC

Barings Bank

- Barings Bank - 1762 to 26th February 1995
- ING, a Dutch bank, purchased Barings Bank in 1995 for the nominal sum of £1and assumed all of Barings' liabilities, forming the subsidiary ING Barings
- The bank lost £827 million ($1.3 billion) the loss is twice the banks available trading capital
- It was due to speculative investing, primarily in futures contracts, at the bank's Singapore office.
- Nick Leeson Key Personnel in the Barings Bank (Born on 25thFebruary 1967) (age 44)

Major Drawbacks of FVM – A Practical Scenario

a. Banks mounting loan losses have stated they have been significantly damaged in implementing the fair-value accounting standards.

b. The case of AIG, which recently took an $11 billion write-down as a result of fair valuation of its credit default swaps after its auditor found material weaknesses in AIG's internal controls over its financial reporting of credit default swaps

Major Drawbacks of FVM – A Practical Scenario

- Morgan Stanley, whose Level 3 assets made up 7.4 percent of the firm's total at the end of the third quarter, said that it wrote down $3.7 billion in the first two months of the fourth quarter 2007 because of the declining subprime market.
- On analyzing some of the US banks, the holdings of level-three assets are substantial. Lehman has $22 billion, Bear Stearns has $20 billion, and JP Morgan Chase $60 billion.

4 Challenges to Fair Value

1. Fair value accounting is potentially unreliable in the absence of quoted market prices
2. Fair value accounting will increase volatility in reported income.
3. There is an inconsistency between measuring assets and liabilities at current values (especially at a current exit value) when it is expected that a company will continue its operations as an ongoing entity
4. Fair value understates the "true economic value" of financial instruments when markets are depressed

International Valuation Standards Council

- Over the last decade, the International Valuation Standards (IVS) have been adopted or recognized by many valuation institutes, user groups or financial regulators around the world.
- The IVSB is an independent standard-setting board, appointed and overseen by the Board of Trustees.
- The historic base of the IVSC rests with real estate valuation.

Fair Value Measurement

- Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parites in an arm's length transaction.
- Fair value has been introduced in IFRS as
  - A means of putting a value on an incomplete transaction
  - A measurement attribute for subsequent measurement in a number of significant standards

Fair Value Measurement

- Fair value is a market-based measurement and as such not affected by factors specific to a particular company
- If available, an observable market price in an active market is the best evidence of fair value
- But what if a) there is more than one market price, b) the market is illiquid, c) there are no recent prices, and d) there is no market for the specific item to be measured ?

Fair Value Measurement – IFRS 13

- The IFRS explains how to measure fair value for financial reporting.
- Some IFRSs require or permit entities to measure or disclose the fair value of assets, liabilities or their own equity instruments.
- Fair value is a market-based measurement, not an entity-specific measurement.

IFRS 13 on Fair Value Measurement

IFRS 13 does not deal with

- ***when*** an entity is required to use fair value,

instead on

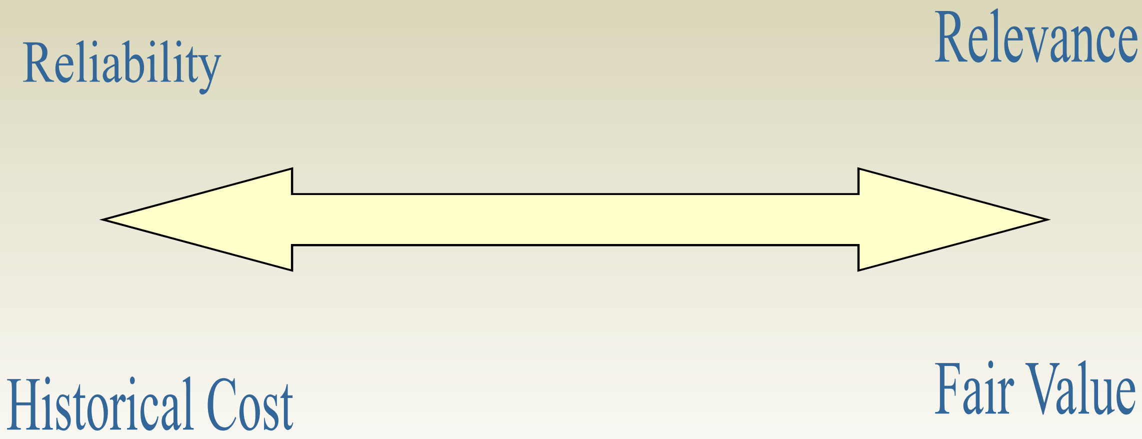
- ***how*** to measure the fair value of financial and non financial assets and liabilities when required or permitted by IFRS

Fair Value Measurement Hierarchy

- Need for a formal hierarchy which recognizes different market circumstances in how a fair value is derived
- Bottom layer = fair value entirely derived using a model and company data with no market inputs
- Reliability concerns

The Fair Value Objective

In order to be useful, accounting information should be both **relevant** and **reliable**



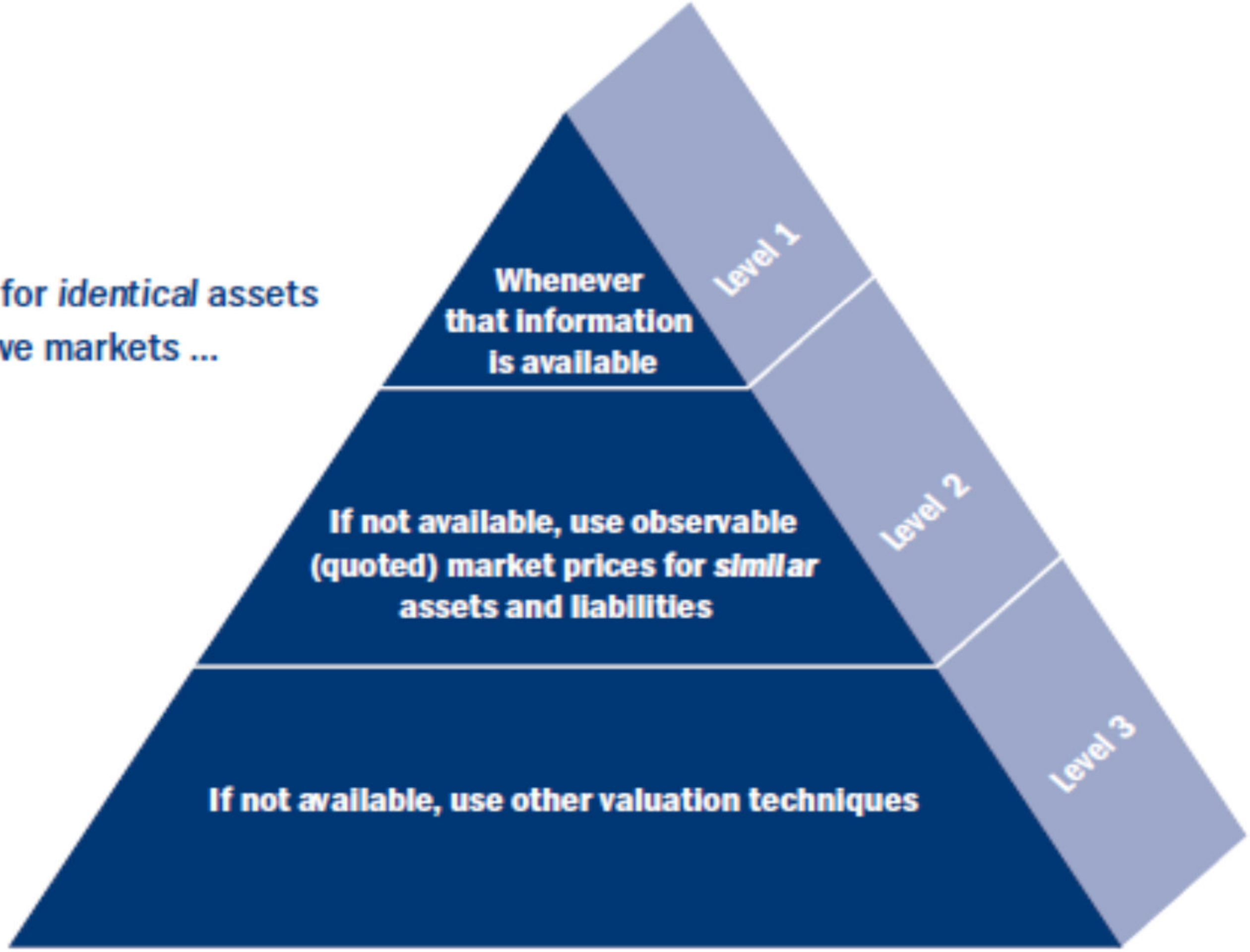
The Fair Value Hierarchy

- Observable Inputs
  - Based on market data obtained from sources independent of the reporting entity
- Unobservable Inputs
  - Reflect reporting entity's own assumptions about the assumptions market participants would use

Fair Value Hierarchy – Input Quality

- Level 1
  - Direct (unadjusted) quoted price form an active market for identical assets
- Level 2
  - Quoted prices for similar assets
  - Other observable inputs (interest rates, yield curves, etc.)
- Level 3
  - Unobservable inputs not derived from the market

Use quoted prices for *identical* assets or liabilities in active markets ...



Common Level 3 Inputs

- Cash flow forecasts for private companies
- Default probabilities and loss severities for private placement debt or asset-backed securities
- Growth expectations (revenue, earnings, etc.)
- Required returns on illiquid investments
- Anticipated holding periods for illiquid investments

What Are Common Level 3 Assets?

- Mortgage and asset backed securities
- Private placement corporate debt
- Equity investments in private companies
- Forward contracts, commitments and guarantees
- Other derivative contracts

Measurement under IFRS

Major principles of IFRSs

Type of asset / liability	Initial Measurement	Subsequent measurement
Inventories IAS 2	Cost	Lower of cost and net realizable value
Property, Plant and Equipment IAS 16	Cost	Cost model or revaluation model
Investment property IAS 40	Cost	Fair value model or cost model
Intangible assets IAS 38	Cost	Cost model or revaluation model
Exploration and Evaluation of mineral assets IFRS 6	Cost	Cost model or revaluation model
Non Monetary Government grants IAS 20	Fair Value or Nominal Value	Fair Value or Nominal Value
Non-current assets held for sale & Disposal groups IFRS 5	lower of carrying value and fair value less costs to sell	lower of carrying value and fair value less costs to sell
Biological Assets IAS 41	Fair value	Fair value less costs to sell

Measurement of Financial Assets

Nature of Financial Assets	Initial recognition	Subsequent measurement
Held for trading	At fair value	At fair value (through profit or loss)
Available for sale	At fair value plus directly attributable transaction costs	At fair value (through equity)
Held to maturity	At fair value plus directly attributable transaction costs	At amortised cost
Loans and Receivables	At fair value plus directly attributable transaction costs	At amortised cost

Measurement of Financial Liability

Nature of Financial Liability	Initial recognition	Subsequent measurement
Financial liabilities at fair value through profit and loss includes derivative liability	At fair value directly attributable transaction cost is charged to profit and loss account	At fair value
Financial liability arising out of continuing involvement asset	Measured at amortised cost or fair value	
Financial guarantee contract less cumulative amortisation recognised		Higher of the 1.Amount initial recognition 2.Valuation as per IAS 37
Other financial liabilities including debentures, bonds, preference shares classified as	At fair value directly attributable transactions cost is included in the fair value	At amortised cost

Conclusion

- Mark to market rules show excessive confidence in the efficiency of financial markets
- There is now substantial evidence that financial markets are not efficient
  - Inefficiency does not lead to just a few percentage points of over- or undervaluation of assets
  - but of massive and systematic misalignment of market prices

Conclusion

- Yet many people continue to believe in the market's infallibility
- and impose rules based on an idea that comes closer to religion than to science
- As a result, these rules aggravate financial and macroeconomic instability

Conclusion

- New rules should be designed
- They should not eliminate market prices altogether
- But they should bring some inertia in these prices
- Throw some sand in the wheels of financial markets.

Way Forward

- Only one model should exist for measuring financial instruments. That model is fair value.
- Fair value measurements should be reliable and computed in a manner that is faithful to the underlying economics of the transaction.
- Measuring financial instruments at fair value should not necessarily mean abandoning historical cost information.
- To accomplish these tasks, the following actions should be taken to address the practical issues:
- Standard-setters must provide more detailed, how-to accounting, valuation, and auditing guidance.
- The profession must work together and with others outside the profession including users and valuation experts.
- Preparers, auditors, and users must become better educated about fair value accounting.

G 20 Support for Fair Value Accounting

- On 15 November 2008, the G20 summit on the financial markets and the world economy was held in Washington.
- On 11 November 2008, the trustees of the IASC Foundation wrote to U.S. President George W. Bush and requested that a copy of their letter be circulated to participants ahead of the G20 meeting.
- The letter expresses support for both fair value accounting and the independent standard-setting process and expresses the view that efforts to improve the financial reporting should be led by the IASB in accordance with the established standard setting process.

About the Author

- *CA. Rajkumar S Adukia is an eminent business consultant, academician, writer, and speaker. He is the senior partner of Adukia & Associates.*

- *In addition to being a Chartered Accountant, Company Secretary, Cost Accountant, MBA, Dip IFR (UK), Mr. Adukia also holds a Degree in Law and Diploma in Labor Laws and IPR.*

- *Mr. Adukia, a rank holder from Bombay University completed the Chartered Accountancy examination with 1st Rank in Inter CA & 6th Rank in Final CA, and 3rd Rank in Final Cost Accountancy Course in 1983.*

- *He started his practice as a Chartered Accountant on 1st July 1983, in the three decades following which he left no stone unturned, be it academic expertise or professional development.*

About the Author

- *He has been coordinating with various Professional Institutions, Associations, Universities, University Grants Commission and other Educational Institutions.*

- *Authored more than 50 books on a vast range of topics including Internal Audit, Bank Audit, SEZ, CARO, PMLA, Anti-dumping, Income Tax Search, Survey and Seizure, IFRS, LLP, Labour Laws, Real estate, ERM, Inbound and Outbound Investments, Green Audit etc.*

- *The author can be reached at **rajkumarradukia@caaa.in***
  Mob – 09820061049 / 09323061049

- *For more details log on to www.caaa.in*

Thank You!