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Perspective on Fair Value Measurement

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Abstract

Although fair value is not a new measurement attribute, the interest of discussing fair value has been aroused by the release of new accounting standards. This article decodes fair value measurement again from four aspects respectively. Fair value measurement attribute is for asset measurement in the end, a kind of initiative measurement from master-slave relationship. As a matter of fact, fair value measurement is a measurement process. However, considering the special time, the relationship of exclusiveness does not exist between fair value and other measurement attributes. Simultaneously, fair value refers to fairness of value in special time and it is meaningless for fair value without the concept of time.

Keywords: Fair value, Assets, Measurement attribute

With rapid development of Chinese economy, whether accounting reflection corresponds to outside demands has gradually become a much-talked-about topic in the circle of accounting theory and practice. The central issue of accounting reflection rests with the quality of accounting data generated through accounting measurement. Just as the independence of auditing is soul of auditing, the quality of accounting data is soul of accounting. Accounting data with high quality is an important symbol for actual reflection of accounting. There have been various opinions on whether introduction of fair value measurement in accounting practice in China can generate accounting data with high quality. Those who hold a supportive opinion believe that, as an artificial accounting information system, estimation and hypothesis are intrinsic in accounting, so measurement of fair value does not affect its reliability (Xie Shifen, 2004). Reliability is just an issue of degree, and there does not exist any measurement attribute that is unexceptionable in terms of reliability (Chen Zhaohui, 2000). Those who oppose to the above opinion believe that, it is really extremely difficult for fair value to realize “fairness” since fair value is affected by external environment and artificial estimation. Especially, since 2008 when the financial crisis broke out, fair value has been faced up with unprecedented challenges. Those from banking and political circles hold the view in succession that fair value accounting standards are the “accomplice” of this crisis, and fair value measurement standards deteriorate the credit crisis. In the process of disputes for almost twenty years in China, it can be said that attitudes towards fair value have been full of twists and turns, the intricate process of approval --- negation --- approval in succession. New Accounting Standards for Business Enterprises released on February 15, 2006, have almost made their last pitches, and we should boldly use fair value measurement to improve quality of accounting data. Taking as a sample those A-share listed companies since implementation of new accounting standards in 2007, Liu Ying (2009) regarded the period of half a year as a sub-duration. It is indicated by the evidence that fair value measurement has value relevance, which in turn is interrelated with the market environment, and that relevance of fair value measurement in the bull market is higher than that in the bear market. This conclusion tells us that promotion of fair value measurement is feasible and may improve quality of accounting information disclosure. In this article, the author attempts to express his humble opinions in four aspects from the perspective of the nature of fair value measurement in the hope that the extensive accounting staff in listed companies can better understand fair value and better carry out new standards.

1. Ultimate direction of fair value measurement --- measurement of assets

Under the circumstance of satisfying specified conditions, application of fair value measurement is, as a matter of fact, measurement of assets. In accounting, accounting factors are classified into six major factors, including asset, liability, ownership interest, income, expense and profit. Measurement of fair value on other factors should be based on fair value measurement on assets produced in the transaction. According to Li Yu (2009), the core of accounting measurement is measurement on assets, and all other factors can be defined or set price by assets. Among the three static accounting factors, asset is in the central position all the time, and changes of liability and ownership interest can both be expressed by assets. Therefore, from the perspective of fair value measurement, measurement on other factors by use of fair value can ultimately be transformed into fair value measurement on assets.

From the perspective of manifestation forms, accounting measurement can mainly be classified into two major parts, namely, assets valuation and income determination. The so-called assets valuation is to use currency amount to confirm and display acquisition (such as realization of sales revenue) of all asset items, its employ (such as generation of a cost) and its balance (remaining assets). According to Ge Jiashu and Lin Zhijun, valuation of assets can also be applied to measurement on liabilities and property right. Liability is usually termed as negative assets, whereas property right refers to the remaining assets or net assets after deducting liabilities from assets, both of which can not go without assets valuation or measurement. After implementation of the new standards, China began to attach great importance to the asset-liability view, and the accounting standard for income tax in China was a case in point. Under the concept of assets and liabilities, measurement determined by income is subordinate to assets valuation. Therefore, either measurement on the factor of operation results or measurement on the factor of financial situation should be finally attributed to fair value measurement on assets. In turn, unfairness of assets measurement value may also affect measurement on other factors.

From the perspective of accounting practice, the ultimate direction of fair value measurement is that the idea of measurement on assets is to be well verified. For instance, assets received by an enterprise from an investor should enter an item in an account according to the value agreed in the investment contract by both parties of a transaction, with exception of unfair value agreed, which indicates the entry value of assets should be fair. If the value agreed is not fair, then there may appear two sorts of value for the assets, that is, agreed value and fair value. It is stipulated in the new standards that the entry value of assets have to be fair. Thus, assets should enter an item in an account based on fair value, while paid-up capital may enter an item of an account based on agreed value, with other items being balance adjustment. Here, agreed value means that the investor has voting capital amount, which in turn refers to the value agreed by both parties, but not according to fair value. Therefore, the stipulation that entry value of assets have to be fair actually determines that unfair voting capital amount agreed should be adjusted in balance. After adjustment, total interest amount generated is also fair. Thus, it can be seen that, fairness of interest is determined by fairness of assets.

2. Fair value measurement is a sort of initiative measurement, but not passive measurement.

According to the master-slave relationship between measurements, the six major factors of accounting can be classified into initiative measurement factor and passive measurement factor. Initiative measurement factor refers to the factor directly measured by such measurement attributes as fair value, whereas passive measurement factor refers to the accounting factor whose measurement amount can only be confirmed based on measurement on other factors (including measurement attributes and value of measurement). From the perspective of factors of static financial situation, assets and liabilities can be regarded as initiative measurement factor, and ownership interest can be seen as passive measurement factor. Considering the accounting reform in the past several years in China, it is measurement on assets and liabilities that have been mainly standardized, especially measurement on assets. Since merely data of initiative measurement factors are accurate, amount of factors of passive measurement is naturally determined. From the perspective of factors of operation results, income and expense belong to initiative measurement factor, whereas profit belongs to passive measurement factor. As for confirmation of income and expense, specific stipulations have been made in the new standards, including confirmation and measurement of income and expense, because data about income and expense directly decide data about profit. As has been mentioned previously, measurement on assets is the core of the entire accounting measurements. Under the concept of assets and liabilities, measurement determined by income is subordinate to assets valuation. Therefore, compared with measurement on factors of dynamic operation results, measurement on factors of static financial situation can be attributed as initiative measurement whereas the former belongs to passive measurement.

From the angle of the master-slave relationship between measurements, if an economic activity is required to apply fair value measurement, then it should start with factors of initiative measurement so as to guarantee fairness of factors of passive measurement. For exchange activities (with the precondition of corresponding with fair value measurement) of nonmonetary assets under the mode of fair value measurement, assets received are based on fair value measurement of assets surrendered. Here, first of all, it should be stipulated that assets received should be based on fair value measurement, whereas after assets surrendered have actually been converted into measurement on profits and losses after being surrendered. Hence, measurement on profits and losses rests with measurement on assets received. From this angle, fair value has always been mentioned in allusion to factors of initiative measurement. Thus, fair value measurement is a sort of initiative measurement, but not passive measurement.

In addition, according to the author, to let the extensive accounting staff come to understand the master-slave relationship between measurements can enable them to better apprehend influences and outcome of accounting measurement. Measurement on accounting factors does not only refer to measurement on factors per se, but also determines data about factors of passive measurement. Therefore, we should be prudent in application of fair value measurement. Otherwise, the "chain reaction" may be caused. The accounting standards in China adhere to the moderate and prudent principle in application of fair value. As a matter of fact, after full implementation of accounting standards, the Ministry of Finance have prompted enterprises by all means to prudently apply fair value measurement. For example, in the case of investment real estates, although in "Accounting Standards for Enterprises No. 3 - Investment Real Estates", it is stipulated that follow-up measurement mode of fair value should be adopted in investment real estates. However, at the same time, strict restricted conditions are also specified in application of fair value. It is indicated through the data in "Analysis Report on the Implementation of New Accounting Standards by Chinese Listed Companies in 2007" by the Department of Accounting of the Ministry of Finance, 630 out of 1570 listed companies held investment real estates in 2007, among which only 18 listed companies adopted the fair value mode to conduct the follow-up measurement on investment real estates, which should be attributed to implementation of the principle of "Day-to-day door-to-Market Analysis" by the Department of Accounting of the Ministry of Finance. After the new standards were carried out, the Department of Accounting of the Ministry of Finance tracked and analyzed reports of each listed company in 2007, which reflected the prudent attitude of the country towards implementation of fair value measurement from the very beginning. It is emphasized that fair value belongs to initiative measurement and may arouse the "chain reaction", so it can better cultivate and establish the prudent concept of accounting staff.

3. Fair value measurement is a process.

Fair value measurement refers to the amount of exchange of assets or settlement of obligation of their own free will by the two parties of transaction in a fair deal. As for an item of asset, whether the amount --- the fair value measurement --- of exchange of assets or settlement of obligation can be adopted is affected by lots of factors, but not finished at a stroke, because fair value measurement is a process. However, it has been less than three years since the new accounting standards were carried out in China. Therefore, according to the author, if too high expectation is placed upon effects of applying fair value measurement, then it is not in accordance with the current situation in China. How to understand this process? The author is going to discuss it from the following several aspects:

3.1 Fair value measurement is a progress and is developmental direction of accounting.

Western countries have always been a pilot in research and application of fair value measurement. Especially in USA, fair value was attempted to use since 1970s. Afterwards, studies on fair value have never really stopped. Until September 15, 2006, US Financial Accounting Standards Board released the Statement of Financial Accounting Standards NO.157 --- "Fair Value Measurement" (SFAS NO.157). In the new standards, meliorative guidance was put forward for assets and liabilities of fair value measurement, and made response to information disclosure of investors. It was stipulated, a company should give more disclosure to such aspects as scope of assets and liabilities of fair value measurement, information applied in fair value measurement and influences of fair value measurement upon income, etc. International Accounting Standards Board (IASB) also adopted fair value measurement in IAS32. A general view of courses of study by the international accounting circle on fair value for almost 40 years, it can be found out that, fair value measurement can obviously improve quality of accounting data and represents developmental direction of accounting measurement in the future. However, in earlier 2008, the Subprime Lending Crisis broke out in USA, and fair value measurement was faced up with severe challenges. Those who criticized fair value measurement mainly included the following financial institutions: the Stars and Stripes, Merrill Lynch, United Bank of Switzerland, American International Group (AIG) and the Blackstone Group who censured that fair value measurement had exaggerated the subordinate debt, which aggravated the Subprime Lending Crisis. Under the great pressure of political and financial circles, some changes have taken place in fair value measurement in western countries. Fair value is not a direct cause to give rise to the Subprime Lending Crisis. However, outbreak of the Subprime Lending Crisis indeed revealed that fair value measurement was still not extremely perfect. Thus, we should speed up research on newly emerging issues and attempt to revise and make perfect fair value measurement, but the future trend of fair value measurement will not alter. Fair value measurement is market-oriented, which emphasizes fair transaction and market perfection. Although America possesses a developed market economy, problems still happen in fair value measurement. What's more, the existing market economy in China is still not extremely perfect, and US and the European Union still have not acknowledged the status of the market economy in China. It should come to our mind that there is still a long way to go for the market economy in China. Considering the current situation of China, fair value measurement will be long term process.

3.2 Fair value measurement is a process of continually testing professional judgment of accounting staff.

According to Zhang Lianqi, considering its purpose, fair value is a process to seek for an objective kind of value, but this process has to be realized through the subjective judgment of human being, which enables fair value to evolve into a kind of utility value. Utility of the same object means differently to different people, and even the same person may differ under different circumstances. Therefore, it is difficult to generate a stable evaluation scale. Furthermore, the evaluation depends on such factors as the background, scholarly attainments, purpose and concept, etc, of the subjects, so it is difficult for others to make a decision on the right and wrong. This sort of property of insufficient rigidity and superabundant elasticity is susceptible to being manipulated. On one hand, the above viewpoint indicates the perplexity encountered under fair value measurement, and, on the other hand, also tells us that accounting staff should be strengthened in terms of their professional ethics and professional judgment capacity in order to adopt the amount of assets exchange or settlement of obligation --- fair value measurement. However, improvement of moral quality and cultivation of judgment capacity calls for a long term process, which determines that adoption of fair value measurement requires a long process to actually realize more fair value measurement.

3.3 In a narrow sense, amount of fair value of an item of asset is always changing, and accounting measurement needs to track the process of changes so as to realize measurement of the overall process of fair value.

Under fair value measurement, accounting staff may at any time adjust the book value. So long as fair value fluctuates, it is proved that a transaction occurs and the book value should be adjusted accordingly. According to Zhou Mingchun and Liu Xihong (2009), the reason for high information cost of application of fair value is that the confirmation process of fair value usually consumes a large amount of human power and material resources. Furthermore, the procedure is quite complicated, and cost of information may be increased if the procedure lasts for long. Actual fair value measurement cost is extremely high. However, offer of accounting information is restricted by the principle of cost effectiveness. As for offer of accounting information with high cost, there are usually two methods used by an accountant: firstly, surrender of the offer and secondly, simplification of the offer. As a matter of fact, the second method is what is adopted in the existing standards in China. According to the new standards, adjustment can only be made on the balance sheet date and the book adjustment is not required to make in other periods of time. Thus, cost of fair value measurement is largely reduced, and at the same time, demand of investors on more relevant accounting information is given due consideration. Therefore, essentially speaking, fair value measurement is a process in which the book value is adjusted at any time.

4. Fair value refers to fairness of value in special time, and it has no meaning at all without the concept of time.

According to the author, accounting measurement has its relativity in the aspect of time concept, so the value measured by means of a measurement attribute also has its relativity in the aspect of time concept. For example, considering relationship between historical cost and fair value, historical cost reflects value of a transaction or an item during a certain period of time in the past, which was fair at that time or was conformed based on fair value. Historical cost of a certain item of asset or liability under the current circumstance might be the fair value of this item of asset or liability in the past, whereas the fair value of a certain item of asset or liability under the current circumstance may be the historical cost of this item of asset or liability in the future. Therefore, it can not be said that historical cost is unfair or fair value is absolutely fair, and when the value of the transaction is selected to be confirmed and reflected should be taken into consideration. If the value measured in the past is selected to be reflected at present due to constraints of accounting hypothesis, then the value is already "out-dated", so there is obviously nothing meaningful to criticize unfairness of the value. Likewise, if the value measured at present is reflected in the future due to various restraints, then the value belongs to disclosure of data in the future, and even if it is much fair at present, it will mean nothing in the future.

Considering the special time, amount of a transaction may be expressed as several measurement attributes. This indicates that fair value is not necessarily a completely independent measurement attribute, but has close relationship with other measurement attributes. According to Han Dongping, et al (2009), fair value is equal to other measurement attributes, but it is contradictory to parallel fair value to other measurement attributes in the new standards. Besides, there are also some people who believe that the relationship between measurement attributes should be exclusive (Li Yu, 2009), and the equality relation of amount should not exist between measurement attributes. However, the author in this paper is not about to this viewpoint. According to him, a certain relationship may exist between measurement attributes (including fair value), but not the relationship of exclusiveness. We should not think that two sorts of measurement attributes are equal just because their amount is equal. Amount of measurement is merely one aspect of measurement attribute, and it also has characteristics of other aspects, such as foundation and angle of measurement, etc. There are the following reasons why we don't agree with the above viewpoint. Firstly, although their amount is the same, basis of their measurement is different. According to Professor Ge Jiashu, the basis of assets valuation can be classified into output value basis and input value basis. Output value basis includes fair value and net realizable value, etc, whereas input value basis includes historical cost and replacement costs. Therefore, although the amount of special time is equal, fair value is different from cost measurement in that the former is a sort of output value measurement, but cost is not. Secondly, under a definite circumstance, the non-excludability relationship between measurement attributes is more significant, which provides good reference for us to recognize the relationship between fair value and other measurement attributes under an indefinite circumstance (realistic circumstance). For example, under a definite circumstance, present value refers to fair value. Here, it is confirmed that future cash flow and interest rate (namely, discount rate) produced during a transaction are already known. In the Second Section of the book "Financial Accounting Theory" by William R. Scott, he took an extremely simple example to illustrate the total feasibility of the current value. What's more, the discounted present value of future cash flow equals to the market price of assets, that is, fair value. Otherwise, the phenomenon of interest arbitrage may occur. The so-called interest arbitrage refers to the phenomenon in which the market price of a market enables one to purchase goods and services from one market and then sells them in another market to acquire profits. Existence of the motive of interest arbitrage ensures that the market price of an item of asset is always equal to the present value of future cash flow.

In sum, as a measurement attribute, fair value has been promoted for application by all countries in the establishment structure of their standards by sparing no effort, which has already become a major trend in international application. Thus, we should also boldly advocate its use. Although it has all sorts of disadvantages, just as a lot of opponents have pointed out, such as, easily manipulated by human beings and insufficiency of reliability, etc, the major trend of fair value has been determined and is irreversible. The International Financial Reporting Standards have extensively used fair value measurement, and quite a large number of countries in the world (including Hong Kong) are implementing the International Financial Reporting Standards. There has not been any evidence to indicate that fair value can not be used. On the contrary, fair value measurement has obviously improved quality of financial reporting.

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