

The Study of the Application Status of Fair Value Accounting in China

Yichao Liu

School of Business and Management, North China Electric Power University, Beijing 102206, China

E-mail: wendylcy@126.com

Abstract

With more trade frictions as well as increasingly frequent and expanded trades between developed countries and China after its entry into WTO, fair value accounting has found its way even deeper into people's hearts because it can reflect assets income and valid value of debt payment, offer exact information support for relevant decision makers, and more importantly, narrow the gap between China's accounting standards and international ones as soon as possible. From the perspectives of concept, history of application, origin analysis and countermeasures, this paper conducts research and exploration into the application of fair value accounting in China.

Keywords: Fair value, Fair value accounting, Capital, Assets Market

1. Introduction

The concept of fair value accounting doesn't seem so strange to most of us. Literally, "fair" means justice, showing that justice relies greatly on people's subjective sense. With the fact exposed to us, we may conclude different judgments based on different perspectives or principles. However, "value" is a concrete economic term, which can be employed to express a basis for accounting. Combined together, fair value refers to expressing certain assets' value exactly with a widely accepted and recognized standard. It is a complex historical issue to define fair value and it is of great significance since its definition influences its application quite seriously. Even up to now, there has been no universal definition for it in domestic and foreign accounting fields.

2. The Connotation of Fair Value

2.1 The Definition of Fair Value

Fair value is defined by Canadian Institute of Chartered Accountants as the value of consideration agreed on in a fair transaction based on both voluntary sides familiar with the situation. According to the principles for financial reports issued by British Accounting Principles Board, fair value means the amount of assets or debts involved in a fair transaction or a liquidation sale based on both voluntary sides familiar with the situation. In September 2006, it was defined in the announcement on financial report principles exclusively issued by FASB as the money received by selling capital or paid by transferring debts in orderly transactions among market participants on a measurement date. In the enterprise accounting principles issued by Chinese Ministry of Finance in February 2006, fair value means the amount of money for capital exchange or debt payment involving both voluntary sides familiar with the situation in fair transactions, in which both sides are enterprises conducting continuous business who have no plan to have liquidation, sharply reduce business scale or have transactions under unfavorable circumstances. Basically, this definition is equal to those international accounting principles.

2.2 Relevant Concept Discrimination on Fair Value

2.2.1 Fair Value and Market Value

According to political economics, commodity value should be converted into a price manifested in monetary form, that is, reflecting value with price. In financial accounting, price is a direct manifestation for value. Accordingly, market price refers to that of a particular property or a particular debt, that is, the observable price determined by market. For a long run, market price is given the greatest priority during the process of introducing fair value in China.

2.2.2 Fair Value and Fair Price

Although these are two similar concepts, we deny replacing fair value with fair price. First, compared with fair value, fair price seems more proper and reasonable. Second, fair price means fair market price and advantages in market price serve as the basis for fair value. The two are not totally identical. Finally, fair value is only intended to emphasize the importance of objective value when pricing assets or debts while the emphasis on price can best

reflect the true value of assets.

2.2.3 Fair Value, Bid Price and Selling Price

There are two alternatives for fair value in an imperfect market environment, including bid price and selling price. The former refers to the amount of money paid for a particular property on a measurement date while the latter refers to the amount of money received by selling assets on a measurement date. It is quite subjective when choosing one between the two to be the alternative for fair value. It is also the great difficulty in defining fair value that makes the instability in its application to China's accounting field.

3. The Application of Fair Value in China

In terms of the application of fair value, there are three main stages:

3.1 The Recommendation Stage

This stage lasted from 1998 to 2000, during which the Ministry of Finance strongly advocated fair value. First appearing in Enterprise Accounting Principles: Debt Reconstruction issued by the Ministry of Finance in June 1998, fair value are mentioned later in Enterprise Accounting Principles: Investment and Enterprise Accounting Principles: Non-Monetary Transaction. These stipulations on fair value are focused on the point that the creditor should allocate the book value of receivable creditor's rights based on the proportion of different non-cash assets in the total fair value of non-cash assets and the value after allocation should be the entry one finally if several debt liquidations by non-cash assets are involved. If debts are paid off in the form of stock rights, the proportion of the fair value of different stock rights in the total should be relied on to conduct allocation.

There are several reasons for strong recommendation of fair value in this period:

1) The demand of China's economic development

At this point, socialist market economy system and orderly market structure have been established in China and modern enterprise system is being established, offering a favorable platform for the application of fair value. China's entry into WTO serves as another important factor. Since relevant rules have to be connected with the world in order to enter WTO, it seems natural to introduce fair value into accounting principles.

2) There have been some understanding and application of fair value in China's theory and practice. Fair value measurement truly reflects the economic interest brought about by enterprises and the value to be transferred when paying off debts. Therefore, there has been a practical basis for fair value's application in China's accounting practice.

3) China's accounting standards are geared to international accounting standards. During this period, a large amount of accounting standards on fair value are issued, making it a fad in the world, including China.

3.2 The Evasion Stage

This period lasted from 2001 to 2006, during which fair value was not employed to have realistic measurement on enterprises' profit and loss but to help some quoted companies to have cheating and control in profit unscrupulously, such as Qiong Minyuan and Zheng Baiwen who tackled their profit without any control. Accordingly, the Ministry of Finance had to adjust the part related to fair value in its accounting standards after 2001, avoiding fair value by resorting to book value in economic affairs.

The adjustment in the employment of fair value should be attributed to the following factors:

1) It is immature element market and inactive market that increase the chances of manipulation in fair value.

2) Fair value cannot satisfy investors and shareholders' demands for safe and precise accounting information. Therefore, historical cost is re-mentioned in order to avoid any negative consequence.

However, it is obviously unfair to blame fair value for imprecise accounting information. Instead, it is ineffective supervision means that create large space for manipulation. It is obvious that there would be less chance for subjective control over profit with proper and correct procedures, rules and principles for supervision in China.

3.3 The Re-Introduction Stage

In the new accounting standards issued after 2006, fair value was mentioned again. With the rapid development of knowledge economy and information economy, a large number of financial tools come into being in enterprises, calling for exact evaluation of financial risks and investment opportunities. Accordingly, a lot of standards issued after 2006 witnessed the concept of fair value to some degree. Compared with those international accounting standards, the application of fair value in these standards is more closely related to China's reality, which will effectively avoid the previous abused fair value. Actually, by introducing the security

mechanism of fair value reasonably and effectively, we will have China's accounting practice environment improved profoundly and extended widely. Accordingly, relevant parties' interest will stand at a new balanced point in a wider environment.

4. Reasons for the Application of Fair Value in China

Based on the above study on fair value's history, the reasons for its application are listed as follows:

(1) Fair value is of natural superior factors.

Fair value, a factual measurement of assets value, is characterized by its emphasis on authenticity, fairness and reliability, which serve as the ultimate goal for China's accounting practice. Financial accounting is intended to reflect how well the management level has conducted their responsibilities, which helps its users to make reasonable economic decisions. As is shown, the leading role of goals in accounting standards has been established in China.

(2) The profound development of market economy has promoted the application of fair value.

After its entry into WTO, China has had greater trade frictions with developed countries due to their reluctance to admit the status of Chinese market economy. However, open and transparent disclosure of accounting information has become an effective method to reverse such a situation. With constant and rapid rise in GFP in recent years in China, it is difficult for traditional historical cost measurement pattern to truly and fully reflect enterprises' operation and risks. In spite of the large number of derivative financial tools, such as options, futures and forward contracts popular at assets market, they have no fixed forms and don't go through real transactions, leading to failures in measurement. Only with fair value can this be settled properly. In some sense, fair value is an outcome of competition.

(3) Being geared to international accounting standards is an international motivation for the introduction of fair value.

Due to the differences between China's accounting standards and the international ones, China's market economy hasn't been accepted by most nations up to now, which has severely blocked its being integrated into economic globalization. The largest difference lies in whether fair value is included. Therefore, only by narrowing the institutional disparities will the distance between China and other developed countries be narrowed. In spite of the insufficient conditions for its application in China at the moment, fair value must be introduced since universal accounting standards are bound to come into being with the convergence of systems among different nations.

5. Countermeasures and Suggestions on the Application of Fair Value

5.1 Establishing Theoretical System of Fair Value Accounting

5.1.1 Strengthening the Study on Basic Accounting Theory

In this aspect, the range and condition of fair value's application as well as its relations with other measurement attributes should be covered in addition to its concept, measurement methods, characteristics and selection rules.

5.1.2 Promoting the Theoretical Study on Fair Value Accounting Standardization

In terms of practice, fair value and other relevant financial accounting goals, basic accounting assumptions, confirmation, measurement, records and reports should be standardized.

5.1.3 Promoting the Theoretical Study on Fair Value Measurement Patterns

Different measurement patterns are composed of different measurement units and attributes, therefore, there are two theories on the measurement of fair value, that is, the theory of a flat money/fair value pattern and the theory of a constant purchasing power/fair value pattern. With their respective advantages, it is quite urgent to have more studies on them in order to accelerate diminishing harassment in practice.

5.2 Perfecting Fair Value Evaluation Technology

At the current market, with a small amount of observable market information, a large proportion of fair value of assets and debts needs to be measured with complex evaluation technology. However, there are only a limited number of researches on relevant evaluation technologies and there is no detailed explanation in the new standards. Accordingly, the following measures should be taken:

1) Employing evaluation technology to confirm and institutionalize the conditions, principles and standards of fair value;

2) Strengthening the research on the applicability and reliability of evaluation technology as well as the

verification of its result;

3) Introducing and publicizing relevant mathematical patterns for basic analysis and exploring new technologies for evaluation;

4) Actively studying and learning from advanced evaluation technologies in other countries, closely tracking the development of international evaluation technologies to improve China's evaluation level.

5.3 Establishing Fair Value Measurement Standards Conforming to China's Reality and Convergent with International Standards

5.4 Actively Improving the External Environment for the Application of Fair Value

5.4.1 Improving the effectiveness of all factor markets to offer a favorable market environment for the application of fair value;

5.4.2 Actively promoting the construction of Chinese information-oriented market to offer sufficient market data support;

5.4.3 Perfecting the comprehensive supervision system of quoted companies to reduce the chances of profit manipulation;

5.4.4 Enhancing the intensity of education and training staff in accounting, agencies and supervision to improve their comprehensive quality.

The research on fair value is a progressive and complex process, so is its practical application a topic worth our attention for a long run. What has been mentioned in this paper is expected to trigger more attention to this topic, hence leading to profound development in both the basic theory and practical operation related to fair value in China.

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