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Fair Value Accounting Standard (IAS 39) Versus the Historical Costs Principle

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Abstract

The International Accounting Standards Board and other financial statement users are often in conflict on which is a better financial reporting method, the fair value or the historical cost. This research is conducted by evaluation studies by agencies such as the United States Securities and Exchange Commissions on the use of fair value of entities. The findings indicated the usefulness of historical cost, but global industrialization calls for the use of a uniform reporting standard among countries. The fair market value, as discussed in IAS 39 has risks associated on its' misapplication. Despite this, more financial statement users favor the fair market value in financial reporting.

Keywords: *International Accounting Standards Board, IAS 39, fair market value, historical cost, financial reporting*

1. Introduction

The globalization of many businesses calls for the adoption of International Accounting Standards as a means of reporting and classifying financial statements. Financial authorities assert that the international uniformity of accounting standards can cut the costs of conducting business across countries. Uniform accounting standards make the financial information compared, thereby, enhancing the proper analysis and valuation of financial statements. In addition to that, standard

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setters who favor the fair value accounting, argue that the use of fair value methodology improves the relevance of financial reports. Relevant information is a means for decision makers, such as investors to come up with a better and informed decision. However, despite the arguments for the international application of new accounting standards, there are countries that shun from adopting these modes of financial measurement on the concept that such is a deviation from the generally accepted accounting principle. This study is focused on the basis of the following hypothesis a) the IAS 39 makes the financial data more accurate than historical costs, and b) the IAS 39 is an accounting fraud tool as its application is a move away from the historical cost principle.

One example of deviating from the generally accepted accounting principles is the adoption of the International Accounting Standards 39 (IAS 39). The official acceptance of this Accounting principle is controversial due to the differing points of view among financial statement users. Accountants from different sectors are not one in their opinion on which is better to be followed in disclosing financial data. Some accountants favor the use of international accounting standard 39, on the argument that it is a more accurate method of valuation. Those who are against it, say that such adoption is a deviation from the historical cost principle, and it can be used to conceal an accounting fraud. It is then the aim of this paper to draw attention on which is a better point of view in the accounting parlance, the historical cost principle or the Fair Value Accounting Standards 39.

1.1 The Qualitative Characteristics of Accounting Reports

The International Accounting Standards Board (IASB) in 2010 specified the major objectives of financial reports which are to make available to users with valuable information on the economic and financial condition of entities, in order to assist decision makers to come up with informed decisions. The board specified the two major criteria that are to be met in order to come up with better financial decisions:

*Relevance- In order to make a difference in the process of decision making, the financial information should be helpful in assessing the past, present as well as the future events in relation to the economic standing of the entity (Qualitative)

*Reliability- A financial report is reliable when users can depend on the neutrality, verifiability and completeness of the information. The user should be able to rely on the representational faithfulness that what the information purports to represent is what it truly represent.

2. Historical Cost Principle

The historical cost principle requires the valuation of an asset or resource that is given up, or the value of the liability that is incurred to gain an asset or services. The historical cost principle involved the recording of financial transactions in their initial or historical costs. Recording transactions at historical costs is not only favored because of its simplicity and lower administrative costs, but also because historical costing is considered more reliable (Lefebre, Simonova and Scarlat, 2009). It conforms to the matching concept which stipulates that the costs of assets or resources recognized in the statement of income should have corresponding revenue reflected in the statement. This concept is tied to the past recorded value of transactions, and it strongly favors the consistency and comparability of financial figures. According to supporters of historical costing, actual data have a lesser probability of having an error as opposed to fair value that comes from hypothetical estimates. With historical costing, subsequent appreciation of the asset is not recognized in the financial papers, except as allowed or stated in the generally accepted accounting standards. Therefore, historical cost accounting advocates that the increase or decrease in value is not recognized in the financial statement, until such time that the asset is sold or the liability is extinguished. An example of historical recording is when a depreciable asset was initially purchased in the middle of an accounting year at $10 million; the concept of historical costs entails that such asset should be recorded at its purchase price less accumulated depreciation despite the increase in its fair value. “The concept of historical cost is important because market values change so often that allowing reporting of assets and liabilities at current values would distort the whole fabric of accounting, impair comparability and makes accounting information unreliable (Cost)”.

2.1 IAS 39 Makes the Financial Data More Accurate Than Historical Costs

Despite the favorability of historical costing in some instances, there are the downsides of using the method. This concept is one of the measuring methods used to record assets and liabilities, but its simplicity often times cannot matched with the need of many financial statement users. This is due to the argument that historical costing presents an excessively conservative financial standing of an organization:

*does not consider the actual economic value of a financial asset or liability *does not reflect the changes in purchasing power of the currency

*this method includes estimates that are subject to human error in terms of estimating the remaining economic life of assets, joint costs, and warranty liabilities.

*assumption of a going concern when many entities may be in their final stages

*the simplicity of the method makes it difficult to account for complex assets such as derivatives and hedging instruments.

2.2 The Fair Vale Method Can Be Used As an Accounting Fraud Tool

The complexity and flexibility of the fair value method make it susceptible to be manipulated and susceptible to manipulation. The fair value principle refers to the adoption of valuation practices wherein there is regular updating by reference to current prices for similar assets and securities as assessed within the circumstance of a liquid market (Greenberg et al., 2013). IAS 39 defines fair value as the amount for which an asset could be traded, or a liability settled, between two informed parties in an arm's length transaction (Linner n.d.). The use of fair value measurement is presumed on the concept that an entity is a going concern, and that the changes in the fair value should be reflected in the balance sheet and the profit or loss is forwarded in the income statement. This resulted in the worldwide adoption of fair value accounting because of the argument that fair value gives a relevant and timely valuation of accounting information (Linner, n.d.). Standard setters justify their decision to implement the fair value accounting methods on the idea that such practices meet the need of investors and financial analysts of relevant and timely information.

2.3 The International Accounting Standards 39

The International Accounting Standard 39 is a complex principle as it applies to derivative financial instruments such as call and put options, forwards, futures and swaps. Contractual agreement that arises from speculating on future market fluctuation gives rise to derivatives. The complexity of this standard comes from the its requirement, specifically to hedge accounting, (IAS 39) that inhibits the terms of consistent and meaningful data that should be provided to investors about the effects of an entities accounting strategies. The application of IAS 39 includes the trading of non-financial items like valuable metals at a future date. "The objective of this Standard is to establish principles for recognizing and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items (International). The recognition of financial instruments begins when a particular unit or entity formed a contractual arrangement with the issuer of an instrument. The measurement of the instrument is determined by the type of instrument and its categories. There is also a special rule on the measurement of embedded derivatives and hedging instruments (IAS 39).

The development of IAS 39 started back in October 1984, when the exposure draft E26 was made tackling the scope on Accounting for investments. Subsequent years saw the different revision of the draft regarding financial instruments. In 1988, the International Accounting Standards Committee (IASC), started to actively set agenda of financial instruments. The Committee was not able to unite with other financial sectors regarding measurement issues, and so with a limited scope, it released the IAS 32 *Financial Instruments: Disclosure and Presentation* in the year 1995. In order to deal with matters not covered in IAS 32, the committee made a consensus and issued IAS 39 in 1999 (Spector n.d.). In 2001, the International Accounting Standards Board (IASB) replaced the IASC. The board immediately took note of issues pointed by audit firms, regulators and other standard setters that are identified with the IAS 39. In 2003, IAS 39 was revised after the proposed changes in 2002 had been accepted. Further amendments were made to conform to the suggestions and proposals from financial regulators.

2.3 Scope of IAS 39

The scope of International Accounting Standards 39 covers all entities and financial instruments, except when it is clearly in conflict with another accounting standard or an item is classified with a different accounting treatment. The exception, however, is not absolute. For example, one rule in IAS 39 excludes the interest in subsidiaries, associates, or joint ventures as these items are accounted using other standards, such as IAS 27 on *Consolidated and Separate Financial* Statements for accounting for an entities interest in its subsidiaries. Even at that, in essence the IAS 39 covers these items as the standard further added: “entities shall apply this standard to an interest in a subsidiary, associate, or joint venture that according to IAS 27, IAS 28, or IAS 31 is accounted for under this standard (Spector n.d.).

All derivatives are also covered by IAS 39. Derivatives are financial contracts or instruments that have all of the following qualifications:

*Its value fluctuates as a reaction to the change of a certain interest rate, the value of the instrument, price index rates and other underlying variables. It could also be affected by non-financial factors, provided that such factor cannot be traced specifically to any one of the parties.

*the settlement is at a future date and by a net cash payment

* It does not require an initial investment or an initial net investment for that matter; that is lesser than what is needed for other types of contracts of which a similar response to changes in market value factors is expected (CFM16090)

In June 2013, the International Accounting Standards Board released a limited-scope change to IAS 39. The amendment, is entitled *Novation of Derivatives and Continuation of Hedge Accounting* (Amendments to IAS 39). The amendments allow the continuation of hedge accounting in cases where a derivative that was initially classified as a hedging instrument, has undergone novation in order to allow clearing with a central counterparty resulting from regulations or certain conditions are met. Novation itself means that both parties agreed to the substitute of their initial counterparts with a fresh single. "This easement has been inaugurated in response to legislative changes across many jurisdictions that would contribute to the widespread innovation of over-the counter derivatives (IASB). These varieties are a result of the commitment of standard setters to the betterment of the transparency and regulation in an internationally consistent and non-biased way (IASB)

2.3.1 Examples of Differential Coefficients

- Onward- These are contracts to trade an asset, may it be a financial instrument, commodity or a foreign currency at a defined value and engagement. The actual delivery of the object or payment in hard currency at maturity settles the contract.
- Futures-This is a contract that is similar to forwards, but with slight differences in the following areas: while forwards are tailored individually and are settled through delivery or payment, futures are generic and are exchange traded. The futures contracts are traded and payments are settled in a future exchange market.
- Options- This is a kind of contract that affords the purchaser the right, but not the obligation, to purchase or sell a certain bit of a financial instrument at a determined value, at a stipulated future date. An option fee is paid to the seller to compensate the risk associated with trading the option.

- Caps and Floors- These are oft times mentioned to as interest rate choices. Both the buyer and the seller are compensated by the cap and floor rates respectively.

2.4 Classification of Financial Assets As Required By IAS 39

Financial Assets at Fair Value through profit and red ink

*designated- it includes any financial asset that is indicated, and quantified at fair value and with the fair value fluctuations reflected in profit and loss.

*Held for Trading- As the epithet connotes, this includes financial assets that are taken for the intent of trading. Almost all derivatives, with the exception of those that are classified as hedging instruments, are held for the purpose of trading and gaining profit in a short term.

Available for Sale Financial Assets- These are non-derivative financial asset that is initially classified as available for sale, and may include financial instruments that are accepted from the groups of loans receivable, held-to-maturity and assets at fair value through net income and red ink.

Loans and Receivables- these are non-derivatives with fixed and determinable payments not specifically quoted in the active market.

Held-To-Maturity Investments- also non-derivatives that is intended to be held until maturity.

The International Accounting Standards Board, through IAS 39 has further set the principles in recognizing not only financial asset, but also of financial liabilities and contracts in purchasing and selling financial and non-financial instruments. The application of International Accounting Standard 39 requires the use of fair value, thus changing the way of measuring and recognizing financial instruments (Nimer et al., 2011). The IAS 39 was endorsed by many accounting standard setters to meet the requirement for conducting business across international borders. The standard was set to establish comparable measurements amidst a diverse range of costing standards that leads to the confusion in comparing and reading financial reports, particularly in reporting complex financial instruments such as derivatives.

2.5 Measurement of Financial Instruments According To IAS 39

	Initial	Subsequent	Changes recorded to
a. Derivatives	Cost	Fair value	Income statement
b. Loans and receivables	Cost	Cost/ Amortized cost	Income statement
c. Financial Assets Held for trading	Cost	Fair value	Income statement
d. Financial Assets available for sale	Cost	Fair value	Equity or income statement
e. Financial assets held-to-maturity	Cost	Amortized cost	-
f. Financial liabilities held for trading	Cost	Fair value	Income statement
g. Other financial Liabilities	Cost	Amortized cost	-

Source: Anderson, A., Milo, A., IAS 39, *What Do Companies Have to Consider?*

In year 2008, the United States Securities and Exchange Commission (U.S SEC) held a massive consultation that studied the application of fair value accounting and its use in different institutions. The bulk of those who commented on the application of fair value measurement said that said principle gives the financial statement users, such as the investors "additional insights into the risks to which the company may be debunked and the potential liquidity issues the company could face if needed to sell securities rather than keep them for the long term" (as quoted. in Lefebre).

Nevertheless, as there are advantages, there also comes the disadvantage of utilizing the fair value system. For instance, in the above mentioned consultation conducted by U.S. SEC, the participants indicated that when market conditions reversed into the negative side, the fair value method results to a less relevant and less reliable financial reports because of the "very unstable" market conditions from which to establish the fair value. Another loophole on the use of fair value is the unavoidable, use of the subjective view in cases when one cannot particularly observe an asset. Such judgment may come from management and the use of other information that may not be reliable, hence the uncertainty about the validity of the assumptions used. In uncomplicated cases, defining the fair value of an item may be leisurely as they may be listed and published in business journals, however, it may not be comfortable for the valuation of complex legal documents (The Bond). Entities may require to use valuation models and demand into account various data that may include economic forecasts, market conditions and monetary values of similar points in order to come upward with a reasonable fair value valuation.

The IAS 39 in particular was a theme of criticism since its execution. The Moody's Global Credit Research issue on December 2008 cited Moody's Investors Service, Inc. criticizes the IASB for not putting the amendments to IAS 39 in the normal due process and scrutiny before its implementation. The IASB was perceived to be pressured to go on with the amendments due to the global crisis in the year 2008 that put the European businesses at a disadvantage compared to their U.S counterparts

3. Findings

A. IAS 39 makes the financial data more accurate than historical costs:

a. Using the fair value method, investment property is recorded on the balance sheet at fair value, while the changes in the fair value; whether profit or loss, is reflected in the income statement.

b. Fair values are faithful representations of assets and liabilities.

c. Fair values are comparable and reliable- market prices are reflective of all economic prices. Under complete markets, the investors do not need to estimate the equity value because it is already reported through fair value accounting (Serakibi n.d.).

B. IAS 39 is an accounting fraud tool:
a. With the promulgation of IAS 39, companies were given the freedom to choose on how to treat various assets and liabilities such as the following example:

i. A company's freedom to prefer. An entity is given the chance to initially record its assets and liabilities at costs or market value. Fair value measurement is entity specific, and an asset can be assessed differently by different companies, resulting in the decline of the reliability of estimates (Fair Value). The flexibility of choice may entice the managed to list a rise in market value as profits or he may hide it in equity.

ii. Manipulation by management- the categorization of financial instruments depended on the design of the entity to retain it until maturity, support it for trading or as an available for sale. With IAS 39, the management is given the opportunity to "recognized unrealized profits, even before the disposal of the asset (Nour et al., n.d.)

b. Exploiting fluctuations in market value- There are many entities that purposely declared profits on their stock investments basing on their calendar year's closing prices despite the asset being held, the determination for their dispersion is then made accordingly (Nour et al., n.d.)

c. Since fair value is impacted by personal judgment, such values may be susceptible to manipulations.

d. An improper classification of financial securities allows for the promulgation of fraud. A reduction in market value may be classed either in profit or loss or in the other comprehensive income.

i. A trading securities may be misclassified as available for sale, so that the unrealized losses may be shifted our from the profit and loss in other comprehensive income

ii. An available for sale security may be misclassified as trading security, with the purpose of reporting unrealized gains in profit or loss instead of reflecting it to other comprehensive income.

iii. An entity may misclassify a debt security as held-to-maturity, despite management intent not to hold the security until maturity

e. The IAS 39 has a wide scope, it's almost impossible to cover and monitor all risks tied to it.

4. Auditing Fair Value Estimates

An alert was issued in 2008 by the IASB to focus on areas within the International Standards on Auditing, with the intent to give assistance to auditors particularly in auditing the reasonableness of accounting estimates. This has been arranged in consideration of the economic crisis in 2008, and in preparation for uncertainty in the future (International Auditing and Assurance Standards Board) The notice is particularly important in auditing entities that are holding investments in financial instruments, mainly those in liquid markets. Consideration should be made in auditing fair value accounting estimates. An auditor should note that there is a need to incorporate unbiased judgment on assumptions that are made by experts that are engaged by the entity. More often than not, auditors are faced with the challenge of securing reliable information that supports the indicated fair values.

It is recommended that auditors who are faced with the uncertainty of auditing information in times of uncertainty should use diverse techniques to be able to come up with an informed and independent opinion. As a rule, he should make a point to understand the entity and the environment where it operates. "Due to the complex nature of certain financial instruments, it is vital that both the entity and the auditors understand the instruments in which the entity has invested" (AS qtd. in International). In addition to the customary auditing procedures, the auditor may elect to engage the service of an expert to come up with a better evaluation of assets and investments. Further, the auditing practitioner should obtain a written representation of the entity or its management with regards the significant assumptions used in reporting.

5. Conclusion

There are controversial issues that come to the decision of some entities on whether to use historical costs or fair value costing. The Generally Accepted Accounting Principles had been advocating the use of historical costs, where an entity's assets and liabilities are carried at costs or market value whichever is lower. This principle is viewed as one of the most conservative methods; however, objections to its use are raised because the historical cost does not reflect the actual standing of a company's assets. On the other hand, the fair value method is a complex and highly criticized principle because of the many risks associated with its use. The Accounting Standards Board had promulgated IAS 39, and has issued a number of amendments to such standards in order to meet the needs of diverse users. The IASB is attempting to come up with an ideal standard that will meet the concerns of financial statement users as the globalization of businesses calls for the adoption of timely and updated standards such as fair value measurement and reporting.

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