

Historical Development of the Fair Value Model

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Contributor: Esraa Esam Alharasis, Ahmad Saleem Tarawneh, Maha Shehadeh, Hossam Haddad, Ahmad Marei, Elina F. Hasan

The use of fair value (F.V.) can help businesses obtain more up-to-date financial information on how they are doing and make financial reporting more transparent than traditional accounting methods. It also poses many problems for auditors because they have to make detailed estimates and adjustments when they look at the assets and liabilities of a company. Because "Fair Value Measurements (F.V.M.s)" are based on the current prices, certain assets and liabilities were not evaluable because there were not enough efficient markets for them. There is an "agency problem" between managers and owners, which means more incentives for managers to manipulate and misrepresent financial information.

Keywords: fair value model ; reimbursement costs ; held-for-trading ; available-for-sale ; fair value option

1. Introduction

Following the publication of the "International Financial Reporting Standards (I.F.R.S.s)," the "International Accounting Standards Board (I.A.S.B)" emphasised the need to use the fair value (F.V.) model ^[1]. The I.F.R.S.s' primary objective was to ensure the application of F.V. ^[2]. The first implementation of the (F.V.) model occurred with the publication of the "I.A.S.39: Financial Instruments: Recognition and Measurement" in 2005, and had a significant impact on the global banking sector ^[3]. According to the I.A.S. 39, F.V. for financial assets is classified into three categories: "held-for-trading (H.F.T.), available-for-sale (A.F.S.), and the fair value option (F.V.O.)". Numerous international accounting standards, including the I.A.S. 39, the I.F.R.S. 7, the I.F.R.S. 13, and the I.F.R.S. 9, have been released and mandate recording some assets at F.V. in the balance sheet, income statement, and stockholders' equity ^{[4][5][6][7][8]}. This is consistent with several cooperative efforts initiated by the "International Accounting Standards Board (I.A.S.B.)" and the "Financial Accounting Standards Board (F.A.S.B.)" to increase the usage of the F.V. model.

The use of F.V. can help businesses obtain more up-to-date financial information on how they are doing and make financial reporting more transparent than traditional accounting methods ^{[9][10][11]}. It also poses many problems for auditors because they have to make detailed estimates and adjustments when they look at the assets and liabilities of a company ^{[12][13]}. Because "Fair Value Measurements (F.V.M.s)" are based on the current prices, certain assets and liabilities were not evaluable because there were not enough efficient markets for them. There is an "agency problem" between managers and owners, which means more incentives for managers to manipulate and misrepresent financial information.

Previous research on monitoring costs of post-F.V. model implementation and its influences on the auditing profession is limited and inconclusive. Furthermore, it is mainly from more significant and established economies, such as the United States (U.S.) and countries in the European Union (E.U.), where the auditing sector is more apparent, as opposed to tiny, developing countries such as Jordan ^[14]. At the same time, the researchers are not aware of any other research emphasising the impact of each type of fair-valued asset that significantly influences audit prices in both developed and developing nations. Different findings have been reached on the degree to which audit data support F.V. verifications due to institutional affiliations and variances in core features ^[15]. Therefore, this aims to bridge this gap in auditing F.V. models by exploring the nature of the relationship between the F.V. model and audit fees, focusing on a principles-based framework (i.e., the I.F.R.S.s) instead of a rules-based framework (i.e., U.S. G.A.A.P.). Second, for the first time, it aims to test how each type of fair-valued asset is measured by the F.V. model as requested by the I.F.R.S.s and the I.S.A. on external auditor reimbursements in Jordan.

Moreover, the present research also illustrates the nature of Jordanian capital markets and the issues that arose after the initial implementation of the F.V. model in 2005. Many studies have been undertaken to present the recent empirical evidence dealing with the economic consequences of the I.F.R.S.s implementation and the incentives behind the adoption decision. However, no attempt has been made yet to summarise the significant impact of topics related to the actual implications of the application of the F.V. model and its noticeable effects on the auditing profession and, in particular,

audit fees. The researchers are not aware of any effort in the M.E. that considers factual information about the actual application of the F.V. model and the real implications on audit prices.

2. Fair Value Development Overview

The F.A.S.B. is not the only organisation responsible for developing standards for insurance accounting and financial instruments (F.I.)—the “International Accounting Standards Committee (I.A.S.C.),” which was renamed the I.A.S.B. in 1999, is another organisation that has been working hard to reach a level of homogeneity in the accounting principles used by other organisations and industrial entities operating on a global scale for high-level financial reporting. The work toward F.I. resulted in the publication of the I.A.S. 39 in 1998, and several revisions to the I.A.S. 39 have been made since then. For the most part, the I.A.S.C.’s activities have been aligned with the F.A.S.B., and both have F.I. as their focal point. However, the committee proposed two more initiatives: the I.A.S. 41 Agriculture (2000), which requires the F.V. model to be used by all individuals who engage in agricultural operations, and the I.A.S. 40 Investment Property (2000), which integrates the F.V. model into nonfinancial assets ^[16].

The Financial Accounting Standards Board (F.A.S.B.) created the Statement of Financial Accounting Standards (F.A.S.) 115 in 1994, categorising financial assets as “held-to-maturity, held-for-sale or held-for-trading.” This statement applies to all enterprises operating in the financial sector. F.A.S. 115 permitted enterprises to utilise discounted cash flow as the primary criteria for “held-to-maturity” assets and mandated that firms use F.V. when valuing assets falling into the other two categories. In 1998, a new and better statement—F.A.S. 133—was produced based on F.A.S. 115. According to F.A.S. 133, derivatives must be held on the balance sheet at fair value. Any changes in their F.V., other than those resulting from particular hedging operations, must be reported in the income statement. While it is true that F.V. principles have been reinstated, this has made their implementation in practice more intimidating and contentious than ever. To decrease complexity and controversy, a new standard, F.A.S. 157, was issued by the F.A.S.B. The Standard was called “Fair Value Measurements”, and it gave a basic, noncontroversial definition for F.V. It provided a general framework to develop “fair value estimates (F.V.E.)” and required those estimates to be disclosed. In other words, the primary function of F.A.S. 157 is to specify how F.V. must be determined in the cases where the F.V. is requested by a different standard—prescribing specific accounting treatments or imposing requirements for F.V. are not within the scope of the functions of F.A.S. 157.

Following the release of the I.A.S. 39 “Financial Instruments: Recognition and Measurement,” the F.V. model was used for the first time. This had a significant impact on the international finance industry ^[3]. When the I.A.S. 39 came out in 2004, it explained how to recognise and measure financial assets and liabilities and certain agreements to purchase or sell nonmonetary things such as automobiles ^[5]. It was then changed to the “I.A.S. 39 for the fair value option” on 15 June 2005 and began on 1 January 2006. The I.A.S. 39 states that businesses must follow a three-level hierarchy when using the F.V. model to figure out the F.V. for F.I. Additionally, the I.A.S. 39 advises businesses to include most of their financial assets and liabilities on the balance sheet at F.V. or “financial value” ^[4]. Financial assets must be classified in one of the following ways under the I.A.S. 39: ^[4].

“Financial assets at fair value through profit or loss, Available-for-sale financial assets, Loans and receivables and Held-to-maturity investments”.

These sections must be utilised to identify how a particular financial asset is realised and measured in the financial statements. Variation can occur in the implementation criteria and how unrealised F.V. profits or losses were recognised according to the classification used ^[5]. Financial assets analysed at F.V. via gains or losses are classified into two parts: designated and held-for-trade. Designated refers to any financial asset initially recognised as being measured at F.V., including changes in profit or loss at F.V. and held-for-trading refers to financial assets acquired to quickly sell to retain shorter-term profits, such as all derivatives except hedging instruments. Second, available-for-sale financial assets (A.F.S.) are nonderivative financial assets first identified as such.

Furthermore, those assets include instruments that are not loans and receivables, held-to-maturity investments, or financial assets valued at F.V. via gains or losses. A.F.S. assets are valued at F.V. and reported on the balance sheet in line with the I.A.S. 39, with changes in F.V. recognised in the equity statement as soon as they occur. Third, nonderivative financial assets with no predetermined payments and seldom traded are valued at their amortised cost. Finally, held-to-maturity investments (H.T.M.) or fair value options (F.V.O.s) are a type of financial asset that denotes specific payable treasury bonds that entities intend to hold until maturity, other than loans and receivables, and are not designated as assets at F.V. through profit or loss or as readily available for sale at the time of initial recognition. The amortised cost

method is used to determine the worth of H.T.M. investments. On 12 November 2009, the “I.F.R.S. 9: Financial Instruments” became effective, replacing the I.A.S. 39, which previously classified and measured financial assets ^[5]. The release of the I.F.R.S. 9, which is part of the I.A.S. 39 replacement effort, represents a significant step forward in this sector. The published version mainly replaces the I.A.S. 39, with new rules on impairment or hedging still under consideration. The primary goal of the I.F.R.S. 9 is to simplify the I.A.S. Plus 2019f (financial statement standard).

In 2003, the I.A.S. 32: Financial Instruments: Presentation was renamed “Financial Instruments: Disclosure and Presentation” to reflect the relocation of all required disclosures for financial instruments to the “I.A.S. 32: Financial Instruments: Presentation.” The I.A.S.B. issued the “I.F.R.S. 7: Financial Instruments: Disclosures” on 1 January 2007, to replace the I.A.S. 32’s disclosure regulations. Additionally, the I.F.R.S. 7 has replaced the “I.A.S. 30: Disclosures in Bank and Similar Financial Institutions’ Financial Statements.” In 2005, the International Accounting Standards Board (I.A.S.B.) issued the I.F.R.S. 7. ^[4] According to the I.F.R.S. 7, entities must declare certain information on their financial statements. Regardless of their sector, all publicly listed firms must apply the I.F.R.S. 7 to all financial and nonfinancial operations ^[6]. Level 1 represents quoted prices for identical assets or liabilities in active markets that are unadjusted, level 2 represents quoted prices for assets or liabilities that are observable directly or indirectly, and level 3 is based on estimated unobservable inputs to determine asset and liability prices using a variety of valuation techniques ^[4]. Financial assets were scheduled to be reclassified on 13 October 2008, due to changes to the I.A.S. 39 and the International Financial Reporting Standards (I.F.R.S.s) 7. As a result, corporations are required to disclose information about the significance of Financial Instruments under the I.F.R.S. 7. (F.I.). Assets held to maturity, such as investments, loans, and receivables, are included in this statement. Financial obligations are assessed at F.V. via profit and loss, separating trade from designated.

The International Accounting Standards Board (I.A.S.B.) and the Financial Accounting Standards Board (F.A.S.B.) worked on the “I.F.R.S. 13: fair value measurement,” which was released in May 2011 and became effective on 1 January 2013. Companies are obliged to report more information on the F.V. hierarchy under the I.F.R.S. 13. The hierarchy of the F.V. and the definitions for each level are identical to prior standards. The F.V. is defined in the I.F.R.S. 13 as “the price that would be received for selling an asset or paid for transferring a liability in an orderly transaction between market participants at the measurement date” ^[7]. For instance, the I.F.R.S. 13 broadens the scope of F.V.M.s to include nonfinancial assets and liabilities, thereby making it a more comprehensive application of I.F.R.S. 7. The International Accounting Standards Board (I.A.S.B.) released the new Standard in response to the 2008 financial crisis. The principles-based I.F.R.S. 13 F.V.M.s standard offers advice to businesses on assessing and disclosing the F.V. of their assets, liabilities, and equity instruments.

3. Jordan Profile

Jordan is an Arab country with strong social and international relationships. Cultural and political factors have led to several improvements in its corporations and how they conduct business, especially their preparation of accounting information ^{[8][7]}. Significant improvements in accounting regulations began in early 1988 when Jordan became a member of the International Accounting Standards Committee (I.A.S.C.). This was followed by the establishment of the Jordanian Association of Certified Public Accountants (J.A.C.P.A.) as a local accounting body in 1989. The I.A.S.C. then advised the J.A.C.P.A. to adopt the I.A.S.s for all Jordanian firms in 1990. In 1997, the “Companies Law” introduced government policy framework in Jordan and the “Companies Law No. 22” was issued which required all Jordanian companies regulated by the Companies Law to prepare accounting records and present audited financial information based on “internationally recognised accounting and auditing principles” ^[5]. Shortly after, in 1998, the “Securities Act No. 23” was issued and the Jordan Securities Commission (J.S.C.) declared that all listed companies were required to follow the financial reporting rules of the I.F.R.S.s, and auditing had to be completed under the guidelines of the International Standard on Auditing (I.S.A.) ^[4].

Given the scarce natural resources in Jordan, the government has tried to enhance governance and disclosure frameworks during the last few decades to improve trust and confidence in the economy ^[4]. Therefore, the adoption of the I.A.S.s and I.F.R.S.s by developing market economies, such as Jordan, became critical to reaching a high level of transparency and comparability of financial information, which expanded the international trade between Arab countries at global levels ^{[17][18]}. The main objective of these requirements was to increase the number of disclosures in firms’ annual reports. Thus, improving the quality of firms’ financial reporting and assisting users in making decisions ^[19]. However, the transition to the I.F.R.S.s and I.A.S.s has remarkable implications for the accounting and auditing profession worldwide given that the situation is worsening in developing countries and Jordan, in particular ^[17].

By 2005, Jordanian finance businesses were required to use F.V.A. under the I.A.S. 39, and the common assets measured based on F.V.A. were held-for-trading and held-for-sale. The adoption of F.V.A. in Jordan was the major issue

that brought severe problems to the country's economy. The recognition of unrealised gains and losses of the fair-valued assets in Jordan raised share prices to their highest levels during the economic downturn. The volatility in share prices caused poor investment decisions due to the lack of marketplace efficiency. The growing reliance of Jordan's economy on external exports caused the increased usage of financial assets in Jordanian companies which eventually led to damaging publicity about financial instruments' losses in the press ^[19]. The problem of implementing F.V.A. was escalated by the growing need for disclosures regarding the fair value of financial assets. Such events forced the government to take steps through the J.S.C. to overcome the problems caused by fair-value adoption on Jordan's stock market. The "New Fair Value" regulations were released in February 2008 through the J.S.C. and later revised in 2011 to overcome volatility in the market. Recently, in 2014 during the years of boom before the recession, the J.S.C.'s new regulations emphasised supervising external auditors' roles in improving the quality of disclosed fair-valued information by Jordanian firms. In 2015, the government promulgated the "Jordan 2025" plan, which focused on an export-oriented economic strategy through boosting trade with other countries in the region and especially the Gulf Cooperation Council (G.C.C.) states. The plan aims to make Jordan a gateway to regional markets and take advantage of free trade agreements ^[19]. Such regulations could meet the Jordanian's government objectives: to attract foreign investors by sending positive signals about the country's firms' financial stability; and to publish high-quality financial information.

The Middle East (M.E.) region is economically diverse, with significant discrepancies in natural resources between countries. These countries are most likely to rely on foreign investments and international funds, connecting to the global environment, which becomes paramount to sustaining their economic cooperation and political integration ^[17]. Clarity and transparency of accounting practices become extremely important in connecting to investors, trading partners, and foreign buyers. Considered an attractive setting, Middle Eastern nations operate under a unique political, cultural, legal, and economic environment ^[14]. The growing interest in accounting research on Middle Eastern countries is boosted by common heritage, language, religion, beliefs, traditions, and geography that reinforce their cultural, social, and economic lives ^[12]. A combination of political, financial, and technological improvements channel critical changes in accounting, such as the adoption of the I.F.R.S.s, which have a common effect across all areas of life ^[15]. Jordan enjoys political stability in a very turbulent region. Difficult political and economic conditions have seriously affected Jordan's economy ^[19]. Despite the increased involvement of the state in these political conditions in neighbouring economies, the basics of the economy were already built ^[18]. These cultural and political factors have led to several improvements in the behaviour of Jordanian corporations and how they communicate their financial information ^[17]. With limited information about the Middle Eastern accounting environment and Jordan in particular, this reflects an increasing interest in the area as a channel for foreign investments ^{[17][18][20]}. With dramatic changes happening in the Middle Eastern business environment ^[17], there is further motivation to contribute to government authorities' current and future policy developments to create favourable financial reporting conditions. This can be achieved by integrating and promoting the Middle East and Jordan in the international business environment.

Therefore, Jordan as a case scenario for this examination is selected for many reasons: firstly, results obtained from this examination can be generalised to the broader M.E. The growing interest in accounting research on Middle Eastern nations is boosted by their similar heritage, political system, language, religion, beliefs, traditions, culture, etc. ^[17]. Secondly, the increasing use of financial instruments by Jordanian companies and the public around financial instrument losses reported in the media further encourages this examination to concentrate on F.V.A. of financial assets in Jordan ^[17]. Thirdly, Jordan is the only Arab country which requires listed firms to disclose the audit fees paid in their annual reports as a legal requirement and has required this since 2001. Finally, the implementation of the I.A.S.s and I.F.R.S.s for almost 30 years in Jordan provides insightful evaluations on how F.V.M.s are prepared and audited under different circumstances ^[17].

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