

## COMMENT LETTER ON THE EXPOSURE DRAFT (ED/2009/5)

### Fair Value Measurement

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The purpose of this comment letter is to bring to the IASB's attention research that applies to the issues discussed in the exposure draft. The authors thus attempt to make an academically based comment, and will only incidentally make comments on issues arising in practice.

The proposals presented by the IASB and articulated in the exposure draft on Fair Value Measurement, are predominantly based on FASB's Statement no. 157 and represent not only another move toward convergence of the two constituencies' accounting practices but also a step closer to the realization of what has been termed the fair value paradigm (Hitz 2007; Shortridge and Smith 2009).

The objective is the development of a consistent framework on fair value that would replace the piecemeal guidance dispersed throughout many IFRSs. As such, *consistency* in the proposed standard is sought after by the authors, as is *clarity*. Although a discussion of the merits of fair value as a measurement basis is asked to be restricted by the Board, we find it fruitful to attempt to evaluate the proposed standard not only on the basis of the two above-mentioned criteria, but also on how well it stands up to scrutiny both theoretically and empirically. Some research discussed below is *a priori*, but representative *a posteriori* research is also reflected upon, the arguments and conclusions from both types echoing the most prominent views presented here.

Our comment is organized as follows: First, we present prior research, by method, starting with empirical research, which is followed by theoretical research. Second, we provide answers to some questions asked in the Exposure Draft.

#### **Empirical evidence from the market-based accounting research field of value-relevance of fair value**

Before considering the meaning of fair value on a more theoretical basis, we first review the evidence from empirical studies within the market-based accounting research field to assess the alleged merit of fair value accounting. This evidence is, by and large, inconclusive; only where financial instruments are concerned is the picture less ambiguous.

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Many of the early studies look at the value-relevance of fair value disclosures under SFAS No. 107 in order to find evidence that investors price fair value. One of these studies, carried out by Barth (1994), looks at banks' investment securities and the incremental value-relevance of fair value disclosures as compared with historical costs. The author finds that fair values of this particular financial instrument can explain security prices, but that gains and losses in the studied securities are not value-relevant for fair value measurements, possibly as a result of the accumulation of estimation error (as expressed in (Penman 2007): "with random errors in both the opening and closing balance sheet – bias aside – the errors are compounded in the income statement").

According to Eccher et al. (1996), fair value disclosures in commercial banks are associated with security prices, both alone and incrementally to benchmark book values, although in the latter case results are inconsistent over the studied period, any consistency observed pertaining, in addition, to investment securities only. Importantly, book values are more value-relevant on the whole than fair value disclosures. The results of Park et al. (1999) about fair value disclosures for investment securities and bank equity produce similar conclusions.

The regression model in (Barth et al. 1996), building on other specifications and controlling for certain variables, yield results that are more supportive of fair value disclosures, since in addition to investment securities, loans and long-term debt are shown to be value-relevant (deposits and off-balance sheet items are notably not). Raised reliability issues are thereby attenuated as far as loans are concerned.

This can be seen as a direct response to a contemporary with the study above, (Nelson 1996), whose results offer a different picture. Examining also fair value disclosures under SFAS no. 107, the study shows that fair values of investment securities in commercial banks have some incremental value-relevance to book values, but fair value disclosures of most other financial instruments, such as loans, long-term debt, deposits and off-balance sheet items, have no ability to explain security prices.

Another often cited study strengthens the support for fair value measurement, however, by showing that off-balance sheet items, specifically bank derivatives, are indeed value-relevant as measured by the stock price association with fair value disclosures (Venkatachalam 1996).

Furthermore, (Hodder et al. 2006) look at volatility levels of different income measures in commercial banks, and conclude that while the full-fair-value construct displays a much higher volatility than the other income measures, this volatility is representative of market-based risks and therefore has value-relevance for investors.

The results in (So and Smith 2009) indicate that the placement of the fair value information matters; fair values of investment properties in the income statement are to a higher degree reflected in market returns than fair value changes in the revaluation reserve, which may be considered as confirmation of the importance and value-relevance of the fair value measure.

The support for fair value is extended further by Barth and Clinch (1998), who show that in an Australian setting, where such practices are permissible, revaluations of not only financial but

also tangible and intangible assets are value-relevant, thus suggesting that fair value measurements for many types of assets also would be used by investors in security pricing. Meanwhile, Carroll et al. (2003) find that reliability issues when assets are measured at fair value in thin non-active markets are not as severe as feared: evidence from closed-end funds shows consistent value-relevance even for such fair value estimates (based on the association between share prices and investment securities as well as between stock returns and gains and losses in securities).

Although, as indicated above, there is evidence that value-relevance may exist for not only financial instruments in so-called thin markets where market prices are not readily available but also for non-financial assets, this is enshrouded in substantial controversy. Doubts as to the existence and extent of value-relevance of fair value arise when measurements rather become estimates. At the core of all this we find a “reliability debate”. Such a debate can be carried out on the basis of fair value measurements in general, but for model-based measurements in particular.

Whereas the exit price (to be discussed in more depth below) has verifiability merits when active markets exist, (more or less severe) estimation difficulties surrounding the determination of fair values using level 2 and level 3 inputs are expected in the case of many non-financial assets where there are no active markets. The resulting measurement errors may be classified, as in (Barth and Landsman 1995), as “unsystematic” in the sense that they are entirely random, or “systematic” to the extent that management’s discretionary behavior strategically biases estimates. The potential existence of unsystematic measurement errors is returned to in our theoretical discussion; meanwhile, the empirical case for the latter scenario is inconclusive. For instance, whereas Beaver and Venkatachalam (2003) show that loan fair values contain measurement errors affecting their reliability, the discretionary components are still found to be value-relevant; Barth and Clinch (1998) further show that investors do not ostensibly distinguish valuations made by independent appraisers as opposed to directors, meaning potential manipulation of values by management is offset by the added benefits of private information. This is echoed by (Aboody et al. 1999), who look at revaluation of fixed assets and future firm performance. Then again, the value-relevance of asset revaluations is shown to be less in firms with a high debt-to-equity ratio, suggesting investors hold reservations toward revaluations made by financially distressed firms. The results in (Dietrich et al. 2000), related to investment property estimates under fair value, are even less supportive of reliability claims for assets where fair value estimates are exposed to managerial discretion. Similarly, Nissim (2003) sets up proxies for management incentives and provides some evidence that banks manage the fair values of loans, a financial instrument for which market prices are frequently absent (cf. Barth et al. 1996; Nelson 1996). Another related study looks at the recognition of acquired brands by UK firms; given that voluntarily recognizing an acquired brand and separating it from goodwill allows for impairment tests to replace the immediate write-offs otherwise required for goodwill at the time, the author concludes that a corrosion in reported asset values may thus be avoided, which in turn allows firms to act on the incentive to cut contracting costs associated with London Stock Exchange shareholder approval for future acquisitions and disposals (Muller 1999).

A recent study on investment fund and real estate companies (Danbolt and Rees 2008) show that for both industries, fair value accounting explains stock market returns better than historical costs.<sup>2</sup> However, full-fair-value accounting is rejected based on that their regression results display evidence of difficulties in determining non-financial asset fair values, as the explanatory power of fair value earnings in the real estate industry is considerably lower than for the investment fund industry. Earnings management for the real estate industry, where assets are deemed more difficult to estimate, is an inference they draw from their results.

A direct implication from the argument above is that the merits of fair values for level 3 inputs should be questioned. We will keep this in mind as we proceed with some theoretical considerations below.

Before doing that, however, we will summarize Barth et al (2008), a study that focuses on the relevance of measuring liabilities at fair value. A concern that has been raised relating to the fair value measurement of liabilities is that a decline in credit rating will result in a gain and a resulting increase in equity. This effect is seen as counterintuitive, for example by the European Central Bank, and contrary to the interests of prudent bank regulators (in industries with regulated minimum capital requirements). Barth et al, however, find that realized gains are superseded by larger losses realized in assets. The reason for a downgrade in ratings is that the firm is doing poorly, which is reflected in a decline in asset values. Thus, as long as both liabilities and assets are valued at fair value, the concern of e.g. the ECB appears to be not applicable.

### **Theoretical considerations regarding the implications behind the fair value definition and fair value as a measurement basis**

In kindred spirit to the Board's view, Barlev and Haddad (2007) argue that fair value accounting (as opposed to historical cost accounting) may contribute to harmonization and comparability of international accounting, due to that for fair values the timing of measurements are "acceptable worldwide", purchasing power changes do not cause such severe distortions over time where fair value is reported, values are location-independent when based on international market prices, and subjectivity is lessened because current prices are not entity-specific. A positive reinforcement cycle is made possible as extended use of fair value in turn provides more globalized, harmonized capital markets, which in turn facilitate fair value accounting. Little reservation is shown toward the possibility of active markets being absent; potential reliability issues are believed to be dwarfed by the more serious problems caused by the local nature of historical cost accounting – both in time and geographically. The theoretical considerations in (Hitz 2007) lead to a considerably different conclusion: that the fair value income concept is lacking in its very formulation or existence, and that for non-financial items in thin markets this is even more obtrusive.

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<sup>2</sup> As an aside, in their case the use of fair values in the income statement gives little additional information when controlling for asset values as represented by changes in equity (cf. So and Smith 2009).

In order to see why the latter of these two opposing views carries some weight, the proposed definition of fair value will now be attended to, the three main features of which – orderly transaction, market participants, and measurement date – will be commented on subsequently, beginning with the overarching notion of an exit price.

The exit price notion of fair value is not a problem in and of itself, as long as it represents a specific current value (“the price that would be received to sell an asset or paid to transfer a liability” (IASB 2009b)) in a market-based exchange setting. Furthermore, with the unambiguous references to the market and the inclusion of ‘*orderly*’ [transaction], potential confusion surrounding the exit price is largely avoided; it precludes the possibility of treating it as a liquidation value. References to the market rather than to entity-specific events, further precludes any measurement based on value-in-use.

The inconsistencies with the actual recommendations in the standard quickly amass, however. At first, it seems reasonable that behind the fair value definition is the notion of market efficiency. If markets are efficient in the semi-strong form, prices efficiently impound publicly available information (Fama 1970), and the assumption that this holds can be deduced from the Boards’ justifications for fair value accounting (Milburn 2008) – that fair value is timely in its incorporation of information about current market conditions as well as representative of collective market beliefs and actual market volatility. So far, everything is in order, because the proposed fair value definition is consistent with market efficiency (which presumes open markets, active markets with ample transactions, public information that is bountifully available and market participants that are not compelled to transact (Milburn 2008)) and is promising under such assumptions.

However, accepting that an exit price is a reasonable benchmark for fair value where market prices are easily available, the use of unobservable (level 3) inputs to estimate fair value introduces a caveat. (Milburn 2008) continues to provide insights here: in the new conceptual framework proposed by the IASB, faithful representation is defined as “the depiction of an economic phenomenon [that] is complete, neutral, and free from material error” (IASCF 2008). Although the “verifiability” criterion has been abandoned, the “free from material error” clause as well as the neutrality criterion, raise legitimate concerns regarding unobservable inputs (see Milburn 2008). The claim that “the fair value measurement objective [for level 3 inputs] remains the same, i.e. an exit price from the perspective of a market participant that holds the asset or owes the liability” (IASB 2009b, §53) is, as Milburn (2008) points out, an acutely flawed argument because “[h]aving an objective is not sufficient”. Furthermore, the valuation techniques suggested “can be very crude and rough bases for estimating fair values, especially when applied to non-contractual assets, and particularly when applied to non-contractual assets with highest and best uses in revenue-generating process (in-use assets)”. Clearly, significant reliance is on the individual’s judgments when making the estimates. Milburn (2008) uses the following as an example:

“If multiple valuation techniques are used to measure fair value, the results ... shall be evaluated and weighted, as appropriate, considering the reasonableness of the range of values indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances” (IASB 2009b, §39).

This particular phrasing is far from reassuring and can be seen as an unfortunate tautology.

Despite the arguments put forth in the Basis for Conclusions for the Exposure Draft (IASB 2009a), that the different levels of inputs do not necessitate any distinctions between, or different labels for, different types of fair value, Milburn (2008) summarizes rather well the overall view held by the authors:

“[T]he concept of fair value implicit in the provisions of SFAS No. 157 [and the recent Exposure Draft] might, taken as a whole, be considered to comprise a family of current value measurement bases ranging from reasonably efficient market values to current cost and present value bases that are significantly dependent on entity expectations – all described as ‘fair value’” (Milburn 2008, p. 312).

In other words, the proposed definition of fair value, with its reference to an exit price, is inconsistent with actual recommendations, because it is not strictly an exit price that is considered in the level 3 input scenario. In light of this, the empirical evidence considered earlier, i.e. the mixed relevance of fair value, is hardly surprising.

Taking a step further, Hitz (2007) expresses his reservations toward model-based fair value by adopting as a starting point the *information aggregation hypothesis*: the notion that “market price aggregates in an efficient and virtually unbiased manner the consensus expectations of investors in the market concerning the cash flow pattern of the asset or liability” (Hitz, p. 328). This (along with the decision-usefulness paradigm) is a major driver of fair value accounting and may be considered acceptable if, and only if, there are functioning markets.

“[M]odel-based fair value cannot, by definition, represent an aggregate of expectations dispersed in the market place: since valuation rests on the information set of one person or one organization, this fair value loses its capacity to efficiently collect and aggregate consensus expectations about the cash flow profile of the relevant position. The paradigmatic information aggregation assumption falters – a result that substantially questions standard setters’ theoretical reasoning on the desirability of fair value measurement. Rather than market information, model-based fair value inevitably incorporates management’s private information and assumptions, that is, elements of value in use. [...] Curiously, model-based fair value is capable of creating useful information in the strict, information content sense, when credible communication of private management information takes place. Empirical evidence suggests this is happening (Barth and Clinch 1998; Beaver and Venkatachalam 2003). Accordingly, fair value measurement on the marking-to-model level receives vindication only where the fair value definition is violated and elements of value in use are incorporated. Obviously, this observation refutes rather than confirms the theoretical basis of fair value measurement.” (Hitz, p. 343-344)

In view of this, the analysis by Whittington (2008) is compelling in that it underlines the need for entity-specific considerations in order for the information to be decision-useful; private information cannot and should not be ignored. If value-in-use is rejected on the basis that it is entity-specific and incorporates management skill (seen as the goodwill component distinguishing value-in-use from exit value (see Barth and Landsman 1995; Hitz 2007)), the relevance of the accounting measure may then be undermined since share prices have been shown to reflect these entity-specific features, i.e. investors value them (see Barth and Landsman 1995).

Moving on, the focus on *market participants* is consistent with the overall market orientation in the proposed standard and the definition satisfactorily expands on the previously shorter definition, “knowledgeable, willing parties in an arm’s length transaction”. However, as Milburn (2008) points out, the focus on market participants instead of markets “seems in danger of confusing entity-specific (market participant) values with market value”. Importantly, as Milburn (2008) also clarifies, the market is not a place where all market participants share the same view on what utility an asset might have; rather, through *interaction* of actors with different expectations, a consensus might be reached. This means that if there is no market process for the market (no active markets), can hypothetical, inevitably individual market participants act as stand-ins? This concern relates to the notion of the highest and best use of an asset, and especially the in-use valuation premise, as suggested in the Exposure Draft. How do you, in practice, determine what the highest and best use is? Can an active market ever be expected to exist for the in-use valuation premise, given the apparently scant likelihood that other firms have access to the same group of assets? If there is no active market and hypothetical prices must be sought for an asset which is not currently used to its full potential, how far do you go in search of a “market value”? Can the intentions and objectives of only a few independent, knowledgeable, willing and able market participants serve to determine the highest and best use? The authors have difficulty finding the answers to these questions. It is believed that where there are no observable inputs, estimating an exit price based on the highest and best use may in practice yield measurements that are unacceptably inaccurate, while still retaining the appearance of a market measure.

The final part of the fair value definition, referring to the *measurement date*, also provokes concerns as the term can be considered ill-defined. It could be clarified that this refers to the balance sheet date when fair value is used.

### **Answers to questions asked in the Exposure Draft**

Based on what has been said above, answers to some of the questions in the Exposure Draft are summarized below:

#### **Question 1 Definition of fair value**

The definition of fair value is acceptable when a market process exists, but is not consistent with the permissible practice of market estimates. The exit price becomes vague and reliability of the measure drops (either because of intentional bias in the estimates, or due to purely unsystematic measurement errors). Finally, market participants – especially hypothetical ones - seem to be poor substitutes for an actual market, and the measurement date concept needs to be expanded upon.

#### **Question 3 Most advantageous market**

This is defined as the most advantageous market to which the entity has access. In this respect the resulting value could become entity-specific rather than market-related. This contradicts the definition of fair value.

#### **Question 4 Market participants**

To the extent that market participants are not well defined, this could be problematic. Cf. the answer to Question 1 above.

#### **Question 5 Highest and best use**

Guidance is thought to be largely principles-based in this part of the standard; what is meant in practice by the highest and best use when there is no active market is unclear. A concern is that without more detailed guidance on how to carry out this valuation in practice, the fair value estimates will reflect too much uncertainty or individual judgment, decreasing the value-relevance of the reported amounts. It could also lead to an entity-specific rather than market-related value, which contradicts the definition of fair value.

#### **Question 6 Used together with other assets**

See the answer to Question 5 above.

#### **Question 7**

Even though we cannot – based on the literature – provide a direct answer to the questions as posted, we can, however, conclude that it is relevant to measure financial liabilities at fair value, in spite of previous concerns regarding this.

#### **Question 10 Valuation techniques**

The use of valuation techniques as well as unobservable inputs receives scant support from extant empirical and theoretical research. The lack of reliability for mark-to-model measurements concerns the authors, cf. the answer to Question 1 above.

#### **Question 11 Disclosures**

In light of what has just been concluded, and as suggested by (Landsman 2007), it seems likely that disclosure of valuation assumptions and inputs may provide a (partial) remedy for the reliability issue and adverse selection facing fair values, especially for level 3 inputs of the hierarchy. We are therefore supportive of the guidance requiring extensive disclosure on fair value methods and inputs.

#### **Question 12 Convergence with US GAAP**

In general, the draft IFRS is more principles-based than SFAS 157, in that more judgment is permitted. This may lead to entity-specific values entering the fair value measurements. As suggested above, this in contradiction with the definition of fair value. In addition, the literature suggests that this lowers the quality of financial reporting.



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