Abstrakt

Tento článek je příspěvkem do diskuse k vývoji vhodné české terminologie v oblasti auditu. Ukazuje se, že v devadesátých letech byly určité termíny do češtiny převzaty nevhodně; dodnes to způsobuje problémy spočívající v nedorozumění mezi odbornou veřejností a co víc, v možné špatné aplikaci určitých zákonných nebo profesních požadavků.

Klíčová slova: Terminologie, audit, ověřování

Summary

This article deals with key terms used when speaking about assurance services. In 90' there was a vague approach to professional terms that causes misunderstanding till today. Key terms like "audit", "opinion", "assurance" are discussed and compared to their English counterparts. It is shown that slight changes in meaning may have significant impacts.

Key words: Key terms, audit, assurance

JEL klasifikace: M41

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NĚKOLIK POZNÁMEK K OCEŇOVÁNÍ FAIR VALUE[99]

Some Concerns about Fair Value Measurement

David Procházka

Introduction

Measurement of accounting elements is one of the crucial factors in the process of preparing financial statements, which fairly present economic activity of an accounting entity. Elements of financial statements can be measured by various attributes, corresponding to the nature of an element and the purpose for which the element has been incurred by entity. The reliability and relevance of the attribute measure are the key points of measuring assets, liabilities, equity and other elements.

In connection with the recent financial and subsequent economic crisis, many opinions appeared blaming fair value measurements in financial statements to be one or even the main driver of the crisis. There are of course dissenting points of view. The aim of this paper is to analyze economic backgrounds of fair value and to depict strengths and weaknesses of the fair value concept for accounting purposes. The paper will evaluate the role of fair value accounting in the contemporary financial and economic crisis.

Background

Nobes (2001) carried out the first major analysis of fair value accounting. Plantin et al. (2005) and Penman (2006) describe plusses and minuses of contemporary fair value accounting more deeply. The critical debate on usefulness of fair value accounting has arisen in connection with the financial crunch and economic crisis in years 2007 – 2009. The opponents of fair value accounting (further also "FVA") insist on that financial reporting based on fair value measurement has accelerated the financial crisis and significantly worsened the impact on affected companies. Fair value accounting is facing to the criticism especially from the banking sector; e.g. according to the president of the American Bankers Association (2008): *"The problems that exist in today's financial markets can be traced to many different factors. One key factor that is recognized as having exacerbated these problems is fair value accounting."* No wonder, that the representatives of the companies strongly hit by the crunch pronounce chief objections to FVA. For example, Martin Sullivan, AIG chief executive, said that *"fair value accounting had had unintended consequences and called for its suspension"* (Financial Times, 2008a).

The strongest opposition against fair value accounting probably comes from Wallison (2008) who argues that fair value accounting has been the principal cause of an unprecedented decline in asset values and an unprecedented rise in instability among financial institutions. Moreover, Wallison (2009, p. 2-3) believes that fair value accounting is highly pro-cycling and should be abandoned or at least significantly modified in order to ensure that accounting statements report information on stability of the entity rather than on its earnings power. The same remark on pro-cycling feature of fair value accounting and the necessity to change the mark-to-market accounting based on fair value (for the financial institutions) was expressed by Bloomfield et al. (2006) or by King (O´Grady, 2008). Last, but not at least the Chairman

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of Federal Reserve Bank Ben Bernanke said that *"the need to mark assets at "fire sale" prices had created a vicious circle"* (Rappeport, 2008). There are some supporting views also from academics, e.g. Abdel-khalik (2008) criticise fair value measurement from the point of inconsistency of measurement within financial statements. According to his opinion, the mixture of measurement bases used hinder the users from making judgement on what happened with their money (i.e. stewardship function of accounting) and what management will be able to do with their money (i.e. function of accounting as a source of information for decision-making). However, Abdel-khalik does not call for abandoning fair value measurement; he adheres to separate sets of financial statements each using a single measurement basis.

On the other hand, there are several important opinions in favour of FVA. Rummell (2008) pointed out, that critics had confused the cause and the consequence by stating that *"banks mounting loan losses are leading to a growing number of calls to shoot the messenger – fair-value accounting standards"*. The supporters of FVA claims that financial reporting based on fair value is just a messenger, which transmit information on what has actually happened (Financial Times, 2008b). Veron (2008) and Andre et al. (2009) carry out a deeper analysis of the role of FVA in the current crisis and the effort to *"shoot the messenger"*. Escaffre et al. (2008) argues against virulent attacks on fair value accounting due to its (alleged) pro-cyclicality.

There are several issues regarding fair value raised in connection with the recent financial crunch. The unrealised gains and losses from changes in the fair value imply that dividends may well be paid in advance of any cash flow is obtained. Moreover, the subjectivity in estimates of fair value opens space for the earnings manipulation (Herbohn, 2006). Fair values can be unreliable because of intrinsic error in the measurement or in the inputs of measurement process. Models used for fair value calculations may contain simplified assumptions that introduce measurement error and require inputs (such as income of cash flow forecasts) that are themselves subject to measurement error. Thus, the functions of accounting can be violated.

Fair value measurement issues raised by the recent financial crisis

Main arguments against fair value accounting

We can divide the concerns about fair value measurement in following groups:

Unrealised profits – revaluation of assets and liabilities at the balance date to their up-to-date fair value can lead to recognition of unrealised gains. If the unrealised profit is distributed to owners, the entity's capital can be eroded. The risk of inappropriate distribution of unrealised profits is in a question esp. when markets are under bubble price development.

Reliability of measurement – fair value is a hypothetical value reflecting fair conditions and positions of all market participants. In many cases, an estimate of such conditions has to be made in order to calculate fair value. The reliability of fair value measurement is impeded esp. in inactive and illiquid markets and under mass sale out of a particular asset. Consequently, a failure is reported as a success and vice versa.

Relevance of measurement – there are some doubts about relevance of information contained in income statement and the usefulness of net income as a measure of management performance when entities apply mixed bases to measure balance sheet elements.

Suboptimal behaviour – mark-to-market and fair value accounting lead to premature recognition of profits in comparison with the traditional historical cost model. Management may be impelled to adverse selections in order to meet expected or targeted numbers. This is mainly the case of financial instruments. Some bodies believe that suboptimal behaviour of companies may influence the markets and may cause systematic market risk and pro-cyclicality on the aggregate level. On the company's level, fair value accounting leads to increase in information asymmetry and reducing transparency of financial statements.

The counterarguments in favour of fair value accounting

Unrealised profits and possible erosion of capital

Changes in fair value of entity's assets and liabilities recognised in income statement (or in other comprehensive income) are holding gains and losses, which have not been realised as at the reporting date. As Abdel-khalik (2008, p. 7) stresses changes in *"fair values are only expectations the realization of which is conditional on many factors—primarily management decision to liquidate the position and market stability or volatility."* Calling Mises' (1966, p. 210) remark on the inconstancy of prices, we should be aware when deciding whether to distribute or not such unrealised profits.

Fair value accounting can be characterised by an inherent possible risk of capital erosion stemming from the distribution of unrealised profits. From my point of view, the function of accounting is not to hinder the users from distributing unearned profits. Financial reporting should only inform the users what can be distributed without erosion of capital. However, the decision whether to maintain the entity's capital is just up to the owners. The restrictions set by the state authorities can be a limiting factor for distribution of profits in order to protect the creditors, minority owners, etc. What is remaining can be distributed and it is the owners' competence to decide which course to follow.

The critics of FVA believe that under historical cost model or amortised cost model, which they consider as alternatives to the fair value model, the erosion of capital due to distribution of unrealised profits cannot happened. However, historical cost accounting contains incentives to get up to "gains trading" or to securitize and sell assets. There is no economic difference between unrealised profit (holding gain), which has emerged due to the change in fair value and realised profit arisen by selling an asset at the selling price higher than purchase price, if the profit has been reinvested in another asset.

The discretionary in accounting numbers in historical cost model reaches a higher level than in the case of fair value measurement and this was one of major reasons for the implementation of fair value measurement in financial reporting. The return to historical costs would lead to old problems. Moreover, disadvantages of historical costs make things worse during crises (compare with Laux and Leuz, 2009).

Reliability and relevance of fair value measurement

The definition of fair value both in the US GAAP and in the IFRS presumes that an entity *"is a going concern without any intention or need to liquidate, to curtail materially the scale of its operations or to undertake a transaction on adverse terms"* (IAS 39.AG71). Consequently, fair value is delimited as a price agreed by a willing buyer and a willing seller in an arm's length transaction. Fair value is market-based measurement, which is not entity-specific.