FAIR VALUE ACCOUNTING VERSUS FINANCIAL CRISIS: DEBATES AND REALITY OF VIETNAM

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Abstract

The recent financial crisis has brought in many arguments for and against the fair value accounting method. These arguments mainly focus on the future of implementation of this method and challenge financial accounting standards boards to the scope of fair value accounting. By this paper, the author would like to sum up the content of fair value accounting and compare it with the historical cost accounting. By analyzing strengths and weaknesses of methods in response to the economic climate, the author relates to the application of the fair value accounting by financial accounting standards boards and enterprises in Vietnam.

1. Problem

The recent financial crisis has aroused a lot of controversy over the employment of fair value accounting among accounting practitioners, policy makers of the US Congress, European Commission (EC) and bankers. Some argue that the fair value accounting, a.k.a. mark-to-market accounting, could make the crisis more serious and pervasive. By a correspondence with the US Securities and Exchange Commission (SEC) dated September 2008, the American Bankers Association judged that the crisis was fueled by many different identifiable factors, one of which was the fair value accounting. Policies makers of the US Congress also shared the same judgments. Accordingly, it forced the US Financial Accounting Standards Board (FASB) to amend the fair value accounting principles. However, for advocates of this method, it is merely a ‘disseminator of information’ and the employment of this method should not be hindered, trashed or prohibited.

The point is that whether or not the fair value accounting may deteriorate the financial crisis; whether or not the historical cost accounting may surmount weaknesses of the fair value accounting in the context of financial crisis; and what Vietnam’s accounting practitioners may draw from arguments around these two methods. In response to these issues, it is a must to clarify the scientific and practical fundamentals regarding arguments of these two methods.

2. Fair value accounting

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a. Concepts and features:

The fair value accounting is a method of valuing the assets and liabilities of a business for presentation of financial statements. According to the International Financial Reporting Standards (IFRS) and the US Generally Accepted Accounting Principles (US GAAP), the fair value accounting is defined as the value of an exchangeable asset or a liability settled by and between parties with eligibility in transactions at par (IFRS7, IAS39 & FAS157).

With regard to the fair value accounting, assets and liabilities are classified on the basis of three different levels of liquidity. At the level one, for those with high liquidity, the market price is the basis for identifying the fair value directly. Accounting practitioners may assume that the market price is the most accurate fundamental to measure the fair value because it may be perceived and observed by market participants, and is a stable ground to estimate the receivables from transfer of assets. Thus, the fair value identified at this level is also known as the mark-to-market accounting. Yet, due to the fact that assets and liabilities cannot always grasp all these features, accounting standards permit us to determine the fair value at higher levels. At the level two, for unmarketable assets and liabilities, the enterprise may value its assets and liabilities by means of the observable market inputs, which include the quoted price or discount rate for identical assets or those related to the ones to be evaluated. Once these inputs are not available, assets and liabilities shall be valued at the level three. In the event that the market lacks such inputs, the enterprise shall employ the mark-to-model approach but not the mark-to-market accounting to value level-3 assets and liabilities. By this approach, the enterprise may put forward some assumptions to determine the fair value.

b. Application of fair value accounting:

The first and foremost usage of fair value accounting is for the sake of financial instruments such as bonds, shares, derivatives related to swaps, futures and options. In essence, it is significant to note that meanwhile the fair value accounting, for financial instruments, holds a lot of attraction to specific standards for its application, the fair value accounting itself is quietly becoming more pervasive and gradually popular for disclosures of financial statements (IASB, 2008). For example, to evaluate loss of goodwill is mainly based on the evaluation of fair value (IAS 36). Under the acquisition method of accounting, the fair value accounting is employed to define and record benefits of minority shareholders at the day of merger (IASB 2008; IFRS7; FASB 2008). A similar application is found in examination of standards of assets under a finance lease, the capitalization of expenses on leased assets based on discount of future cash flow arising from the act of getting leased assets (IASB, 2008).

c. Practical and theoretical fundamentals of fair value accounting:

The basic premise of the application of fair value accounting is mainly based on the standpoint that the market is always the best instrument to value assets. In a recent research, Milburn (2008) concluded that in a liquid and well-organized market, the market price accurately reflects the fair value of assets or liabilities at service of financial statements. According to the author, assumption of a liquid or perfect market is the basis of IASB and FASB assessment regarding the relevance of fair value set forth in financial statements. However, the relation between the perfect market and the fair value will be broken when measuring the fair value of level-3 assets or liabilities, which is not based on the real value or the observable market price. Accordingly, there is not any strong ground for the employment of fair value accounting. Milburn (2008) also stated that further researches should re-consider the ways of using the fair value accounting when the market liquidity is not available, i.e. the fair value and voluntariness of market participants is violated.

Empirical results show that the securities price of a company is closed to the market price of principal assets or financial instruments instead of their historical cost (i.e. buying price and relevant costs) (Milburn, 2008). The relevance of market value is clearly certified with regard to derivative financial instruments where the market price is higher than the historical cost (Laux & Leuz, 2009). In other words, the fair value or the market price is supposed to be more relevant than the historical cost when reflecting the value of a business at the point of establishing the financial statement.

3. Disadvantages of the application of fair value accounting

Although the fair value accounting may benefit investors, it also suffers criticism as a basis for financial statements. Here are some disadvantages of this method.

- For the accuracy and reliability of accounting data: due to managers' intervention in level-3 assets or liabilities, the accuracy and reliability of accounting data is partly decreased.

- For the prudence and consistency of accounting data: The fair value accounting may result in the lack of prudence owing to the fact that an asset, according to the historical cost accounting, may be depreciated if there is any evidence to prove that it has had long-term losses and the company cannot fully recover it. Furthermore, the depreciation lasts in such a long term, that is, the asset will not be appreciated if there is any change to the business climate because the historical cost accounting just permits the recovery of contingency reserve. Yet, according to the fair value accounting, all profits and losses, either realized or pending, must be recorded in financial statements. Assets depreciated may be appreciated again depending on the referential market price and changes in the business climate in the future.

- Increased instability of profit in performance reports and distortion of information in the balance sheet: With changes in the assets value, the fair value accounting also generates problems corresponding to the debit in the balance sheet. Because the two parts of a balance sheet are assessed on the basis of market price, losses of values of investment in asset column will be balanced by the depreciation of payable liabilities discounted with a higher interest rate. It leads to a paradox in which issued bonds of a company shown in the liability payable on the balance sheet; and when the value of such the liabilities goes down, the value of equity capital from shareholders will go up on the condition that the gross asset is unchangeable or suffers smaller losses. Accordingly, by the fair value accounting, the bigger the risk is, the richer the business becomes just in the papers. This paradox was proven in 2007 via accounting profits of US$7.5b for Merrill Lynch, or US$4b for Lehman Brothers, which was produced by the fair value accounting. Thus, many suppose that bad credits have been fired by the fair value accounting in that the more an enterprise loans, the more it is rewarded when the market is bearish. Besides, the fair value accounting also brings in contradictions for enterprises running its business by the equity capital. Should the market become bearish, the loss will definitely reach high because expected profits from depreciation of liabilities cannot be compensated for it. For such a securitized market as the US one where stock price is often very far from the asset's real value, the fair value accounting may produce a two-side cycle in a performance report by adding expected profits to the accounting profit when the market is bullish. Accordingly, a substantial decrease may be produced once the market is bearish (Laux & Leuz, 2009). From this view, the fair value accounting just fuels the instability of items reported on the balance sheet and the performance report as well.

- By the fair value accounting, it is necessary to reconsider the role of accountants. With the stress put on the measurement based on mark-to-market and mark-to-model approaches, the application of fair value accounting also has certain impacts on the role of accountants in preparation of financial statements. While financial statements based on the historical cost accounting are managed by accountants, those based on the fair value accounting need evaluation by experts, thus making accountants become assistants of such experts. This is to say, does the training of accountants meet requirements of current financial statements? Furthermore, the fair value accounting forces accountants to have better knowledge of market. In the context of financial crisis with the low liquidity, price is not often corresponding to assets' real value due to the pressure of clearance sale of assets or liabilities of organizations or individuals. At this time, the market price will be determined by buyers and their ability to pay in cash. As fueled by the investor panic, the clearance sale may make the market price keeps on the downward trend. Under such the circumstance, the mechanical application of the fair value accounting may cause the "domino effect" because of the shortage of bank liquidity although such the banks can surely fulfill their obligations on the condition that they may hold mortgaged properties till maturity. Thus, the point is what an accountant should measure and report, especially when the continuity of operation is satisfied. As Brian Wesbury, an American economist and economic forecaster, put it, fair value accounting principles have made a big problem more serious. Most mortgage-backed securities, corporate bonds and structural liabilities still produce their original effects. However, since the market is frozen, the value of these assets has dropped below their real value.

4. Historical cost accounting as an alternative method

In a debate on historical cost accounting, it is necessary to ponder alternate accounting methods. Definitely, selection of the alternate methods depends on assets to be evaluated. Some assumes that historical cost accounting is an alternate method for bank-liquidated assets. Yet, most of people believe that it is suitable for finite-maturity liabilities. If the mark-to-market accounting is criticized during the crisis when the assumption of perfect market is violated, which alternate values do accountants use? And, can the historical cost be applied to weather the crisis? When the market is frozen, as analyzed so far, the fair value accounting cannot always produce accurate and reliable information. Neither does the historical cost accounting (Laux & Leux, 2009). Firstly, recording loans in ledgers at their original values is similar to the ignorance of reality. Secondly, even for termed assets, investors may be interested in the market price with a view to evaluating their previous decisions in relation to the current market conditions. Accordingly, shareholders also assist that the fair value accounting is really necessary nowadays. Investing advisors of FASB suppose that disclosures of fair value are significant to investors and users of financial statements during the bear market and the liquidity crisis. In this view, if a bank does not reflect its bonds in pursuant to the market's upheavals, investors may be doubtful of its assets' value, thereby not supporting the restructure of capital of institutions in need.

5. Debates

Debates result in a fact that accounting disclosures are more and more significant and relevant to the interest of parties involved. To some extent, these disclosures are not neutral enough because they depend much on the current economic conditions and cannot escape from the market. That is to say, the price is a fundamental of accounting practice. Yet, the accounting measurement method has certain impacts on the price in return, especially during the financial crisis. Via debates on the fair value accounting, there emerge two issues.

Firstly, information of fair value accounting is always highly unstable and sensitive to the market price, thus they may deviate the perception of investors when the market is booming or falls to the crisis. A company may insure its liquidity today, but not tomorrow or on alternative days if the market is fluctuating with a high amplitude. Financial statements based on the fair value accounting as a discloser of accounting information is really necessary but not sufficient. Risks must be thoroughly measured and quantified in the notes so as to enable persons involved to have an exact decision.

Secondly, the disclosures of fair value accounting do not always serve long-term goals because they are unstable and hard to verify. The application of fair value accounting may result in two opposite issues when referring to the term and scope of the current financial crisis. On one hand, intervention in the fair value accounting in light of level-3 assets and liabilities may permit managers to provisionally delay valuing illiquid liabilities; the sensitivity to the market price may boost the pressure on the business during the economic boom when the capital will be adjusted up, forcing managers to maintain the return on equity. On the other hand, once the real value of assets is going to slump, the fair value accounting may distort balance sheets. Accordingly, the revaluation of assets' value and market price-based decreasing capital may fuel the financial crisis and make the recession more serious.

Nonetheless, it is needed to realize that the historical cost accounting cannot deal with issues posed by the fair value accounting. As for us, financial statements based on the fair value accounting are necessary; and users of these instruments cannot ignore their notes or detach the disclosures from the current market context when making a suitable decision for their own sake.

6. Fair value accounting in Vietnam

In reality, the fair value accounting has not been officially acknowledged in Vietnam, even though the mergers and acquisitions also employ the fair value accounting. Yet, the fair value in this case is absolutely different from that of IAS. It is just employed to define the benefits of minority shareholders on merger date instead of establishing financial statements.

Some listed companies, especially Vietnam's commercial banks, have started to employ the mark-to-market accounting for the fiscal year of 2008, in spite of some disputes and disagreement with independent auditors, which are the fundamental for defining the contingency reserve for financial investment at the point of setting up the financial statement. By comprehensive evidences collected from many different sources, it is possible to draw typical cases as follows.

value accounting will be applied to both assets and liabilities. It is such a new point in that Vietnam's accounting standards just permit to price assets on the basis of the market value. However, these two circulars have not clarified how to calculate the fair value of financial instruments but present methods of price verification. In our opinion, Vietnam's financial instruments are similar to assets and liabilities of level-1 or level-2 as classified by the IAS39. The two circulars also do not tell how to determine the fair value of illiquid or non-transactional assets. Besides, in pursuant to the Circular No.228/2009/TT-BTC, if the market value of securities cannot be assessed, enterprises cannot set up a contingency reserve for depreciation. It is really a difficulty for managers and accountants and even independent auditors when establishing and auditing the 2009 financial statement. Moreover, it also contradicts to the fair value account-

Entities	Accounting methods employed	Auditor-recommended accounting methods	Difference from the auditor's results
Sacombank	Reserve by discounting cash flow generated in the future by securities so as to compare with book values	Compare the market price with the book value at the point of setting up financial statement (PwC)	Profit adjusted down by VND133b according to the pricing method of independent auditor
Kinh Do Group	No contingency reserve for unlisted securities for lack of reference price	Have a contingency reserve on the basis of the reference price of equivalent securities (E&Y)	Pre-auditing profit reaches VND142.3b; and the after-auditing one slumps by VND67.7b, a difference of VND203b
Minh Phu Seafood JSC	No contingency reserve for unlisted and illiquid securities	Have a contingency reserve on the basis of the reference price of equivalent securities (KPMG)	The after-audting profit decreases by VND43b, causing a loss of VND31.8b and being kept under the close inspection of HoSE. The pre- and after-auditing difference is 1.044%

Source: http://tinnhanhchungkhoan.vn

NB: Initials in parentheses denote auditing companies

Apparently, the fair value accounting may be applied in the context of Vietnam. Recently, in order to deal with disputes and disagreements between companies and independent auditors in light of the 2009 financial statements, the Minister of Finance promulgated the Circular No.210/2009/TT-BTC dated Nov.6, 2009 so as to direct the application of IAS to Vietnam's financial instruments; and the Circular No.228/2009/TT-BTC dated Dec.7, 2009 so as to direct the establishment and use of contingency reserves. The first circular affirms that the fair ing based on IAS. Thus, the story about fair value accounting has just been raised in Vietnam.

7. Conclusion

The paper just goes over the fair value accounting method and some conclusions relating to the application of this method in financial statements. Analyses have clarified the significant role of accounting disclosures to both investors and persons involved, especially to the prospect of the society and community. Considerations of IASB, FASB and EC are laid on a strong ground in that if assumption of perfect market is violated, the fair value accounting may confuse users of financial statements with evaluating the fair value of an enterprise which may cause a “domino effect” when the market price and short-term benefits become preferential and fade the intrinsic value as well as the long-term benefits. Meanwhile the accuracy and reliability of fair value accounting disclosures is clarified, negative issues of fair value accounting must be continuously taken into contemplation. The financial crisis is the first and biggest challenge to fair value accounting practitioners. This crisis will be a premise for further empirical researches on fair value accounting for the time to come, which may enable researchers and accounting practitioners to evaluate better pros and cons of fair value accounting. For Vietnam, competent authorities like the Ministry of Finance, Vietnams Accounting Association (VAA) and the Vietnam Association of Certified Public Accountants (VACPA) should collaborate to work out Vietnam’s accounting standards (VAS) concerning financial instruments; specific regulations on the application of fair value accounting with a view to avoiding disputes and disagreements amongst enterprises and independent auditors as well as insure the harmony of VAS with IAS. The purpose of employing different accounting methods is just to enhance the accuracy and reliability of accounting disclosures■

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