The Influence of Fair Value on the Quality of Accounting Information

-- From the Perspective of Accounting Measurement

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Abstract: For a long period of time, historical cost has been one of the main measurement attributes of financial accounting. But with the rapid development of market economy, the capital market is gradually improved, while the dispersion of equity is enhanced. The purpose of financial accounting changes from fiduciary duty to decision usefulness. Accounting information based on historical cost cannot meet the requirements of information users due to its weak relevance and timeliness. Meanwhile, fair value is more favored by information users since it is more closely related to decision-making, and can reflect the real value of assets and liabilities more objectively. In February 15, 2006, the Ministry of Finance issued the Accounting Standards for Business Enterprises, which further expands the application scope and strength of fair value, which marks the convergence of Chinese accounting standards and international accounting standards. However, the financial crisis caused by American subprime mortgage crisis brings the issue of fair value to focus of public discussion again, causing people to argue and doubt its usefulness. Then how to recognize and evaluate fair value? How can fair value influence the quality of accounting information? These are questions discussed in this paper.

1. The Connotation of Fair Value and the Composition of Accounting Information Quality

According to the Accounting Standards for Business Enterprises: Basic Standards issued in February 2006, the characteristics of accounting information quality are described as eight requirements: reliability, relevance, intelligibility, comparability, substance over form, importance, prudence and timeliness. Among them, reliability, relevance and intelligibility are main quality requirements; other characteristics belongs to the secondary quality requirements.

Although there are disagreements and arguments about the quality of accounting information, it is commonly agreed that the basic characteristics of accounting information quality are relevance and reliability. Relevance helps information users to better evaluate the past information, so as to better control the present situation and predict the future. Accounting information should be related to decision making, and has the ability of causing differences. Reliability means that, the accounting information provided by enterprises needs to truthfully report related transactions and affairs; partiality to any particular interest groups or intended results is not acceptable.

According to the Accounting Standards for Business Enterprises: Basic Standards issued by the Ministry of Finance in 2006, fair value means, under the condition of fair value measurement, transaction parties who are familiar with the market exchange assets or repay the debt voluntarily. The transaction amount of assets and liabilities is determined in accordance with even bargain. It can be seen that although the definition of fair value varies by country, its essence remains the same. The connotation of fair value can be accurately understood from following perspectives. First, the transaction is completed on the basis of mutual willingness principle; the transaction price is a fair trade price that both parties are willing to accept. Second, fair value is value measurement, rather than cost measurement.

2. The Influence of Fair Value on the Quality of Accounting Information

2.1 The influence of accounting measurement attribution on the quality of accounting information

In the process of accounting operation, the four links of accounting confirmation, accounting measurement, accounting record and accounting report are interrelated and interlinked. They constitute a complete accounting cycle process. Confirmation is the premise of measurement, while measurement is the result of confirmation. Accounting confirmation and accounting measurement are the most important parts, but accounting confirmation cannot be separated from accounting measurement. At the same time, accounting measurement is also the premise of accounting record and report. Without accounting measurement, the confirmed economic matters cannot be converted into quantitative accounting information and reported. Thus, accounting measurement is the core of financial accounting operation system. This paper studies the issue of fair value from the perspective of accounting measurement.

In accounting business, monetary measurement is usually used to reflect the contents of accounting elements. Improper application of accounting measurement attributes can affect the result of accounting measurement, resulting in deviation between the accounting factors of book value and real value. Therefore, to correctly select and effectively use the measurement attributes of accounting elements can help to improve the quality of accounting information.

In order to improve the usefulness of accounting information, accounting measurement has been continuously reforming. The accounting measurement attributes develop from the single historical cost measurement to a variety of measurement attributes. In Concepts Statement No. 5 issued by Financial Accounting Standards Board (FASB) of the United States, five measurement attributes are listed: historical cost, replacement cost, current market value, net realizable value and future cash flow value. The historical cost measurement attribute is the reflection of the past. It is more objective and reliable since it records the actual results of transactions and business affairs. But its relevance is poor since it cannot reflect the current value. The current value measurement is mainly reflected in current cost, market value, net realizable value and the value of future cash flow. It is closely related to enterprise asset replacement and investment decisions, and has strong information relevance. But its reliability is poor since a lot of information on current value cannot be obtained directly; estimation is needed in this process.

2.2 Analysis on the accounting information relevance of fair value measurement

First, the information of fair value measurement can play the role of guiding effective resources allocation. The stakeholders of enterprises make economic decisions on the basis of objective and fair accounting information. The market economy, like an "invisible hand", occupies an important position in the allocation of resources, and has unparalleled superiority. Under the guidance of price signals, market mechanism encourages people to efficiently use limited resources, and to invest these resources to realize the purpose of maximizing utility.

Correct price signals can guide people to make correct decisions; false and unreal price signals can lead people to make wrong decisions, or even invest resources in wrong directions. Fair value is the value information which is most closely related to the actual transaction price at present. It does not only help enterprises to correctly evaluate their current financial situations, but also help them to correctly predict the amount of cash flow at present and in the future, so as to guide accounting information users to make correct economic decisions. Therefore, the information of fair value measurement is the most decision-making related information.

Second, the accounting information of fair value measurement is the most timely and predictable information. The basis of fair value is actual market transaction price. The information of fair value measurement is obviously timely in current decision-making. In an efficient market, the market price can reflect the current price of related assets and liabilities quickly and fairly. Therefore, in a perfect and effective market, the market can reflect the fair value of assets or liabilities in a particular time point or in a specific economic state, while the expectations of market participants can also be reflected through market price. Market price is an objective and unbiased statistical index, much is highly favored by information users.

Whereas, historical cost is the actual value of assets and liabilities at a particular time point in the past. It records the actual transaction history, but it cannot reflect the changes of market price. Only cumulative changes of assets and debt can be reflected in transactions. The constantly changing market price cannot be clearly reflected in historical cost information; while that kind of information is mostly related to current decision making. In the aspect of forecasting function, fair value also has superiority which other value information cannot compare. Theoretically, fair value is the present value of future cash flow. Therefore, as long as the fair value of assets or liabilities is calculated through current market interest rate, decision makers can easily calculate the expectation value of assets or liabilities at a future date, and enhance the accuracy of prediction.

Third, the information of fair value measurement can eliminate the interference of abnormal differences. Relevance means that accounting information should have the ability of causing difference. That is to say, accounting information should be able to predict the difference between different economic behaviors, so that decision-makers can make the right choice. But some of these artificial differences can not improve the relevance of decision making; they may mislead the decision making instead. For example, the valuation of purchased assets based on historical cost will lead to different prices of assets according to different purchase time; different cost calculation methods will lead to different costs of the same product.

Fair value is a kind of fair and proper market price. Through related valuation techniques and models, the fair value calculated by an accounting entity or different accounting entities remains the same. The values of assets and liabilities are determined according to those methods. They can eliminate the impacts of manipulation factors and interference difference caused by non objective measurements, so as to enhance the comparability of accounting information, and improve the relevance of it.

2.3 Analysis on the accounting information reliability of fair value measurement

For fair value information, reliability is the greatest challenge in information quality. Some people worry that, although fair value can provide relatively timely and useful accounting information, it cannot guarantee the reliability of information. Many people holds that, fair value is largely estimated, assumed and judged; its reliability should be doubted.

The reliability is usually measured by two indicators, authenticity and neutrality. For neutrality, fair and neutral are two similar concepts; they both express meanings like even bargain and equal status. Obviously, compared with historical cost, fair value is more neutral. For authenticity, in theory, fair value is better than historical cost in accurately reflecting the real value of measured objects. But in actual situation, we usually use accounting data verification or multiple independent measurement of variance to measure the authenticity. Verifiability is employed to ensure the authenticity of accounting information; it is a binding standard which stipulates the acquisition method of accounting information. It is a derived index of authenticity. In this respect, the verifiability of an estimated fair value is obviously lower than the historical cost.

Seemingly, the accounting information of fair value measurement pursues the relevance of accounting information. In fact, it improves the relevance by improving the authenticity. The real essence of fair value is the coexistence of real, fair, correlation and dependability. The fair value measurement will inevitably make subjective judgments on the amount, time and discount rate of future cash flow. These judgments are uncertain. Fair value may be no better than historical cost in the measurement attribute of verifiability, but it can predict the value more correctly, and reflect the accounting subject as well as the economic essence more accurately. Due to the use of scientific evaluation methods and objective observation methods, fair value measurement can not only make the measurement of assets and liabilities more correctly, but also reflect changes in the valuation of assets and liabilities more timely and accurately. It is conducive to accounting information users to make correct judgments and decisions.

In addition, fair value is unbiased market pricing. The measurement techniques of different accounting entities or the techniques of an accounting entity at different times remain the same. The timeliness, comparability and consistency of accounting information can be greatly enhanced, which can compensate for the lack of verification. Besides, the judgments and estimates involved in re measurement under historical cost accounting are not necessarily higher than those under fair value. Their verifiability is also questionable.

In fact, our doubts about the reliability of fair value are doubts about the effectiveness of the market and doubts about the reliability of assessment techniques. If the market is effective and the evaluation techniques are reliable, the reliability of fair value is guaranteed. Without effective and reliable market prices, although the fair value information is composed of estimations and judgments, it is relatively reliable in the reflection of enterprise values. At present, many financial products have mature valuation techniques, such as capital asset pricing model and B-S option pricing model, which are all supported by evidence. Fair value calculated through these methods are quite reliable.

Another doubt about the reliability of fair value lies in its own volatility. It is especially true for some financial instruments, whose prices fluctuates under the influence of interest rates, exchange rates and other targets. But volatility is the basic attribute of the price of financial instruments. The rational expectation of market participants are made based on information they got; that expectation is the price we discussed. In addition, because of the continuous access to new information, market participants constantly change their expectations. It is necessary to make full and timely disclosure of the volatility. Therefore, we should not doubt the rationality and reliability of the changing price.

3. Conclusion

Through above analysis, it is not difficult to find that, it is biased and arbitrary to hold that the historical cost measurement is more reliable than the fair value measurement. In fact, the reliability of the historical cost measurement is only "verifiable". The information of fair value measurement is reliable because of its usefulness in decision making, while reliability does not exclude reasonable estimation. It is not the purpose of accounting information. The ultimate goal of pursuing reliability is to improve the usefulness of accounting information.

In the current economic environment, the strengthening of the relevance of accounting information will inevitably lead to the weakening of reliability, and vice versa. Therefore, accounting measurement attributes must also be selected and developed under the restriction of the basic quality characteristics of accounting information. The difficult and key point of fair value measurement lies in the effective mediation of relevance and reliability of the resulting accounting information.

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