The Effect of Applying Fair Value on the Financial Statements of UK Leading Companies

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CHAPTER I

Introduction

1.1 Overview

It has been argued that international accounting standards board (IASB) are moving away from the concepts of stewardship historical cost and historical cost towards the concepts of providing useful information for making decisions based on fair value and cash flow (Ball, 2006). Fair value is the most controversial issue of broadly adopted International Financial Reporting Standards (IFRSs). Belkaoui (2004) argued that accounting system should be set to produce relevant information for rational decisions making. While the users’ needs are different, accounting system cannot provide information which is desirable for all users’ decisions. So financial statements’ preparers should decide on the kind of information which should be included in and which should not, aiming to achieve high level of providing effective information towards making rational decisions. Fair value financial statements can reflect the firm’s economic reality which enhances not only the efficiency of the invested capital, but also the management efficiency, financial statements harmonization and the justness of income distribution.

Most of the countries’ economies are developing; new accounting standards are needed to fulfill the gap of needs which are produced by the new industries and transactions. IFRS was set to fill this gap and enhance the financial statements quality and harmonization. IFRS which was issued by IASB in London is gaining an increasingly important attention around the world as global standards for the financial
statements. EU Regulation 1606/2002 required the listed companies in the European stock market to apply IFRS on their financial statements. The implementation of IFRSs on the financial statements has produced many effects on the firms adopting these standards. Iatridis (2010) studied the effects of applying IFRS and its fair value on firms. He found that applying IFRS has a positive impact on the financial position and firm’s performance through increasing the growth and the profitability, and improving the leverage ability by reducing the future risk. In contrast, fair value’s problem is that it always assumes that the market is relatively perfect and complete. If this market is available, fair value provides useful information for the passive investors and creditors depending on current market prices. Fair value opponents claimed that market is not always relatively perfect and complete which requires more monitoring of the financial statements in behavior of shareholders and presenting the past transactions by using specific measures (historical cost) which reflect the real opportunities that the firm had to increase shareholders value (Whittington, 2008).

Fearnley et al. (2010) argued that while UK is forced to use IFRS responding to the EU requirements, UK government should work hard to overturn it. Furthermore, she claimed that even though IFRS did damage UK financial statements, UK accounting standards setters still aim to increase its burden on the companies, including small ones.

The main reason which forced the use of fair value is historical cost problems during the inflations and the government interference aiming to provide the real economic value of the firm. Adopting IFRS in EU provides a base for preparing financial statements which are more convergent and has pushed for higher levels of governance. Implementation of fair value will have a significant impact on the work of accountants and auditors that by using fair value they produce information
depending on future evaluations rather than on historical values (Langendijk, Swagerman and Verhoog, 2003). The most important question which should be answered after the financial crisis and the recent mortgage meltdown is whether firms should use historical cost or fair value. The two boards FASB and IASB are moving towards the use of fair value and away from historical cost (Foster and Shastri, 2010). Accounting standards setters believe that fair value increases the relevance of financial statements, improves the comparability, transparency and the timeliness of the financial information, which leads to more useful information for users in making their decisions and evaluating the equity (Christensen and Nikolaev, 2009).

Recently, IFRS has been adopted in many countries (approximately 100 countries) around the world. Furthermore, many countries, such as Mexico, Canada, Japan and India, have declared that they are powerfully going to adopt or converge with IFRS during the period from 2009 to 2011 (Kinkela, Harris and Malidretos, 2010). Veron (2008) pointed out that accounting standards should be improved to get the objects of fair value accounting. Nowadays, the Securities and Exchange Commission (SEC) is highly interested in using IFRS. SEC has been set on the 2\textsuperscript{nd} of March 2010 as a commission statement which works to enhance the convergence and globalism of the accounting standards. This statement put a list of objectives about harmonization to be obtained:

1. Provide more comparable financial information for the investors and industries over the world.
2. Reduce the costs which the multi listed companied have to bear.
3. Increase the comparability between the capital markets.
4. Enhance the efficiency of invested capital and financial information.
5. Provide a strong base for improving the global economic growth rate.
Furthermore, this statement improves the US consideration of IFRS and there is a possibility that the US is going to adopt it as early as 2014 (Kinkela, Harris and Malidretos, 2010).

1.2 Study Motivation

The two boards FASB and IASB are moving towards the usage of fair value and away from historical cost (Foster and Shastri, 2010). Accounting standards setters believe that fair value increases the relevance of financial statements, improves the comparability, transparency and the timeliness of the financial information, which leads to more useful information for users in making their decisions and evaluating the equity (Christensen and Nikolaev, 2009). Relevancy and reliability are the most important attributes of the accounting information, and accounting standards setters choose between historical cost and fair value should balance between the level of relevancy and reliability. But accounting standards setters now are more concerned with the relevance of the financial information. Therefore, they require the firms to use fair value measurements which provide more recent and relevant information to the investors and creditors than historical cost. These measurements are more useful for users in order to assess the firm’s performance and predict the future view (cash flow, financial position) of the firm. Standards setters do not seem to accept that the reliability should be outweigh than the relevance of financial statements. The most controversial issue between fair value and historical cost is their relevancy and reliability (Christensen and Nikolaev, 2009). After the adoption of IFRS the justification of fair value is not dependable on its costs and benefits any more, but on the decreasing in the reliability and the increasing of the managerial discretion.
Shareholders need financial information to assess the equity’s value and judge the management performance. Therefore, this information should present the current value of the firm. Fair value reflects the up-to-date economic value of the firm which allows shareholders to know how much their firm is worth. Managers should use the firm’s resources to maximize the shareholders value and they should choose the best investments for the firm’s future and its value. Presenting financial information in fair value helps shareholders in assessing the management performance and knowing whether it is doing well or just wasting the firm’s resources. Therefore, fair value decreases the agency cost (Penman, 2007). The demand for fair value will increase if it was proved that historical cost is deficient for accounting objectives. It is argue that ideal fair value provides sufficient book value, but it conveys insufficient information about the firm’s earnings. In contrast, historical cost covers information in the balance sheet that does not reflect the firm’s value, but income statement provides sufficient information about the firm’s earnings (Penman, 2007). The problem with fair value’s reliability is that it is relatively depending on the existence of active market which produces an independent source of the estimate’s verification and makes the verification process more difficult (Christensen and Nikolaev, 2009).

The most controversial issue between fair value and historical cost is their relevancy and reliability. The most obstacle of fair value is its reliability which affects not just the users’ decisions but also their contracts. This weakness of fair value increases agency problems and allows the management to revalue the assets and liabilities opportunistically (Christensen and Nikolaev, 2009).

Therefore, fair value is the new phenomenon that accounting standards setters and accounting users are interested in. This research is going to study the effect of fair
value on 20 UK companies starting from 2005 and if it provides more useful information for financial statements users.
CHAPTER II

Fair Value

2.1 Fair Value Concept

IASB is moving away from historical cost towards fair value, which provides useful information for the decisions making of investors (Ball, 2006). Fair value has many definitions; in 2006 the IASB published a discussion paper which defines fair value as presenting the assets and liabilities at the value which the firm will achieve in an arm’s length transaction at the balance sheet’s date. Fair value provides information which reflects the firm’s financial position and the management’s stewardship by stating the assets and liabilities in the balance sheet at their current market (Penman, 2007). Fair value arguably produces more relevant and understandable information of the assets and liabilities in the financial statements than cost-based measures. Furthermore, fair value has become an accounting principle (Hague, 2004).

Using fair value makes balance sheet the primary vehicle for providing useful information for shareholders rather than the income statement. Income statement under fair value conveys the economic income of the firm because it reflects the changes in the firm’s values over time. Depending on the economic principle which is the current changes of values reflects the future values. Balance sheet under fair value can be as a base for estimating the future values of the assets and liabilities. In contrast, income statement cannot be a base for predicting the future values because of the changes in the earnings and expenses which come from the gains and losses of the revaluation of the assets and liabilities. Overall we can say with fair value balance
sheet provides efficient values and that income statement conveys information about the management performance and exposure risk. Penman (2007) pointed out that income statement with fair value can be a measure for the investment management performance. Income statement can reflect the investment success and the volatility which investors are interested in. And finally, he ended up that accounting under fair value is sufficient and balance scorecard is not needed anymore.

### 2.2 Historical Cost Concept

The use of historical cost is a controversial issue in accounting because historical cost provides old rather than current financial information which makes measurement process very easy because of the evidence value existence. On the other hand, the assessment of the management performance is inefficient and hard to be applied. Using historical cost makes income statement the primary vehicle for providing useful information for shareholders rather than balance sheet (Penman, 2007).

Historical cost’s income statement provides the performed earnings of the management depending on the arbitraging prices in the market. Historical cost conveys the value-added which results from buying inputs at one price and selling them at another. Historical cost views the transaction as buying items at input prices, transforms them according to business plan then selling the products to customer at output prices which usually exceed the cost. In contrast to fair value, preparing income statement under historical cost provides current income which is efficient for predicting the future income but it does not reflect the value shocks, while it reflects the shocks in the input and output prices (Penman, 2007). Matching principle between revenues and expenses is easily applied under historical cost. In contrast, the most criticism of historical cost is its disability to reflect the economic reality during
inflations which forced standards setters to make changes in financial statements in terms of solving these problems.

2.3 Accounting Valuation Methods and Their Problems

One of the most confusing problems of the corporate finance is the valuation. Transactions cannot be done without valuation, so valuation was and still the matter of accounting. It is argued that the misunderstanding of the items is a result of the no general agreement and understanding of how historical cost and fair value should be measured. Accounting objectives cannot be achieved if only one valuation method is used. The combination of many methods (such as historical cost, current replacement cost, exit price and discounted cash flows) in evaluating financial statements’ items can improve their quality, which requires accounting standards setters to specify relevant and reliable information which each one of these methods fulfills. Even when not under the concept of fair value, the alternatives of historical cost have been used in the last two centuries.

It has been argued that companies should have flexibility to choose the value measure because of the difference between the circumstances. In the same business one measure could be suitable for a firm but not for another. Furthermore, it is more likely that the same measure in one business is not suitable for another kind of business. Therefore, flexible measures allow the companies to reflect their economic value and contribution in the society. In contrast, flexible measures open the door for the management to manipulate the financial information and also provide opportunistic accounting choices, which after all affect the quality of the financial statements information, mislead the users and incorrect income distribution (Margaret et al.,
2007). Until now, there is no agreement on the measurements which should be used, which leads to a bigger problem that there are many measures for the same item and different measures for different items. Furthermore, what makes the problem more complicated is that most measures actually have a space for management subjectivity. The usefulness of financial statements information depends on two key issues:

1- Which items should be included or excluded from the financial statements?

2- How to measure these items?

There is a view that financial statements should convey useful information to investors’ rational decisions. On the other hand, the range of the users and their needs are very wide which makes management task in measuring the items more complex that one measure might provide relevant information for some users but not for the other (Margaret et al., 2007). Moreover, the management choice not only affects the quality of the information but also the ability of comparing different financial statements. It is argued that value measures should be consistent which can enhance the comparability of financial statements and provide useful information. Damant (2001) and Scott (2002) claimed that fair value is emerged as a result of the covering of the users’ needs. Mouristen (1994) and Richardson (1987) found, fair value is efficiently productive and relevant.

Agency theory claims that managers usually have an access to the relevant and reliable information of the company. Belkaoui (2004) argued that accounting system should be set to produce relevant information for rational decisions making. While the users’ needs are different, accounting system cannot provide information which is desirable for all users’ decisions. Financial statements’ preparers should decide on the kind of information which should be included in and which should not, aiming to
achieve high level of providing effective information towards making rational decisions. Furthermore, he argued that market participants who own the knowledge can only make abnormal profit when accounting produces inefficient market information and the market participants respond to this information in a particular manner. Investors are interested in values rather than costs, fair value should be used in financial statements (Damant, 2001). The biggest problem that standards setters have faced after the usage of fair value is in the same financial statement where some items are evaluated at fair value while others at historical cost, which decreases the usefulness of calculating total values and leaves them without any sense. For instance, if some assets are evaluated at historical cost (debts) and others are evaluated at fair value (intangible and fixed assets), what does the “total assets” mean? Therefore, by evaluating some items at historical cost and others at fair value we are evaluating them at different money at different time. Money value changes over time, one pound two years ago is not equal to one pound now. Moreover, some items are measured depending on the changes in other items. For example, income is defined as an increase in assets or decrease in liabilities. Therefore, measuring the income depends on the way we are using to measure the assets and liabilities value (Margaret et al., 2007).

The sections below present some of the valuation methods.

### 2.3.1 Historical Cost

Historical cost is “the amount of money or equivalent sacrificed or given up to obtain an item” (Margaret et al., 2007, p.100). The key advantage of historical cost is its reliability that the amount which was paid could be proved by the transaction’s documentation. Historical cost is an objective measure which provides easy
information to be established, analyzed and understood by users (Margaret et al., 2007). On the other hand, historical cost covers information in the balance sheet that does not reflect the firm’s value (Penman, 2007). Historical cost stability increases its reliability but at the same time it produces the main criticism of historical cost because historical cost depends on stable monetary. Furthermore, historical cost depends on past amount which forces the firm to exclude some items (for instance intangible assets) or to estimate them which increases measuring subjectivity and opportunity. Even donated items cannot be included by the firms in financial statement if it just relies on historical cost. Historical cost allows the management to manipulate the income by the freedom to choose the depreciation policy; depreciation for instance could be changed either by shifting the depreciation policy or by the effect of the estimation of the asset’s age. Moreover, the asset might still generate benefits for the firm but its cost is already depreciated (Margaret et al., 2007).

2.3.2 Replacement Cost

An alternative cost measure which measures the cost of replacing the firm’s resource at the date of replacement transaction. It is argued that replacement cost provides more objective base for evaluating assets than any other valuation measure alternatives (Barna, 1957). There are two ways to measure replacement cost:

1- Replacement cost

Here we are measuring the cost of replacing the asset with another asset which is exactly the same asset the firm holds and in the same condition.

2- Current cost
Current cost measures the lowest amount which could be paid by the market to replace or provide the future economic benefit that the firm is expecting to get from the replacement asset (Margaret et al., 2007).

The main advantage of replacement cost is that it solves the problem the firm has if an asset has no resale value but still provides future economic benefits for the firm. Furthermore, replacement cost is reliable because it provides information which based on current market prices which obviously leads to more objective measure and less management ability to manipulate and affect the financial statements. The key criticism of replacement cost is that the firm might not want to replace the asset (it might want to use or sell), while replacement cost just consider the cost of replacing the asset which might be useless information for the firm. For example, firm has an asset which might provide future economic benefits exceed its replacement cost, or its replacement cost even more than its future economic benefits (Margaret et al., 2007). Barna (1957) argued that replacement cost could be a clear concept only if the asset is going to be replaced by an identical one, but this case is usually rare which makes replacement cost to have a strict sense.

2.3.3 Fair Value (Exit Price)

It is argued that accounting value measurements should provide information which is relevant and reliable. IASB has worked to maintain the reliability principle by focusing on that, fair value should be relying on observed market prices (Penman, 2007). IASB defines fair value as an exit price. Fair value provides current information (market prices) which determined by the market forces outside the firm which increases the neutrality of the management and decreases its bias, subjectivity and ability to manipulate the financial statements. It is argued that when a person
wants to purchase or sell something the only useful information he needs to know is the amount of money he is going to pay or get, so fair value considered as useful information for the users. Fair value makes financial statement more comparable because it provides information at the same period of time, and able to be understood by users (Margaret et al., 2007). The simple business principle is that the firm is founded to be continued, but fair value evaluates the items depending on the assumption that the firm is going to be liquidated. Fair value sometimes is useless. For instance, firm created an asset which is very useful for it and generates future benefits, but at the same time it might have no value for other firms. Furthermore, some assets might be held by the firm for long time to sell them, so the short-term fluctuation which fair value reflects might be irrelevance. Moreover, it is argued that fair value reflects market prices which are determined based on buyers and sellers expectations and predictions which sometimes might be incorrect and causes up or down volatility in market prices.

### 2.3.4 Present Value

Present value is the value which a firm can get from an item now by discounting the future cash flow which will be generated by the item. It is argued that present value is forward looking, in contrast to historical cost, and by measuring the future cash flow of the item it reflects the actual value of it. Furthermore, present value considers the time value of the money by discounting future cash flow. It is argued that present value predicts future cash flow which makes financial statements an important source to assess the management performance. Therefore present value is considered as an ideal value measure (Margaret et al., 2007). On the other hand, present value has subjective and uncertain predicting. At the first, the firm should estimate the future benefits of the item by predicting its future cash flow and costs. After that the firm
should decide the discount rate (which is usually decided by banks) and the firm is free to choose any rate which affects the quality of financial information and its comparability. Furthermore, some items are used in combination with other items which makes predicting their future cash flow confusing (Margaret et al., 2007).

2.3.5 Deprival Value

Deprival value represents the amount which the company should pay to replace the asset or receive from selling it when the asset is lost or damaged. Recently, accounting standards setters have replaced deprival value by fair value as favorable value measure (Zijl and Whittington, 2005). Deprival value measures the additional value which results from owning the asset. Deprival cost measures the replacement cost of assets which their recoverable amount exceeds the replacement cost. Therefore the reason behind sticking deprival value with replacement cost is the loss which is happening as the loss of the asset should not be more than its replacement cost (Baxter, 2003). The advantage of deprival value which is over current value and replacement cost is that it considers the circumstances of the firm and if it is actually going to replace the asset or not. It is argued that there are many difficulties in using deprival value in evaluating the assets and these difficulties rely on the incompleteness and imperfection level of the market (Horton and Macve, 2000). The opponents of deprival value pointed out that it is irrelevant that what if the firm does not deprive the asset and deprival value is an average of many value measures (for instance present value or reliable value, replacement cost or current cost); therefore, their criticisms could be pointed for it (Margaret et al., 2007).

2.4 Fair Value Implementation
Fair value implementation as proposed by FASB and IASB produced two questions, the first whether exit measure is efficient to measure the value for shareholders, the second, whether fair value can be used for aggregate assets and liabilities which provides value for shareholders. Fair value is not an appropriate value measure when the firm has the ability to control the market price (arbitrage) because fair value in this case increases the value of shareholders by buying items at input prices and selling them at output prices, input prices cannot be compared by the output prices (Penman, 2007), and fair value here is not an efficient tool for predicting the future.

The IASB is still concentrating on two questions of fair value:

How should fair value be measured?

When should fair value be measured?

The second question seems to have more attention of IASB. Penman (2007) claimed that the matters of fair value measurement are far from resolved. IASB has modified fair value’s rules for many assets and liabilities, but the control principles of its application are not complete and comprehensive yet. Cairns (2006) claimed that the say that IFRS required all balance sheet assets and liabilities to be measured by fair value is not true. The applying of fair value in the accounting is presented in three ways:

1- Applying fair value in mixed attribute model

Fair value here is used as an alternative for historical cost. Accounting initially depends on historical cost and fair value uses under certain conditions for the same assets and liabilities (donation transactions, for selling goodwill and intangible assets).

2- Applying fair value as entry value
Fair value here is measured by using replacement cost that assets are revalued depending on their current cost in the market. The unrealized gains and losses of the revaluing treatment recognize and record in the income statement. It is argued that the replacement cost is very positive in predicting the future and it is not path dependent.

3- Applying fair value as exit value

Assets and liabilities are revalued depending on their current exit price. The unrealized gains and losses recognize and record in the income statement as a part of the comprehensive income (Penman, 2007).

Barth and Landsman (1995) presented many obstacles to the implementation of fair value. First, in perfect and complete market, assets and liabilities have market value and balance sheet figures reflect relevant information to users, but income statement figures do not convey relevant information because of the revaluating assets and liabilities’ gains and losses. Second, in real market, many prices have used to express fair value as exit price, entry price and value-in-use. These prices sometimes present different value for the same item which affects the reliability and comparability of the financial statements.

2.5 The Reliability and Relevance of Fair Value and Historical Cost

The most controversial issue between fair value and historical cost is their relevant and reliability (Christensen and Nikolaev, 2009). After the adoption of IFRS the justification of fair value is not depending any more on its costs and benefits, but on the decreasing in the reliability and the increasing of the managerial discretion. Reliability means that the firm represents faithful and verifiable financial information
to the users. Presenting faithful information requires providing information in which the book value matches the economic value. Verifiability means that the represented information is able to be tested and makes sure that it has the same value of the transaction (Barlev and Haddad, 2003). Relevance and reliability are the most important attributes of the accounting information, and accounting standards setters when choosing between historical cost and fair value should balance between the level of relevance and the reliability. But accounting standards setters now are more concerned about the relevance of the financial information. Therefore, they required the firms to use fair value measurements which provide more recent and relevant information to the investors and creditors than historical cost. These measurements are more useful for users to assess the firm’s performance and predict the future view (cash flow, financial position) of the firm. Standards setters do not seem to accept that the reliability should outweigh the relevance of financial statements (Christensen and Nikolaev, 2009).

Financial statements should provide useful information to the potential investors and creditors to help them in making their investment decisions. These decisions obviously affect the income distribution therefore the welfare level of people in the society, so these decisions should be based on relevance, reliable and timely information to contribute positively in developing the country economy. Providing this information can enhance and improve the quality of investors’ decisions and decrease agency problems. The choice to apply fair value or the historical cost initially depends on the amount of resources and efforts that the firm is ready to spend in order to get reliable fair value. The main obstacle to fair value is its reliability which affects not just the users’ decisions but also their contracts. This weakness of fair value increases agency problems and allows the management to revalue the assets.
opportunistically. Christensen and Nikolaev (2009) suggested that if the firm choose the fair value method rationally, then the outcome through the market can tell if the measure provide a reliable estimate or not. (Margaret et al., 2007) claimed that the choice between fair value and historical cost should be depending on their usefulness for two issues:

1- “Relevance to particular decision for particular users.”

2- “The relative reliability of different costs and values.” (p.100)

Globalization and the capital market development have shaped the financial statements components and the users’ interests. Nowadays, investors concentrate on investments opportunities, performance and future earnings, so cash flow statement has become the most important statement. As a result, the continuous usage of historical cost becomes difficult because its information is not relevant to cash flow statement and it cannot be a base for the prediction of the future cash flow (Barlev and Haddad, 2003). Historical cost enhances agency costs by hiding the economic value of assets and liabilities and generating hidden-reserves which have been seen by the users as disadvantages of financial reports (Kohler, 1957). Historical cost contributes in the failure and bankruptcy of the firm that it does not reflect the economic value. As a result, the firm may default in repay its debts depending on its performance results and the worse is if its assets are overvalued (historical cost) comparing to the market prices which finally affects the firm’s reputation.

Bryer (1999) claimed that historical cost increases the social conflicts. The managerial ability to manipulate the financial statements and present false information increases the social conflicts and affects the fair distribution of the income in the country. Veron (2008) argued that historical cost provides less relevant and comparable
information to users. The opponents of historical cost claimed that it distorts the financial statements. Historical cost does not reflect the changes of the market prices and the interest rates. Furthermore, it depends initially on the conservative principle (costs of research and development are rarely capitalized as intangibles and they usually expensed).

We can easily notice through the development of accounting standards the orientation to new a phenomenon which is fair value, the old historical cost has been replaced by fair value. This movement definitely reflects the needs to increase the financial statements relevance and providing more recent and useful information to the users (Barley and Haddad, 2003). The proponents of fair value argue that there are many benefits of fair value:

1- Provides more relevant information for the users than historical cost.

2- Sends a quick sigh when the value of the investment declines (as the case of the mortgage meltdown).

3- Historical cost contributes in reducing the quality and the rule of the capital market (Foster and Shastri, 2010).

Barth et al. (2001) provided evidence that the estimating of fair value is similar to any accounting estimating. They claimed that the relevance tests are usually associated by reliability tests.

Veron (2008) claimed that the fair value alternatives do not cover the investors’ needs. They potentially hurt the financial statements and reduce the available information for the users. Furthermore, they are sometimes used as tools for the management to manage the earnings and manipulate the financial statements which leads for higher shares’ risk and weaker market performance. Fair value has a positive
impact because it reflects the recent market prices when the market is perfect and complete, but the market most of the time have bubbles, different needs, believes and behavior; and information asymmetries which makes it imperfect and incomplete. Reliability is difficult to be measured with those hypothetical transactions that incorporated in financial statements and they are not objectively measurable which initially affects fair value’s reliability and decreases it (Foster and Shastri, 2010).

Foster and Shastri (2010) suggest that financial reports preparers can still get the benefits of historical cost’s and fair value’s relevance and reliability that they can use historical cost for the financial reports and convey the fair value information in the footnotes. It is right in this way the quality of the financial reports will be enhanced but it will make reports production more costly and need more time. With the absence of an active market the evaluation process of the equity will be difficult which leads to more error in the evaluating process, reduces the reliability of the financial statements, reduces the verifiability, increase the subjectivity of the evaluating process and increases the probability of the managerial opportunism which overall increase the agency problems (Christensen and Nikolaev, 2009). The major active opponents of fair value are French and German banks. They believe that fair value produces the volatility problem of earnings, the anticipated gains and the difficulty of future cash flow estimation. Furthermore, French and German banks claim that fair value associates the problems of subjectivity, prudence and instability (Richard, 2004). Foster and Shastri (2010) claimed that using fair value for financial instruments will affect their response to the changes in the capital market. They also claimed that the fair value rules should be modified to be suitable and thus avoid the problems that appear in the financial statements. Whittington (2008) claimed that improvement to
fair value can be achieved by improving it to be complete and certain and to reach the consistency over time.

2.6 Fair Value and Auditors

Applying fair value to financial statements needs understanding of the situation of the existing active market and an efficient justification and judgment from the management. Fair value makes the financial statements preparation harder and harder. Moreover, deterring fair value in speculative and high risk environment is more difficult (Foster and Shastri, 2010). Fair value initially depends on estimating especially in the case of the level 3. When market has a bubble usually the evaluation be overstate and the participants will not recognize the bubble when the seller decide to sell the assets at the same time, which increase the instability and illiquidity of the market and at the same time decrease the relevance and reliability of the financial statements (Foster and Shastri, 2010). The implementation of fair value have a significant impact on the work of accountants and auditors because using fair value produces information depending on future evaluations rather than on historical values (Langendijk, Swagerman and Verhoog, 2003).

Fair value makes the auditing of financial statements more difficult and expensive to determine the effectiveness of the internal control of the estimations of the financial statements’ components. Auditors usually consider the estimation as a chance to manipulate the financial information, fair value allows the management to make many estimates especially when there is no active market which increases the risk of the financial information. Furthermore, providing sufficient audit evidence about fair
value seems to be difficult and costly (especially when there is not active market) (Foster and Shastri, 2010).

Hoogendoorn (2006) claimed that auditors are deeply involved in achieving full compliance to IFRS. Moreover, their involvement is efficient that the financial statements are prepared with more risk which provides more reliable, relevant, understandable and comparable information. In contrast, Fearnley et al., (2010) claimed that UK bank auditors have been criticized recently by the accounting regulations for the low skepticism of the bank accounts, but the auditors claimed that they are forced to audit the accounts relying on “flawed accounting model”. Auditors feel pressure result of the implementation and application of IFRS are diversity worldwide, which pushes them and accounting standards setters to minimize the differences of implementation of IFRS.

2.7 Fair Value to Whom?

Behind applying any policy should be many objectives. Therefore, many questions should be answered, to whom fair value is fair and to whom it is not? Does fair value increase the financial statements quality? What are the pluses and the minuses of applying fair value? Are the pluses of applying fair value greater than the minuses? Different users demand the financial information and most of them have their own needs that are different from the others. Shareholders might want to recognize the loans at their fair value when there are fallen in their value but not the lenders. Also, the bank’s shareholders might not wish to see the assets at their fair value while the clients do. Banks are not willing to present their assets at fair value if this will affect the confidence of their depositors. Investors welcome the fair value information which reflects the volatilities but the central bank which will be concerned about the effects
of the systematic risk (Penman, 2007). It is argued that fair value seems to be not reliable for debtors, so debt contract are usually written by using historical cost (Watts and Zimmerman, 1986). Lenders are interesting in current value because they provide information about the liquidation value, evaluating the firm’s with fair value will be less costly. Using fair value for evaluation increases the probability of the overstating of the assets’ book value, which in turn decreases the firm’s reputation and increases its risk.

2.8 Advantages and Disadvantages of Level 2 and Level 3 of Fair Value

Companies should consider three levels to get the fair value for their financial statements’ components:

Level 1:

Fair value is based on the quoted market prices when there is an active market.

Level 2:

Fair value is dependent on the observable inputs when there is no active market. But when there are no observable inputs, the financial statements’ preparers usually rely on the estimation therefore achieving the third level.

Level 3:

Because level 3 is sometime called mark-to-model, fair value gets its major criticism in getting the value of the financial statements’ items. In level 3, “preparers would have to make reasonable assumptions about expected future cash flow amounts, timing and uncertainty and about the relevant cost of capital to be used in discounting
projected cash flows to present” (Abdel-khalik, 2008, p. 4). The company’s assets and liabilities are then valued relying on the estimated present values. Gains and losses result from the assets and liabilities evaluation reflected in the income statements. Level 3 has been criticized that in poor economic conditions, fair value leads to pessimistic assumptions, therefore decreasing the assets values, which then leads to lowering the earnings because of the assets’ losses reflected in income statement (Abdel-khalik, 2008).

In contrast to level 1 of fair value, level 2 and level 3 allow the firm to estimate the unobservable prices in the market to meet the participants’ assumptions which they will use in pricing its assets and liabilities. The objection to this estimation understood because it could be used subjectively and damaged the quality of the financial statements. Level 2 and level 3 require more independence and competence from the auditors, corporate board and assessors to monitor the subjective biases and control effectiveness of the management (Penman, 2007). Agency theory claims that managers are usually optimistic. Therefore, when accounting standards open the door for the managers to estimate, they might overstate the items’ value and present information that is far from reality which overall contaminate the level of accounting information. It is argued that the only level which can reflect and present shareholder value is level 1.

2.9 Fair Value and Stewardship

The firm’s performance and financial position are required a performance measures to be presented in financial statements, so some firms trade off some reliability for some more relevance to convey information that reflects the actual performance and success of the firm over the given period (Christensen and Nikolaev, 2009). In historical cost
evaluating process, manager has the dominating power over the evaluation process and the ability to manage the firm’s income and financial position. Fair value reduces the manager’s dominant and lets the market voice to be higher than the manager’s (Barlev and Haddad, 2003). Agency theory suggests that managers have to fulfill the shareholders’ interests, so they have to present current, accurate, useful and verifiable financial information. Fair value has a positive impact on the manager’s behavior. Manager will work hard to understand and examine his duties over the time; give more attention to the surrounded economic environment and give more effort to increase shareholders value (Barlev and Haddad, 2003).

The managerial discretion is one of the reasons for the managerial failure in providing relevant fair value information. Because of agency costs, companies are willing to choose evaluation method that is against the managerial opportunism. For instance, when fair value does not provide optimal information historical cost could be used to avoid the upward assets evaluation (Christensen and Nikolaev, 2009). By using fair value shareholders will be able to get the actual equity value which forces managers to do the best efforts and cover all their duties aiming to increase shareholders value. Applying IFRS reduces information asymmetry and at the same time makes the communication between managers, shareholders, investors and other interested parties easier. Therefore, reducing the agency costs (Iatridis, 2010). Schipper (2005) pointed out that applying fair value needs only limited cost while it provides many benefits (e.g. contracting, useful information for making decisions and performance measurement).
EU Regulation 1606/2002 required the listed companies in the European stock market to apply the International Financial Reporting Standards (IFRS) on their financial statements. The implementation of IFRS on the financial statements has produced many effects on the adopted firms. Iatridis (2010) studied the effects of applied IFRS and its fair value on firms. He found that applying IFRS has a positive impact on the financial position and firm’s performance through increasing the growth and the profitability, and improving the leverage ability by reducing the future risk. In contrast applying fair value was associated by volatility in the figures of the income statement and balance sheet but it would never lead to financial crisis.

Callao, Jarne’ and La´inez (2007) tested the relevance of adopting IFRS on the Spanish companies. They found that the adoption of IFRS does not provide more relevant information to the users in the Spanish stock market because IFRS increases the gap between the book and market values. Furthermore, the adoption of IFRS does not provide any benefits in terms of financial statements’ usefulness in the short term, they expected that the usefulness of IFRS for the statements might appear in the medium to long term. Fair value has been implemented by International Accounting Standards Board (IASB) with two objectives:
1- Information: conveying relevant information to the capital providers which helps them in evaluating, predicting and comparing the firm’s future cash flows.

2- stewardship: to help shareholders in evaluating the efficiency and affectivity of the management’s performance in increasing the shareholders’ value.

Ronen (2008) found that using exit value to measure the fair value has failed in achieving two objectives (the information does not provide relevant information for evaluating the generated future cash flow by the firm) and stewardship (fails to assess the management performance and its contribution in increasing the shareholders value). This is because of the potentiality of estimating future cash flows risks and it only measures the leaving value that the shareholders will get when the firm’s business is under performing. Fair value of IFRS assumes that the market is relatively complete and perfect and the financial statements have to report the market prices (fair value) to passive creditors and investors which help them in making their decisions.

The opponents of fair value assume that there is no perfect or complete market. Financial statements should convey information about past events and transactions by using the specific measures to reflect the actual opportunities that the firm had.

Whittington (2008) found that there is no particular value measure which solves all problems and can be used in all cases, so the firm should choose the value measure depending on the particular circumstances for each item to achieve the objective in conveying relevant and reliable information to users. Song, Thomas and Yi (2010) tested the relevance of each level individually and the influence of corporate governance on them. They found that level 1 and 2 have greater relevance than level
3. Furthermore, firm’s corporate governance affects the fair value relevance. The relevance of fair value (especially level 3) is significantly greater when the corporate governance is strong. Benston (2006) provides evidence that the gap in fair value rules is the reason for bankruptcy of Enron. Enron used level 2 and 3 to evaluate their assets for its internal and external reports. Auditors and financial statements users face many problems with financial statements that were prepared relying on level 2 and 3 of fair value. Overall, Benston (2006) believed that the implementation of fair value in Enron is responsible for its demise. Opponents of the fair value of IFRS claim that fair value should be modified. Landsman (2006) pointed out that the standards setters should consider the following:

1- The space of freedom allowed to managers to estimate the fair value, which affects the management ability to manipulate the financial statements and provide fake information to shareholders.

2- The models’ errors of measuring fair value where the standard setters should work in reducing these errors and improving the models quality to increase their usefulness for the financial statements users.

3- The professional institutes in each country play a vital role in determining the effectiveness of fair value for the financial statements.

3.2 Earning Management

Many researchers studied the effect of the management opportunism on the fair value reliability. The managerial discretion is one of the reasons towards managerial failure in providing relevant fair value information (Barth and Beaver, 1996). Beaver and Venkatachalam (2003) tested the management opportunism through banks and found that managerial evaluation of the loans is associated with managerial opportunism.
Penman (2007) found many advantages and disadvantages of fair value. Fair value works well for stewardship and evaluation with the investment fund. Investors care more about value not historic costs, so financial statements should report fair value. Historical cost failed in reflecting the current financial position of the firm over the time while fair value reports the firm’s economic value. When there is active market fair value measures are not affected by specific factors related to particular firm. On the other hand, fair value raises the matching problems between the expenses and revenues, missing the reliability by the management estimating the value of the asset or liability when the actual market price (there is no active market) is not found. Fair value is not relevant when there is arbitrage market price (when a firm buys and sells according to input and output market prices) and adding these values to the shareholders.

The key criticism of fair value is that IFRS allows the management to estimate the fair value of the asset or the liability when there is no active market, which gives them the opportunity to be biased when it comes to financial statements, which results in misstatement of earning and equity, and inefficient fair value measurements. Managers may make unverifiable estimates of the firm’s assets and liabilities which lead to inefficient and unreliable information and mislead the users’ decisions. For example the manager can be biased in determining whether the goodwill should be impaired or not in addition to estimating the amount of the impaired goodwill (Beatty and Weber, 2005). Furthermore they found that the firm’s debt, bonus, contracting, exchange delisting and turnover affect applying the fair value in the firm. Horton and Macve (2000) pointed out that fair value has, when there is no deep market, no theoretical capital market theory or theoretical basis in economic logic and gives the management a space to manipulate the financial statements and convey misleading
information to shareholders. Opponents of the fair value say that companies should keep using only the historical cost instead of fair value as it may reduce the reliability of financial statements, they neglect the fact that fair value increases the financial statements relevance.

Khurana and Kim (2003) tested the relevance of fair value against historical cost depending on the bank financial statements. They found that historical cost is more relevant than loans’ fair value and deposits because of the volatility of their value. In contrast, in the case of available-for-sale securities, fair value is more relevant than historical cost. Overall, they found that fair value is less relevant than historical cost when there is no active market. Wang (2010) studied the relationship between the manager who estimates the fair value and the verification. He found that this relationship is increased when the auditor and or the verifier are willing to lower the estimated value of their own initial fair value estimate. The two of them could be biased where the effect is inevitable and it is not going to damage the fairness of the financial statements. Pounder (2010) tested the implementation of the fair value of FASB in USA and he found that the firm switches its fair value measure between the three levels of evaluation depending on the degree of reliability of the information that the market provides to the firm.

Demaria and Dufour (n.d.) found that French companies are willing to use historical cost when they are allowed to choose between fair value and historical cost; where their accountants are willing to follow the conservatism principle. For some items in the financial statements IFRS lets the companies to choose between using fair value or historical cost. Christensen and Nikolaev (2009) found that companies when they have the choice they choose to apply historical cost over fair value. Companies with higher debt are more likely to use fair value, using fair value provides the lenders with
up to date liquidation value of the firm’s assets and it is understood as a sign to the management’s reliability and confidence. Furthermore, fair value is not used for equipments, plants or intangible assets. Overall they ended up that most of the companies do not recognize the net benefit of using fair value relying on the users’ demand for reliable information.

It is argued that fair value is relevant because it primarily reflects the market prices and conditions that the investors are actually doing their business according to them. It is also argued that applying fair value makes the financial statements more comparable because it is a tool which depends on the market not on a specific firm. Fair value seems to be consistent because it provides the same relevant financial information over time. Fair value is timely because it basically reflects the economics effects on the firm over time (Emerson, Karim and Rutledge, 2010). King (2010) studied fair value of FASB and found that fair value is going to be expanded to be used for other assets and categories. He mentioned that the largest obstacle in the evaluation process of fair value emerges when it is used by the management to smooth the earnings and manipulate shareholders by disclosing information which is unreliable. Preinreich (1936) considered the importance of using fair value to evaluate the items. Buyers and sellers will know the exact price of the stock; he then described it as if the investor is going to buy the tree (fair value) or the shadow of the tree (another value).

It is argued that fair value increases the relevance of the financial information for the investors. While the value of firm should measure the relevancy and reliability, historical cost hides the financial position of the firm. Relevance and reliable measure for the firm’s value reduce the agency problems, enhance management’s performance and efficiency, and provide relevant and useful information to shareholders, which
improve the economy overall. Barlev and Haddad (2003) pointed out that using fair value provides timely and relevant information which might make a change in the management’s philosophy and strategy. It is argued that fair value enhances the shareholders ability to monitor the equity value and management performance, which pushes the manager to perform basic changes on management’s philosophy and strategy and choose the ones that guard and improve shareholders’ value. New management philosophy which aims to provide profitability and efficient performance will be emerged. Furthermore, new management strategy will also be raised as risk management will contribute efficiently to complete the business management duties. Moreover, fair value provides up to date financial statements which makes measuring the shareholders’ value more easy and at the same time decreases the management risk by presenting the actual financial position of the firm. The adoption of IFRS in Europe associated with increasing the information quality, more relevant and useful information, less information asymmetry and more convergence for the accounting standards (Armstong, Barth, Jagolinzer and Riedl, n.d.).

Christensen and Nikolaev (2009) suggested that if the firm choose the fair value method rationally, then the outcome through the market can tell if the measure provide a reliable estimate or not. Emerson, Karim and Rutledge (2010) criticized the historical measures that used by the time to evaluate the components of the financial statements. They claimed that fair value is facing many powerful issues that opposed its implementation. Fair value is just blamed because it forces banks to report billions in write-downs, and it is contributing in meltdown the capital market. They insisted that the existing requirements and guidance of fair value should be modified and developed to more relevance in its implementation, models and results. Finally they
claimed that fair value might have many disadvantages but it has more advantages which force forward to improve and expanded its usage.

Some studies focused on the reliability of fair value rather than its relevance. Dietrich et al. (2000) found that fair value enhances the ability of external users to evaluate the firm’s financial position and its future cash flow. Similarly, Muller and Riedl (2002) pointed out that market participants find the external appraisals more reliable. While Barth and Clinch (1998) provided evidence that there is no difference of fair value relevance between external and internal appraisal. Howe and Lippitt (2010) pointed out that accounting should be going to use the verified fair value. They presented their approach verified fair value which “includes a combination of grant-date liability recognition, report-date measurement of changes in that liability, and a wholly accurate exercise date cost reporting.” (p. 162). They presented their approach to measure verified fair value, which provides the best estimate for the present value and they applied it on the employee stock option. They found that the resultant fair value was comparable and consistent. Furthermore, they found that verified fair value is the best measure because it is transparent, practical, easy auditable, verified, reliable and can be promoted. By applying verified fair value we can eliminate the disadvantages of fair value and improve its advantages.

3.3 Fair Value and Industries

Many studies have tested the fair value’s relevance in banks. Nelson (1996) found that fair value measures are not incrementally relevant for the book value of the loans, deposit, investment securities, off-balance sheet financial instruments and long-term debt. In contrast, the financial statements with fair value help to predict the future profitability. The same, Barth and Beaver (1996) found that fair value of the loans
does not reflect completely the loan’s default and the risk of interest rate. Nissim (2003) found that applying fair value in banks is negatively related to regulatory asset growth, capital liquidity and the loan’s gross book value, and positively associated with an overstate of the estimation of the loans’ value. Some studies of the relevance of the fair value focused on whether fair value provides incremental information content over the historical cost. Biddle et al. (1995) found that while there is no explicit test to provide evidence that the fair value is more or less relevant than historical cost, then the only way is to test the incremental information content of two of them. Barth (1994) investigated the fair value’s disclosure for the banks’ investment securities and the securities gain and losses. She found that the estimation for investment securities’ fair value provides a significant explanatory power comparing with historical cost’s explanatory power and the measurement models of fair value for investment securities have less error than those of historical cost. In contrast, the exceed of fair value’s explanatory power of securities gains and losses over historical cost depends on the estimation equation, and the estimating measurements models of fair value for the securities gains and losses have more error than those of the historical cost models.

Duangploy and Pence (2010) tested the implementation of fair value hedges on the available-for-sale debt securities. They found that fair value of many financial instruments is not determinable, which forces the management to compare them with other markets or estimate them, which affects the financial statements reliability. They suggested that the first applying fair value hedge for available-for-sale debt securities should be associated by an understanding of the calculating and tracking of the hedged risk. In addition a deep understanding should include changes in fair value of derivatives, hedge ineffectiveness and effectiveness, and amortization of hedging
adjustments. Rees and Ruta (2010) studied the fair value of the debt securities that have other-than-temporary impairment (OTTI) and they found that the discount rate for estimating the fair value should be determined at the end of the year after a discussion with a bank, external auditors and other accounting experts and it should be rational.

After a long time of dormancy in the health care industry, the new arrangements in it requires that the health care’s financial statement should be more relevant and reflect the exact financial positions of the firms. Some researchers have studied the effect of fair value on the health care industry. Hahn and Collier (2010) found that fair value has stated to be applied in the healthcare industry and there are judicial decisions which are useful for the fair value predicting in the healthcare industry and makes it more reliable and easily.

3.4 Fair value for specific items in financial statements

Many studies focused on the relevance of fair value for specific items in the financial statements. Many studies pointed out that fair value is relevant for evaluating the non-financial assets (e.g. Aboody et al. 1999; Easton et al. 1993; Dietrich et al. 2000). Mard, Jones and Jenkins (2010) studied the application of fair value on property and its influence on the property tax and they found that there are three differences between the application of fair value and the theory in:

1- The broadly models for estimating the invested capital value.
2- Applied models for estimating the property value excluding invested capital value.
3- In determining the contributory assets and the method in calculating the economic rent, which finally lead to different calculated fair value.
Ward (1989) studied the implementation of fair value with specific case of charities. He pointed out that the fair value should be applied for evaluating the charities if and only if they are contributing in the fund-raising of the firm, management should provide a proposal about the charities and these proposals should be tested, after that a reasonable evaluating application should be applied. Ramanna (2008) tested the relevance of fair value to estimate the value of the goodwill. He found that the usage of fair value increases the probability of the management’s discretion which according to agency theory could be used opportunistically by the management to manipulate the financial statements. Hann, Heflin and Subramanayam (2007) tested the credit relevance of financial statements under fair value for the accounting of pension. Fair value increases its credit relevance while it does not increase the relevance of the balance sheet. Furthermore, fair value can impair the credit relevance and the value of the income statement and overall it does not increase the credit relevance of either balance sheet or income statement. Petroni and Wahlen (1995) found that fair value is not relevant for the municipal and corporate bonds, but it is relevant for the equities and treasury securities.

In contrast, Carroll et al. (2003) used a sample of closed-end mutual funds and found that fair value is relevant for thinly traded securities. They found that there is a significant association between the fair value of investment securities and stock prices, and also between the fair value securities gains and losses and stock returns. Laurin and Robson (2010) pointed out that there is volatility of the assets’ value when they are measured by fair value; moreover the fluctuations in the liabilities’ expense are more recognizable. They tested the applying of fair value on the public service pensions in Canada. The market participants find fair value less secure and more
expensive than historical cost because it provides information which is more costly and risky.

Overall, it seems that fair value is relevant for balance sheet’s items because it reflects the actual financial position of the company. It still needs to be developed to reflect the actual earnings of the company because the gains and losses of assets and liabilities are set in the income statement.

3.5 Fair Value and Financial Crisis

After the financial crisis in 2008, there were many who thought that fair value had contributed to the financial crisis. Those who have these thoughts claimed that fair value should be a substantial reform or its implementation should be stopped. These criticisms pushed the European Commission and U.S. Congress to put pressure on the standards setters to slow the development of fair value rules. Many studies focused on the relationship between fair value and financial crisis. Fearnley et al. (2010) argued that the IFRS outputs are irrelevant to the way the companies are doing their business and make their accounts more difficult to be understood. She claimed also that while UK is forced to use IFRS responding to the EU requirements, UK government should work hard to overturn it. Furthermore, even though IFRS did damage UK financial statements, UK accounting standards setters still aim to increase its burden on the companies, including small ones. Moreover, she suggested that the UK accounting standards now should be monitored by wide peer group (such as the parliament) and it is the time to reconsider the accounting standards because IFRS does not reflect the “UK traditional true and fair view”.

Laux and Leuz (2010) tested the contribution of fair value in the financial crisis and they found that fair value contributed a little in the financial crisis of the U.S. banks
but the thought that fair value is making the financial crisis bigger is totally wrong. Furthermore, relaxing fair value rules or giving the management more space to avoid these potential problems will open the door for the management to manipulate and reduce the reliability of the financial information in this critical time.

Magnan and Thornton (2010) studied the fair value during the financial crisis and they pointed out that auditing should be more rigorous to eliminate the management’s bias and the investors evaluation of fair value increase by stronger governance and higher quality auditing and high skilled accountants. Standard setters are just interested in improving the quality and skills of the accountants while they ignore the information needs of other shareholders than investors. The standards should be more specific when the firm should apply one of the three levels. Magnan and Thornton (2010) claimed that these crises had a positive impact on the development of fair value that they pushed standards setters to pay more attention to the time when fair value is relevant so then the firm can rely on the market prices. The incremental explanatory power of the financial instruments’ fair value was studied by Fen, Chen and Fu (2010). They found that the financial meltdown, characteristics of the industry, and the changes in the financial and economic conditions affect the fair value’s information and its relevant decreases significantly during the financial meltdown (for example the global financial meltdown in 2008).

As a result of the explanatory power of accounting information, the stock price goes down. They expected that financial crisis in one country is going to spread to other countries making a global financial disaster because the world is being more integrated and the economic conditions are being more complex. Flegm (2005) supports the view that the historical cost’s value measure is inherently objective. The recent movement to fair value is just increasing the potential of managers to commit
fraud and to manipulate the financial statements. For example the case of Enron which is an overall result because of the fair value estimates. Flegm claimed that the subjectivity of fair value should be reduced in order to prevent people from taking advantages of its subjectivity. Scott (2005) pointed out that the standards setters should give more attention to fair value rules and provide more details that control the estimating fair value process which would help to reveal more relevant and reliable information.
CHAPTER IV

Sample and Methodology

4.1 Data Collection

Data collection was performed using DataStream application software that gives access to the world’s largest and most respected historical financial numerical database. The data collection process was conducted as follows:

- A number of 20 leading companies were selected in this experiment, Table 1 illustrates those companies. The reason behind selecting these companies is because they are the top capitalization in UK.

- Using DataStream we downloaded financial reports for each company starting from 1990 and up to 2009 covering twenty years. As shown in Table 1 some of the companies were skipped as they do not cover the required period which is twenty years as some of them started years after 1990.

- The data was transformed into Excel files in order to ease the process of preparing the data for more experiments which will be shown in details in the Hypotheses section.
Table 1 Top 20 Capitalization Companies in UK

<table>
<thead>
<tr>
<th>Company</th>
<th>Sector</th>
<th>UK Rank 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>BP PLC</td>
<td>Oil and Gas Producers</td>
<td>1</td>
</tr>
<tr>
<td>HSBC Holdings PLC</td>
<td>Banks</td>
<td>3</td>
</tr>
<tr>
<td>Vodafone Group PLC</td>
<td>Mobile telecommunications</td>
<td>4</td>
</tr>
<tr>
<td>Rio Tinto PLC</td>
<td>Mining</td>
<td>6</td>
</tr>
<tr>
<td>British American Tobacco PLC</td>
<td>Tobacco</td>
<td>8</td>
</tr>
<tr>
<td>AstraZeneca PLC</td>
<td>Pharmaceuticals and Biotechnology</td>
<td>10</td>
</tr>
<tr>
<td>Lloyds Billiton PLC</td>
<td>Banks</td>
<td>11</td>
</tr>
<tr>
<td>BG Group</td>
<td>Oil and Gas Producers</td>
<td>12</td>
</tr>
<tr>
<td>Anglo American</td>
<td>Mining</td>
<td>13</td>
</tr>
<tr>
<td>Standard Chartered PLC</td>
<td>Banks</td>
<td>15</td>
</tr>
<tr>
<td>Tesco</td>
<td>Food and drug retailers</td>
<td>16</td>
</tr>
<tr>
<td>SAB Miller</td>
<td>Beverages</td>
<td>17</td>
</tr>
<tr>
<td>Diageo</td>
<td>Beverages</td>
<td>18</td>
</tr>
<tr>
<td>Reckitt Benckiser</td>
<td>Household goods and home construction</td>
<td>19</td>
</tr>
<tr>
<td>Royal Bank of Scotland</td>
<td>Banks</td>
<td>20</td>
</tr>
<tr>
<td>Unilever</td>
<td>Food Producers</td>
<td>21</td>
</tr>
<tr>
<td>Prudential</td>
<td>Life Insurance</td>
<td>26</td>
</tr>
<tr>
<td>Bae Systems</td>
<td>Aerospace and defence</td>
<td>27</td>
</tr>
<tr>
<td>Tullow Oil</td>
<td>Oil and Gas Producers</td>
<td>28</td>
</tr>
<tr>
<td>Rolls-Royce Group</td>
<td>Aerospace and defence</td>
<td>29</td>
</tr>
</tbody>
</table>

4.2 The First Adoption of IFRSs

IFRS 1 was issued by IASB. IFRS was presented as a basis for preparing the financial statements in the companies. IFRS started to be effective for the companies on January 1, 2004. The first adoption of IFRS makes general purposes of financial
statements more obvious and unreserved. In 2005 IFRS became mandatory for the listed companies in Europe; at this time fair value was accepted to be a concept in accounting without any consideration to its practical implementation or its legitimacy (Ebbers, 2007). Jermakowicz and Tomaszewski (2006) studied the effect of IFRS on the European Union (EU) companies. They found that most of companies would not adopt IFRS if it is not required by the EU regulation and they are just applying it for consolidation purposes to achieve the harmonization for internal and external reports. Furthermore, they expect that financial results will have volatility. The weak of IFRS implementation guidance is pushing IASB for more convergence. EU managers have the choice to apply IFRS for just the external reports or the internal and external reports, but most of them applied it for internal reports also and got its benefits in making decisions and measuring the company’s performance. Adopting IFRS increases the harmonization between listed companies and many countries are going to adopt IFRS because of the saving cost of applying it on both consolidated and individual financial reports. Applying IFRS reduces information asymmetry and at the same time makes the communication between managers, shareholders, investors and other interested parties easier and therefore, reducing the agency costs (Iatridis, 2010). (Christensen and Nikolaev, 2009) believed that in active market, market forces will be able to prevent the managerial opportunistic by the use of fair value.

4.3 The Impact of First Adoption of Fair Value on Studied Companies in 2005

Companies in UK for all periods until the year ended on 31 December 2004 were preparing their financial statements under the UK Generally Accepted Accounting Practice (UK GAAP). Many group companies in UK prepared their financial
statements under IFRS while the parent companies’ financial statements were still prepared under UK GAAP. Furthermore, many companies presented comparative information under UK GAAP which costs time and money. In 2005 companies in UK were mandated to prepare consolidated financial statements under IFRS. Financial statements of 2005 of most companies represented also the financial statements of 2003 and 2004 under IFRS to provide useful information that could be compared with the ones of 2005. The main differences that UK companies noticed between applying UK GAAP and IFRS are: setting up inventory valuation differences, deferred taxation on acquisition, jointly controlled companies and associates, unremitted earnings of subsidiaries, expenses are being larger, and recognizing the changes of derivatives fair value in income statements.

UK companies claimed that applying IFRS requires the management to make significant judgments and predicting in preparing the consolidated financial statements especially the estimation for the recoverability of assets carrying value, reserves, provisions and liabilities, contingent liabilities, deferred taxation and pensions. UK companies declared that preparing financial statements under IFRS pushed their managements to make estimates which affect not only the presented numbers of assets and liabilities, but also the expenses and revenues of the reported year. Furthermore, companies claimed that predicting the assets impair forced their managements to estimate on high uncertain matters (for instance future commodity prices and the effect of inflation). They pointed out that the new task of their management to recognize the goodwill impair regarding company conditions which makes it difficult. Moreover, some companies claimed that their business requires special accounting rules because their business is unique (such as oil and gas). While IFRS does not deal with such kind of accounting, these companies depended on UK
GAAP as a guide for preparing their financial statements. UK companies pointed out that they depended on bid price at the close of business on the date of balance sheet to get items’ fair value. When there is an active market (as level 1 of fair value) these companies based on the quoted market prices, but when there is no active market they depend on the available observable inputs (level 2 of fair value). But when there are no observable inputs (level 3 of fair value), they used valuation techniques (such as discounted cash flow analysis, pricing models and recent arm’s- length market transactions) to evaluate the fair value for the items, or they sometimes based their evaluation on assumptions which are not supported by current prices in the market or observable market data. Moreover, they declared that after evaluating financial assets, if their fair value is negative they will be recognized as financial liabilities otherwise they will be recognized as financial assets.

UK Companies claimed that their financial statements are based on assumptions and any changes in these assumptions will change the resultant fair value which at the end will affect the assets and liabilities values (for instance HSBC Holdings PLC declared that using less favorable assumptions will decrease the assets value by approximately £20 million, while using more favorable assumptions will increase the assets value by approximately £20 million). Therefore, they declared that their managements are responsible for making efficient assumptions which provide relevant, reliable, understandable and comparable information. They also pointed out that using historical cost information might not be totally useful in predicting all potential events especially those that are extreme in nature.

UK companies declared that the reported financial position, financial performance and cash flow have been affected because of the transition from UK GAAP to IFRS. Furthermore, during this period the recognized income and expenses have changed.
These changes forced them to represent comparative financial information because of the changing in the treatments for many items (such as goodwill, retirement benefits and dividends). UK companies claimed that applying fair value at loans, advances to customers, financial investments and debts had an impact on their shareholders equity (for instance, applying fair value in HSBC Holdings PLC resulted in reducing shareholders equity by £48 million). Many UK companies used the transitional exemptions, which IFRS allows them to use when they move from UK GAAP to IFRS.

4.4 Hypotheses

Arguably IFRS implementation will help to enhance the financial statements transparency and comparability, which in turn leads to improve the quality and reputation of the capital market. These improvements send positive signals to investors that the companies present reliable and relevant information which reduces the information asymmetry, management earnings and therefore agency costs. These will encourage them to invest their money in these companies. It is argued that fair value provides higher relevant and incremental information than historical cost (Danbolt and Rees, 2008). Wang (2010) studied the relationship between the manager who estimates the fair value and the verification. He found that this relationship is increased when the auditor and or the verifier are willing to lower the estimated value of their own initial fair value estimate. Two of them could be biased where the effect is inevitable and it is not going to damage the fairness of the financial statements. Hoogendoorn (2006) claimed the comparability of the balance sheet and income statement has been reduced because of the lack of their formats. Furthermore, some directives consider applying IFRS on the financial statements as backwards step. It is
argued that significant differences between firms’ financial statements will appear because of the fair value implementation.

**H1: Net Income**

Iatridis (2010) pointed out that firms adopting IFRS for the first time have faced higher profitability and growth. Dhaliwal et al (1999) studied whether comprehensive income or net income is the best measure for the firm’s performance by comparing their value by the stock return. It is argued that the standards setters are interested in figuring out which income measure is the best to reflect the changes in the stock market value. Barlev and Haddad (2003) claimed that historical cost hides the actual financial position and income. Danbolt and Rees (2008) studied the income under fair value and they found that historical cost income is considerably less relevant than fair value income. In contrast, income measure becomes irrelevant with the presence of the changes of balance sheet items’ value under fair value.

The first hypothesis therefore expects that if fair value presents useful information it should have a positive significant impact on the net income.

**H2: Intangible Assets**

Business over the world has been changing and intangible assets, which in the past were not considered and missed in the financial statements because they do not have historical cost, play an important role in the firm’s performance and uniqueness. Therefore, standards setters believe that fair value is relevant for financial statements and should be one of the mixed measures of the financial statements’ items (Margaret et al., 2007). The special treatments of intangible assets under IFRS make them important items to be studied. Barlev and Haddad (2003) claimed that historical cost
hides the increases in the assets value which gives managers the ability to stick with profitability measures which are quite good. O’Hanlon and Pope (1999) pointed out that asset’s revaluation provides more relevant information to users. Intangible assets reflect the difference between the firm’s market value and the net assets; therefore if they are measured fairly, they can make firm value equal to equity (Holthausen and Watts, 2000). Danbolt and Rees (2008) claimed that intangible assets’ values are less reliable under fair value. They provided evidence that management usually overstates the intangible assets values. Barth and Clinch (1998) pointed out that fixed intangible assets revaluation is positively and significantly associated by share price. Ramanna (2008) tested the relevance of fair value to estimate the value of the goodwill. He found that the usage of fair value increases the probability of the management’s discretion which according to agency theory could be used opportunistically by the management to manipulate the shareholders. (Beatty and Weber, 2005) pointed out that manager can be biased in determining whether the goodwill should be impaired or not in addition to estimating the amount of the impaired goodwill.

**The second hypothesis assumes that if fair value presents useful information it should have a positive significant impact on intangible assets’ values.**

**H3: Property, Plant and Equipment**

Managers may make unverifiable estimates of the firm’s assets and liabilities which lead to inefficient and unreliable information and mislead the users’ decisions (Beatty and Weber, 2005). Many studies have tested the relevance of the revaluation of fixed assets. Danbolt and Rees (2008) found that fair value is more relevant to the tangible rather than the intangible assets. Barth et al. (2001) argued that the early adjustment of the relevance of tangible assets evaluation failed. They found that the reason to this is
mostly because of the unreliable estimations of the management. Easton, Eddey and Harris (1993) found that the revaluation of fixed assets has a weak explanatory power on the income. In contrast, Aboody, Barth and Kasznik (1998) tested the revaluation of fixed assets in UK companies and they found that the revaluation of fixed assets is associated by higher returns and prices. Barth and Clinch (1998) pointed out that fixed tangible assets revaluation is positively and significantly associated by share price. Laurin and Robson (2010) pointed out that there is volatility of the assets’ value when they are measured by fair value.

The third hypothesis assumes that if fair value presents useful information it should have a positive significant impact on property, plant and equipment values.

**H4: Return on Equity**

It is argued that return on equity is useful for shareholders to evaluate the management performance and the firm’s value. Return on equity is raised based on accounting information. Historical cost hides the actual return on equity. Barlev and Haddad (2003) argued that return on equity gives a biased result under historical cost because under historical cost, managers are able to manipulate the income through income management (such as depreciation). Iatridis (2010) pointed out that firms adopting IFRS for the first time have faced higher profitability and growth. Historical cost does not reflect the increases in the assets value which gives managers the ability to manipulate the profitability measures and present quite good result (Barlev and Haddad, 2003).

The fourth hypothesis assumes that if fair value presents useful information it should have a positive significant impact on the return on equity.
**H5: Depreciation and Amortization**

Historical cost allows the manager to manipulate income statement depending on his freedom to decide on depreciation method and useful life of the asset. Historical cost allows the management to manipulate the income by the freedom to choose the depreciation policy; depreciation for instance could be changed either by shifting the depreciation policy or by the affect of the estimation of the asset’s age. Moreover, the asset might still generate benefits for the firm but its cost is already depreciated (Margaret et al., 2007). Goodwill does not have amortization any more, but it is tested for impairment yearly which affects the amortization amount (Barlev and Haddad, 2003). Fixed assets are now revalued under fair value which affects their depreciation amount over time. It is argued that manager can be biased in determining whether the goodwill should be impaired or not, in addition to estimating the amount of the goodwill impairment (Beatty and Weber, 2005).

**Depending on what was mentioned above, the fifth hypothesis assumes that if fair value presents useful information it should have a negative significant impact on the depreciation and amortization values.**

**4.5 Data Pre-processing**

Before using the data in our experiment the data had to undergo several preprocessing steps. For each company DataStream was used to get 3 main financial reports including: 1- Balance Sheet, 2- Income Statement, and 3- Industrial Ratio reports. For each report we extracted a set of what we consider useful information that will aid us in finding significant results. The extracted bits include Net Fixed Assets and Net Intangible Assets from the Balance Sheet report and Net Income from the Income Statement report. From the Industrial Ratio we selected the Return on Equity and
Total Depreciation and Amortization. The above mentioned variables were organized according to the previously mentioned companies and years.

4.6 Data Inconsistency

One of the main inconsistencies in the data lies in the Intangible Assets were in some companies the Net Intangible Assets were not recognized and were mentioned in the report as zero values.

4.7 Getting Expected Values

The main objective of this experiment is to measure whether the use of fair value provides relevant information for the users of financial statements to be used in investment decision making.

To find out the effect of applying fair value we will predict values of the 5 variables for the years 2005 to 2009 based on the time period between 1990 and 2004 when fair value was not yet applied. In tables 2, 3 and 4 we calculated the average of the 5 variables for the 20 companies mentioned before using the time period from 1990 to 2004 which is the time before applying fair value.

This data is going to be used as a baseline to predict the variables values for the time period from 2005 to 2009 which is the time fair value was applied in financial statements.
### Table 2 Average of the 5 variables 1990 - 1994

<table>
<thead>
<tr>
<th>Variables</th>
<th>1990 (£)</th>
<th>1991 (£)</th>
<th>1992 (£)</th>
<th>1993 (£)</th>
<th>1994 (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>3286896</td>
<td>3591607</td>
<td>4042666</td>
<td>4181921</td>
<td>4057040</td>
</tr>
<tr>
<td>intangible assets</td>
<td>105475</td>
<td>181439</td>
<td>180554.3</td>
<td>161084.3</td>
<td>169426.9</td>
</tr>
<tr>
<td>Net income</td>
<td>318703.6</td>
<td>340866</td>
<td>306713.4</td>
<td>341898</td>
<td>529590.4</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>281776.1</td>
<td>341154.8</td>
<td>378527.4</td>
<td>424122.4</td>
<td>396445.9</td>
</tr>
</tbody>
</table>

### Table 3 Average of the 5 variables 1995 - 1999

<table>
<thead>
<tr>
<th>Variables</th>
<th>1995 (£)</th>
<th>1996 (£)</th>
<th>1997 (£)</th>
<th>1998 (£)</th>
<th>1999 (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>413683</td>
<td>4318928</td>
<td>3722047</td>
<td>4030379</td>
<td>4456607</td>
</tr>
<tr>
<td>intangible assets</td>
<td>159216</td>
<td>150544.4</td>
<td>346370.5</td>
<td>416429.8</td>
<td>1584172</td>
</tr>
<tr>
<td>Net income</td>
<td>591240.2</td>
<td>670953.3</td>
<td>815001.6</td>
<td>774146.9</td>
<td>839559.1</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>406506.4</td>
<td>432086.9</td>
<td>405491.3</td>
<td>461426.8</td>
<td>534469.7</td>
</tr>
</tbody>
</table>

### Table 4 Average of the 5 variables 2000 - 2004

<table>
<thead>
<tr>
<th>Variables</th>
<th>2000 (£)</th>
<th>2001 (£)</th>
<th>2002 (£)</th>
<th>2003 (£)</th>
<th>2004 (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>3955117</td>
<td>4318270</td>
<td>4982927</td>
<td>5488030</td>
<td>5824728</td>
</tr>
<tr>
<td>intangible assets</td>
<td>4777837</td>
<td>9069222</td>
<td>8784832</td>
<td>9303474</td>
<td>8592715</td>
</tr>
<tr>
<td>Net income</td>
<td>961151.8</td>
<td>499747.7</td>
<td>82844.1</td>
<td>570670.8</td>
<td>892176.6</td>
</tr>
<tr>
<td>Return on equity</td>
<td>15.8915</td>
<td>15.832</td>
<td>14.396</td>
<td>16.1775</td>
<td>18.1695</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>815036.6</td>
<td>1588675</td>
<td>1755134</td>
<td>1931073</td>
<td>2055123</td>
</tr>
</tbody>
</table>

### 4.8 Experimental setup (Predicting Expected Values)

As mentioned before we are to predict values of the 5 variables for the years 2005 to 2009 based on the time period between 1990 and 2004 as fair value was not yet applied. To do that we will take the values of the 5 variables during the time span 2005 to 2009 which is the time fair value was applied and we will call it “Actual Values” then using the same time span we will predict the values of the 5 variables
but this time with the absence of the fair value depending on the values obtained from the years 1990 to 2004 and we will call it “Expected Values”. We will compare the Expected with the Actual values of the 5 variable for the period of 2005 to 2009 using a significance test which is a t-test in our case. Performing a t-test using the Expected and Actual values we are investigating whether fair value has significant positive or negative effect on the five variables. Table 5 illustrates the Expected and Actual values of the 2005 – 2009 periods.

Table 5 Actual and Expected Values of the 5 Variables 2005 – 2009

<table>
<thead>
<tr>
<th>Variables</th>
<th>2005 (£)</th>
<th>2006 (£)</th>
<th>2007 (£)</th>
<th>2008 (£)</th>
<th>2009 (£)</th>
<th>Average (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>603,274.5</td>
<td>565,400.5</td>
<td>647,340.4</td>
<td>824,584.2</td>
<td>907,289.5</td>
<td>709,577.8</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>880,567.6</td>
<td>842,923.9</td>
<td>1,045,687.4</td>
<td>1,121,917.0</td>
<td>1,135,342.2</td>
<td>1,005,287.6</td>
</tr>
<tr>
<td>Net income</td>
<td>1,500,832</td>
<td>1,137,695</td>
<td>2,065,614</td>
<td>746,856.4</td>
<td>1,827,364</td>
<td>1,455,672</td>
</tr>
<tr>
<td>Return on equity</td>
<td>24,401.6</td>
<td>27,364.5</td>
<td>22,754.5</td>
<td>15,764.5</td>
<td>19,722</td>
<td>22,001.4</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>174,236.5</td>
<td>998,468.9</td>
<td>1,061,295</td>
<td>1,309,853</td>
<td>1,618,825</td>
<td>1,346,161</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Variables</th>
<th>2005 (£)</th>
<th>2006 (£)</th>
<th>2007 (£)</th>
<th>2008 (£)</th>
<th>2009 (£)</th>
<th>Average (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>527,943.5</td>
<td>540,044.1</td>
<td>552,144.7</td>
<td>564,245.3</td>
<td>576,345.8</td>
<td>552,144.7</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>892,496.9</td>
<td>967,376.0</td>
<td>1,042,282.4</td>
<td>1,117,188.8</td>
<td>1,192,095.1</td>
<td>1,042,282.4</td>
</tr>
<tr>
<td>Net income</td>
<td>763,294.9</td>
<td>787,579.6</td>
<td>811,864.2</td>
<td>836,148.9</td>
<td>860,433.6</td>
<td>811,864.2</td>
</tr>
<tr>
<td>Return on equity</td>
<td>17,57599</td>
<td>17,50054</td>
<td>17,42509</td>
<td>17,34963</td>
<td>17,27418</td>
<td>17,42509</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>181,481.0</td>
<td>193,993.5</td>
<td>206,506.1</td>
<td>219,0187</td>
<td>231,5313</td>
<td>206,5061</td>
</tr>
</tbody>
</table>

Later on a t-test will be performed to measure the significance of the prediction and whether the use of fair value has significant effect on any of the 5 variables.

To proof this assumption we calculated values which we call “Expected Values” that will predict the effect of using fair values on the previously mentioned variables during the period between 1990 and 2009.
4.9 T Test

We use this test for comparing the means of two samples (or treatments), even if they have different numbers of replicates. In simple terms, the t-test compares the actual difference between two means in relation to the variation in the data (expressed as the standard deviation of the difference between the means).

As the main objective of this experiment is to find the relevance of applying fair value on financial statements a t-test was performed to determine significance where we performed standard t-tests (p < 0.05) and (p<0.10), by testing each variable on both the expected and actual values. In Table 6 we tested the significance of each variable, we divided the significances into two levels, positive (+) and negative (-). As illustrated in the table we can see that the only variable that did not show any significance was the intangible assets variable. The expected results in the table are the significance’s directions that we are looking forward to achieve depending on our hypothesis, while the actual results are the results gained from the data we have. The actual result is considered positive when the actual value exceeds the expected value and vice versa.

Table 6 t-test Results

<table>
<thead>
<tr>
<th>Variables</th>
<th>Expected Value (£)</th>
<th>Actual Value (£)</th>
<th>P Value</th>
<th>Significance</th>
<th>Expected Results</th>
<th>Actual Results</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>5,521,447</td>
<td>7,095,778</td>
<td>0.054936</td>
<td>*</td>
<td>(+)</td>
<td>(+)</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>10,422,824</td>
<td>10,052,876</td>
<td>0.206121</td>
<td></td>
<td>(+)</td>
<td>(-)</td>
</tr>
<tr>
<td>Net income</td>
<td>811,864.2</td>
<td>1,455,672</td>
<td>0.052219</td>
<td>*</td>
<td>(+)</td>
<td>(+)</td>
</tr>
<tr>
<td>Return on equity</td>
<td>17.42509</td>
<td>22.0014</td>
<td>0.078827</td>
<td>*</td>
<td>(+)</td>
<td>(+)</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>2,065,061</td>
<td>1,346,161</td>
<td>0.013271</td>
<td>**</td>
<td>(-)</td>
<td>(-)</td>
</tr>
</tbody>
</table>

* Significant at 10% level. (+) Positive Significant Effect.
** Significant at 5% level. (-) Negative Significant Effect.
CHAPTER V

Results and Analysis

In this section we illustrate the results we gain from our experiment with the financial reports of the 20 companies mentioned earlier.

Looking into tables 2, 3 and 4 we calculated the mean average for each variable for the years starting from 1990 and ending on 2004 which are the years where fair value wasn’t yet presented. The first part of Table 5 illustrates the mean averages of the 5 variables we have the results displayed are being calculated with the presence of the fair value as it stated to be applied by the year 2005. In order to measure the effect of applying fair value on the 5 variables, we predicted the same results but this time with the absence of fair value calling the results we gain “Expected Values”. In order to calculate the Expected Values for the years 2005 to 2009 we relied on the results we have in tables 2, 3 and 4 and which helped us in our prediction.

Having the actual and the expected values we had to measure the significance of applying fair value, to do so we ran a t-test (p<0.05) and (p<0.10). Table 6 illustrates the results of the t-test, going through the results we can see that only the Depreciation and Amortization showed significance results based on the (p<0.05) hypothesis with p value = 0.013. All the remaining variables which include Property, plant and equipment, Net income and Return on equity except the intangible assets, showed significance on the hypothesis where (p<0.10).

Considering the Net income, return on equity and the property, plant and equipment variables we found that fair value has significant effect considering (p<0.10). We assume that the reason why these variables did not show significance when (p<0.05)
is due to the financial crises happened in 2008 which understood as the main factor towards bankruptcy in many banks and companies in addition to the huge decrease in properties prices.

In our hypothesis we expected that fair value will have positive effect on 4 variables (Property, plant and equipment, Intangible assets, Net income and Return on equity) and a negative effect on the Depreciation and amortization variable. On the other hand, the actual results showed that fair value has positive effect on 3 variables (Property, plant and equipment, Net income and Return on equity) and a negative effect on the Depreciation and amortization and Intangible assets variables.

Table 6 shows that the positive and negative effects of the expected and actual results match in 4 variables (Property, plant and equipment, Net income, Return on equity and Depreciation and amortization) and mismatch in the Intangible assets variable. According to that we can be consistent that fair value provides useful information in the financial statements when the expected and actual results match. In our case fair value provides useful information about the Property, plant and equipment, Net income, Return on equity and Depreciation and amortization variables.

In contrast to Barth and Clinch (1998) who found that fair value has positive significant effect on intangible assets, we found that fair value has non-significant and negative effect on intangible assets. We still believe that the reason behind the non-significance and negative effect showed in Table 6 is due to inconsistencies in the data as the intangible assets were not recognized and were mentioned as zero values in some of the companies’ financial statements, in addition to the well management prediction of the intangible assets. Again this would have been affected by the financial crises.
CHAPTER VI

Conclusion

Belkaoui (2004) argued that accounting system should be set to produce relevant information for rational decision making. If both fair value and historical cost provide relevant and reliable information to the market then the two of them should be used in the financial statements. Accounting has provided many ways to present information, so the financial statements preparers should work to improve the financial statements’ quality by providing useful information even in the footnotes, summaries…etc.

Accounting alternatives will increase the quality of the financial statements but the preparers should also be concerned with the costs of doing that and compare the cost with the benefits. Fair value provides the solution for measuring the firm’s items. Apart of fair value measurements’ problems, fair value is a plus for accounting and financial statements, while historical cost could be an alternative for fair value when it is ideal for measuring the firm’s item (Penman, 2007). Whittington (2008) found that there is no particular value measure which solves all problems and can be used in all cases; therefore, the firm should choose the value measure depending on the particular circumstances for each item to achieve the objective in conveying relevant and reliable information to the users. Fair value should be used wherever it provides faithful representation of the financial situation of the firm. Mouristen (1994) and Richardson (1987) found that fair value is efficiently productive and relevant.

This research studies the effect of fair value on the top 20 capitalization companies in the UK from 2005 to 2009 depending on their financial statements from 1990 to 2009.
We predicted the values of the 5 variables for the period 2005-2009 depending on the data variables for the period 1990-2004 with the absence of fair value calling the results we gain “Expected Values”. In order to calculate the Expected values for the years 2005 to 2009 we relied on the results we have in tables 2, 3 and 4 and which helped us in our prediction. Having the actual and the expected values from 2005 to 2009 we had to measure the significance of applying fair value on the 20 UK companies using a t-test.

We focus on the effect of fair value according to five variables (Net income, property, plant and equipment, intangible assets, return on equity, and depreciation and amortization). Belkaoui (2004) claimed that share price is sufficient to be used for judging the “effects of alternative accounting procedures”, but it cannot be used for evaluating the desirability of them. We did not adopt the share price approach towards testing the effect of fair value on financial statements because share price is affected by many factors and because we did not know at which time it should be considered.

In our findings, the Depreciation and Amortization showed significance results based on the (p<0.05) hypothesis. All the remaining variables which include Property, plant and equipment, Net income and Return on equity except the intangible assets, showed significance on the hypothesis where (p<0.10).

Considering the Net income, return on equity and the property, plant and equipment variables we found that fair value has significant effect considering (p<0.10). We assume that the reason why these variables did not show significance when (p<0.05) is due to the financial crises happened in 2008.

We found that the positive and negative effects of the expected and actual results match in 4 variables (Property, plant and equipment, Net income, Return on equity
and Depreciation and amortization) and mismatch in the Intangible assets variable. According to that we can be consistent that fair value provides useful information in the financial statements when the expected and actual results match. In our case fair value provides useful information about the Property, plant and equipment, Net income, Return on equity and Depreciation and amortization variables.

We found that fair value has non-significant and negative effect on intangible assets. We still believe that the reason behind the non-significance and negative effect showed in Table 6 is due to inconsistencies in the data as the intangible assets were not recognized and were mentioned as zero values in some of the companies’ financial statements, in addition to the well management prediction of the intangible assets. Again this would have been affected by the financial crises.

To sum up, we can be consistent that fair value provides useful information in the financial statements.
References


