

**FAIR VALUE ACCOUNTING AND FINANCIAL STATEMENT QUALITY**

**The Impact of Fair Value Accounting on Financial Statement Quality in the Banking  
Sector-Evidence from UK “Big Four” Banks**

**OlanikeOlawale-Sanni**

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## ABSTRACT

This study is inclined towards finding the impact of fair value accounting on financial statement quality in the banking sector of UK..The research questions to be addressed in this study will include: Is there a strong relationship between fair value accounting and quality of financial statements? What are the overall benefits of preparing fair value based financial statements in the UK banking sector? In order to achieve research objectives, inductive approach has been used for identifying the components and conducting the analysis of the problem, whereas descriptive approach has been used for the literature review of fair value accounting. Researcher conducted interviews of 20 major investors of top four banks of UK in order to arrive at the conclusion. The most important conclusions that have been reached includes that fair value accounting provides useful and relevant information to financial statements' users and assists them in decision making. A strong relationship exists between fair value and accounting information's appropriateness in decision making. Furthermore, a relationship exists between reliability of information and fair value.

**Key words:** Fair value; accounting information; financial statement; reliability;

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## CHAPTER 1: INTRODUCTION

### 1.1. Overview

IASB encourages firms to adopt fair value accounting (FVA) as opposed to historical cost approach because the former provides more useful information for investment decisions. According to the IASB, fair value can be defined as an accounting approach that presents assets and liabilities of a firm at the value which the company can achieve in an arm's length transaction at year-end (Griffin, 2014). FVA shows the state of the firm and the stewardship of management by valuing assets and liabilities at their current market price. IASB claims that FVA provides more relevant information about assets and liabilities as compared to historic cost-based approach (Blankespoor et al., 2013).

FVA also makes balance sheet as the primary source of useful information for users as compared to income statement. This is because Income statement using FVA shows the economic income of the company and shows changes in the value of company over time. This economic value reflects the future value of the company. In contrast, balance sheet under FVA serves as basis to estimate values of the assets and liabilities in future while income statement fails to provide this estimation (Goh et al., 2015). This is because changes in revenues and expenses are affected by the gains and losses out of assets and liabilities. This research work therefore sets to study the impact of FVA on financial statements and focuses on banking industry in the UK, particularly the big four banks in the UK. The purpose is to understand the impact of FVA on quality of information provided in the financial statements.

## ***1.2. Contextual Background***

The fair value accounting or fair value accounting is a way of measuring the assets of an entity, mainly used in the valuation of financial assets and liabilities, and is still very controversial in recent decades. This controversy occurs practically since the 80s, a decade that the gradual adoption of fair value by issuers FASB and IASB standards begins (Pratt, 2013). The endpoint of the fair value has given rise to numerous debates, both in the academic field, and normative and professional, as it carries important implications for the annual accounts of certain entities, in addition to the innumerable conflicts of interest and opinions that the application of this approach implies among experts. The impact of the application grows enormously in the case of a particular sector, the financial sector, as financial instruments are the main component of their heritage (Ball, LiandShivakumar, 2013).

In addition, turbulence throughout financial markets resulting from the economic crisis which started in mid-2007 stoked again a debate among academics. Losses in connection with the valuation at market prices of assets such as those associated with mortgages, increased uncertainty about the value of structured credit products, decreased market liquidity, and the absence of prices of some complex structured financial products have relocated this endpoint into question (Pratt, 2013).

Many critics of fair value accounting argue that this criterion has exacerbated the severity of this latest financial crisis. So much so that, in May 2011, numerous opinions against the use of fair value forced the FASB to soften its stance towards the adoption of fair value, allowing entities to use the measurement at fair value or historical cost, depending on the characteristics of each financial instrument and the business strategy followed, which remain under the historical cost basis for most loans and financial liabilities (Goh et al., 2015).

Griffin (2014) argued that international accounting standards board (IASB) is encouraging businesses to adopt the concept of fair value accounting and abolish the accounting practices of stewardship historical cost. The concept of Fair Value is an objection on the adoption of International Financial Reporting Standards (IFRSs). The author argued that the purpose of accounting system is to generate relevant information for financial statement users to make rational decisions. Since the needs of different users are different, therefore, accounting system fails to provide desirable information for all users and respective decisions. Therefore according to Ball, Li and Shivakumar (2013), there is a need to develop standards that can provide effective information for all types of users to facilitate them in rational decision making. The concept of Fair value reflects the true economic reality of firms so that it can enhance efficiency of invested capital, management efficiency, harmonization of financial statements, and justification of distribution of income.

The aim of this paper is to study the impact of fair value in the UK banking sector, focusing on the big four banks, based on the theoretical framework for the discussion of fair value in the banking sector. Moreover, the framework of the fair value in the banking sector has made a new classification of viewed items, depending on the two main topics of dealing: the usefulness of fair value information measured from the relevance and reliability perspectives, and analysis of the various effects or consequences resulting from the use of fair value. Therefore, this study aims to determine what has been the impact of fair value in the UK banking sector, to determine whether its use has exacerbated the severity of the financial crisis or, on the contrary, has no significant role in it.

### **1.3. Company Profile**

This study focuses on big four banks in the UK, namely Barclays, HSBC, Lloyds, and Royal Bank of Scotland. This section presents a brief profile of four biggest UK banks by total assets. All four banks are headquartered in the UK and are operating on a global scale. HSBC, for instance, is one of the largest banks in the UK, based on total assets. It claims over 47 million customers and operate using a network of approximately 6,000 offices in around 71 countries. Barclays is the 2<sup>nd</sup> largest bank in the UK with its headquarter in London. It serves banking customers across Europe, Africa, USA, and Asia. Barclays operates in 40 countries and has around 130,000 employees. Following table shows big four banks in the UK based on asset size as of December 31, 2014:

<b>Banks</b>	<b>Total Assets in Billions</b>
HSBC Holdings	\$2,634.14
Barclays PLC	\$2,114.13
Royal Bank of Scotland Group	\$1,635.93
Lloyds Banking Group	\$1,333.99

#### **1.4. Problem Statement**

The usage of the fair value accounting as a measurement attribute for accounting standards had increased considerably in recent time. There has also been an evolution of financial markets and the development of complex financial instruments has even occurred with the passage of time. The decline of cost and transaction based model along with the rise of market-value (fair value) based model of financial reporting certainly has several implications for the role and properties of balance sheet measurement and income accounting as well. This

shift in measurement paradigms has occurred due to the presumed belief relating to higher quality and decision relevance associated with market-based measures as opposed to cost based measures (Knott et al, 2014, p. 31).

In addition, the global financial crisis that occurred in 2008 has created a major debate relating to fair value accounting among several accounting and banking regulators, researchers and many other people. Critics have basically faulted fair value accounting concept to amplify the crisis and has linked this to the major cause of the financial collapse. It has assisted in establishing a circle of falling prices and thereby increasing the overall risk associated with the financial system. Fair value income is recognized as volatile, unreliable and often has being a subject of managerial discretion especially when markets are illiquid or distressed (Bratten, 2012, p. 32). On the other hand, there are proponents of the fair value method who have basically argued that prices would provide the most relevant and timely measures of both assets and liabilities.

The purpose of this study is to analyse the impact of fair value accounting on the quality of the financial statements. To achieve this purpose the research will be focused towards the assessment of the financial statements of the “big four” UK banks (Barclays, HSBC, Lloyds and Royal Bank of Scotland).

### **1.5. Aim and Objectives**

The aim of this research is to analyse the impact of fair value accounting on the quality of the financial statements. The problem in relation to the adoption of FVA on performance reports of the UK “big four” banks will be assessed. This aim is pursued through the following objectives:

- To determine the impact of fair value accounting on financial statement quality in the big four banks of the UK.
- To evaluate the role of FVA in the recent financial crisis in the banking sector.
- To assess how FVA can be implemented and how it can improve financial reporting in banks.

### **1.6. Research Questions**

The research questions to be addressed in this study will include:

- Is there a strong relationship between fair value accounting and quality of financial statements?
- What are the overall benefits of preparing fair value based financial statements in the UK banking sector.

### **1.7. Rationale and Significance**

There is only limited literature focusing on the impact of fair value accounting on financial statements of banking sector in the UK. So far, the review of literature indicates that there is no study that uses qualitative methods to study the relationship. Thus, this study is motivated to conduct a qualitative inquiry and aims to add to existing literature. Furthermore, this study focuses on big four banks in the UK to show the impact of fair value accounting. This study has significant implications because existing standards of accounting for financial institutions have gained considerable attention and involve hot controversy around the set of accounting standards used in the banking sector.

The main concerns are related to financial instruments based on the observation that current markets are categorised by financial instruments and related financial risks. Accounting standards used in banking sector has significant impact on quality of financial statements as well as operations of banks. Thus, it is imperative that banking industry needs to reach to an agreement with the accounting standard-setters as soon as possible so that inconsistency and ambiguity related to financial statements can be resolved and investors can undertake investing decisions more effectively.

### 1.8. *Structure of Dissertation*

This study follows following structure

Chapter 1	Introduces the basic concepts and phenomenon under consideration and a background of this study.
Chapter two	results and findings of the secondary research
Chapter three	discussion of research methodology
Chapter four	Primary research results and discussion
Chapter five	Conclusions, recommendations, and limitations

## CHAPTER 2: LITERATURE REVIEW

### 2.1. *Historical Cost Approach*

According to (Ball, Li, and Shivakumar, 2013), prior to the 80s of the last century, and as a result of ingrained conservatism in accounting practice, the approach followed in the accounts of any entity was the historical cost approach. According to the method of historical cost valuation, all the assets belonging to the entity in the balance sheet of the company are recorded at historical cost or price of purchase (Ball, Li, and Shivakumar, 2013). As the name suggests, in this approach, the income statement was the main tool of analysis, reflecting the revenue made and expenses incurred during the period in connection with the holding of the assets and liabilities of an entity. It was the main vehicle to provide information to shareholders because it showed how company executives have been able to manage the operations to make profit, i.e. the difference between the value of the inputs provided and the value of the outputs (Shalev, Zhang and Zhang, 2013).

From the 80s, following the criticisms on historical cost (for example Kothari and Lester, (2012) argued that historical cost approach does not reflect true and current value of an asset and thus compromises reliability and validity of financial information presented in the annual statements), accounting experts started thinking about a new approach, the approach of balance that was characterised by disconnection with reality, possibility of recognition of results in subsequent periods, inadequate to the complex market environment, and disability in the representation of new financial instruments such as derivatives and structured investments (Christensen and Nikolaev, 2013). It sidesteps the traditional prevailing conservatism which seemed to have caused a downward bias regarding asset valuations. It increases the importance

of balance as a state that meets the objective to make a good assessment of the company, as the book value of its assets and liabilities will approximate the market value. In response to this new thinking started the gradual adoption of fair value as the new accounting standard (Hull and White, 2014).

## 2.2. *Fair Value Accounting Approach*

In its pure form, accounting at fair value or fair value accounting (FVA) values the assets and liabilities under this criterion in the balance sheet and changes in fair value recognized as gains or losses in the income statement. When the fair value is determined by market prices, it is known as accounting at market prices or mark-to-market accounting (MTM) (Müller, Riedl and Sellhorn, 2015). The definition of fair value is found both in the international regulatory body (IFRS 13, which came into force on January 1, 2013) and American standard (SFAS 157). Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in a current transaction between market participants at the measurement date (IFRS 13, SFAS 157) (Kothari and Lester, 2012). In both cases, to increase consistency and comparability in fair value measurements of the assets, leaving aside the existing prior interpretability introduced a hierarchical model of evaluation divided into three levels, depending on the availability of market prices. Where there are prices in active markets for identical assets or liabilities to which it is intended to assess, these should be used and considered inputs from level 1. If they do not exist, they should be used as inputs for second and third level, meeting at the level 2, the prices of similar but not identical items listed in active markets, as well as assets identical but listed on inactive markets and, at level 3, the inputs are unobservable liabilities, estimated from valuation models created by the entities themselves (Bischof, Brüggemann and Daske, 2014).

The fair value is used most often for financial assets and liabilities than for other balance sheet items. Even for these, the normative defined mixed models where the fair value and historical cost interact, and where there are rules that stipulate which items should be reported at fair value and which at historical cost value (Blankespoor et al., 2013). In addition, the unrealized gains and losses that result from valuation of items may or may not affect the outcome of the exercise, depending on their classification, also determined by regulatory bodies (Healy and Palepu, 2012).

### **2.3. *Statement of Financial Accounting Standards (FAS 157)***

According to FAS 157, fair value is the price that will be received by selling an asset or paid in the purchase of an asset in a transaction between participants of market at measurement date. This cancels the old practice of using transaction price for asset or liability as initial fair value. This is to say that fair value no longer provide the basis for what we pay for something; instead, it will be based on what we can sell it for. This definition stresses that fair value is based on market prices and not entity specific and this valuation will be determined by a skeptical buyer rather than optimistic buyer. The amount of data available for this purpose, i.e. to measure fair value, will define how the valuation of any asset or liability can be determined.

Common techniques for valuation which are identified by FAS 157 are income/cost approach and the market approach. These models need input reflecting the assumptions which market participants would use for the pricing or valuation of an asset or a liability. Market data obtained would provide observable inputs, for instance stock exchange prices. If an active market for asset or liability is not available, the entity's own assumptions are reflected by

unobservable inputs. The standard (FAS 157) provides a hierarchy of fair value in which quoted prices in active markets is on the highest priority and unobservable inputs as lowest (Sinnett , 2007).

#### **2.4. Mark to Market**

Mark-to-market accounting discusses the standards of assigning the position to a financial instrument based on fair market price which is prevailing currently, rather than its book value or original cost for similar instruments. Since early 1990s, fair value has been a part of U.S GAAP. Investors require and inquire about the use of fair value when there is the need to estimate value of liabilities and assets. Mark-to-market is a measure of fair value of account that changes over time. For example, instruments traded on future exchange are marked to market on daily basis (Mertzger, 2010). Two steps are followed by banks when they go for mark to market. First, the net realizable values of portfolio of securities which are backed by asset are estimated. It involves the discounting of cash flows of such assets. Under fair value accounting a haircut has to be taken on these values that consider the price at which the asset could be sold. The haircut is large when market is not in function. It has its importance because it proposes that decline in value of assets of bank is not necessarily due to decline that has occurred but rather due to the judgment of the market about the resale risk of a purchaser.

#### **2.5. Academic Debate**

To mark the displacement of the regulations to the fair value, there is a controversial and polemical debate about it. In addition, the financial sector and specifically the banking is in the crosshairs as are the financial instruments measured at fair value, as well as the main component

of the balance sheet of the bank (Haller and Wehrfritz, 2013). The controversy surrounding this criterion arises for various reasons, such as confusion in policy developments, problems in the implementation of the rules, caution in valuing assets at market prices (especially in times of crisis), and the complexity of finding a solution or remedy to make use of it, as the historical cost also has its benefits and limitations (Ryan, 2012).

In the view of the advocates of fair value concept, there are many advantages that protect its use, such as transparency of information, obtaining real-time valuation and thus performance improvement, discipline and efficiency in the market. To reflect current market conditions fair value concept evaluate the value and cash flows at the time of the sale of any financial instrument (Beatty and Liao, 2014). It improves resource allocation by early recognition of any impairment of the asset and the fair value is sometimes the only tool to get relevant and reliable valuation of financial instruments and derivative products. Ultimately, being a measure based on market prices, it is not biased by private entities and provides it with consistency over time (Ellul et al., 2015).

As counterarguments against fair value, various criticisms are reported in the literature, such as excessive and artificial volatility generated both in the results of financial institutions and in their net worth. This brings greater regulatory risk, changes in liquidity management of institutions and an excessively short-sighted approach to decision-making as a result mainly of the association between accounting earnings and the variable remuneration of directors of credit institutions (Merrill et al., 2012). In addition, it explained that this criterion leads to greater cyclical sensitivity of regulatory capital, which magnifies the procyclical behaviour of entities and contributes to the problem of procyclicality in any financial system (Goh et al., 2015).

Other authors contributed to the debate by comparing a model of fair value exclusively against a mixed model valuation in which financial assets and liabilities are valued using different methods, depending on the type, purpose of business, their operating strategy, or accounting standards adopted by managers of the entity (Huizinga and Laeven, 2012). Main advantage of the fair value model is seen as , reducing possible manipulation of results in the absence of a choice between valuation methods and the decrease in the complexity of financial reporting by the disappearance of breakdowns valuation of each item predominate. However, those who prefer the mixed model highlight its greater flexibility and increased value-precision (Ramanna, 2013).

The aspect that, in recent years, has generated more debate has been the impact of this criterion in the recent economic and financial crisis. Critics have argued that the criterion for accounting rules, in the US banking, that forced banks to apply the fair value basis exacerbated the recent economic crisis to undermine the capital of the entities. This resulted in a restriction of the main activity of the entities which is the provision of funds to its customers (Cantrell, McInnis and Yust, 2013).

Some other scholars and associations are of the same opinion as they pointed out that the fair value accounting played a substantial role in the economic crisis, which produced the worsening of financial situation. Accounting standards require that financial institutions deteriorate their assets at very low market prices, even when entities have strong credit performance and did not intend to sell the assets at those prices (Cantrell, McInnis and Yust, 2013). This increase in provisions for regulatory capital assets decreased, which forced them to cut prices even more and, consequently, the capacity to provide funds to its customers.

Therefore, this brought a reduction in credit, and thus a negative impact on consumption in the economy (Huizinga and Laeven, 2012).

However, scholars who defended the fair value basis during the crisis argued that the provisions for the fair value of the assets are limited and seemed unlikely to have triggered a procyclical effect on the economy. Furthermore, most bank assets are not valued at fair value and those that are valued by this criterion have little effect on regulatory capital (Ramanna, 2013). The current situation is that the debate seems to focus on determining which valuation approach is universally best for all circumstances and how to make optimum use of assessment criteria. Therefore, when the business strategy is closely linked to market prices, as is the case of the trading portfolio, there is considerable unanimity that fair value is the most appropriate form of measurement. However, when holding financial instruments, there is diversity of opinion on the criteria to be employed (Merrill et al., 2012).

## **2.6. *Usefulness of Fair Value Accounting Information***

The research on the usefulness of fair value in decision making for users of information began in the 90s on the occasion of the publication of rules including disclosure of this value. The utility has been measured qualitatively by the relevance and reliability of accounting information. Studies showed that fair value basis of measurement showed useful information and even greater degree of usefulness the more it resembles market prices with less estimates used (Goh et al., 2015). From the pioneer in this line, Mary Barth, in 1994, to more recent investigations have shown that the disclosure of estimated fair value of the main balance sheet of banks (loans, investments, deposits and liabilities) provides greater explanatory level that is produced by their book value for the price of the shares of the entity (Ellul et al., 2015). There is

therefore a cross and positive relationship between the fair value of the balance sheet and the share price of the bank. Even further, some studies distinguished between disclosure and recognition, showing that recognized valuations in the balance sheet are more significant than disclosed valuations (Beatty and Liao, 2014).

Studies from the perspective of reliability revealed that it is dependent upon the availability of data and market information. Many are based on the study of the influence of directors or managers on fair value estimates or errors contained in the figures at fair value. In their research, Ryan (2012) and Healy and Palepu (2012) confirmed that the error of estimation of fair values on the balance sheet of the bank appears to be less than the error of using historical cost. However, studies on the management of fair value within banks seem to confirm that there is evidence of possible manipulation of results or earnings management. When the fair value is overestimated, there is negative correlation with capital figures, growth in the loan portfolio and liquidity. In addition, they tested positive correlation with credit losses, which could mean that valuations can be manipulated to influence the market value or management results (Haller and Wehrfritz, 2013).

### **2.7. *Effects of the Application of Fair Value***

With regards to research into the effects of fair value in the banking system, the effects on variables like market performance and price volatility are explained. Regarding the behaviour of the market, where it seems to make use of fair value when valuing assets may not be beneficial in case of illiquid markets because instead of reflecting the future cash flows, fair value shows only the amount of cash purchase prices in the market (Blankespoor et al., 2013).

In relation to price volatility, there are studies that suggest that fair value results were more volatile than valuations through historical cost. However, it has also obtained evidence that stock prices of banks showed no increase in volatility, thus the impact of the use of fair value was not relevant to shareholders. Other authors adhered to the idea that market prices during recessions are not relevant indicators in the valuation of certain assets (Bischof, Brüggemann and Daske, 2014). The bank can reflect on its balance sheet that is insolvent when it really is quite capable of dealing with all of its commitments to maturity of its assets. In the recent financial crisis, the impact of volatility appears to have been accentuated in those entities dealing with mortgage assets, which have led to increased uncertainty in the valuation of structured credit products (Christensen and Nikolaev, 2013).

The procyclical effect indicates that, in response to losses on fair value measurement that reduces regulatory capital, banks then started massive sale of their assets to achieve an increase in the capital ratio (Hull and White, 2014). This made pressure on sales prices to decline, resulting in a loss of capital and new sales with new rounds of price decreases. However, other authors noted that there is no clear and systematic evidence of whether banks during the crisis sell their assets in response to impairment thereof or by lower capital ratios (Ball, Li and Shivakumar, 2013).

## **2.8. Critique of Fair Value**

Critics are of the view that fair value method of accounting has created a short-term perceptibility of pension funding and accelerated the departure of defined business schemes. Commonly, critics claimed that financial crisis shows positive correlation of fair values when

accounting and prudential regulatory systems are tightly coupled, and unreliability of marking to model of less liquid asset markets, particularly for assets which are held for long term (Power, 2010). Further, it was also added that impact of FVA (fair value accounting) is more restrictive in lending policies and more demanding in conditions of loans that are required for risk management, along with the pricing that will be higher than is necessary (Allatt, 2001)

Furthermore, several critics remarked in the imaginary and fictional nature of fair value and lamented their potential and subjectivity for bias and manipulation. Irrespective of whether such criticisms have substance or people believe in fictions, they can contribute in constituting markets (Power, 2010). Many people are comfortable with historic cost accounting due to the fact that it is familiar and more stable in predicting future accounting. Earnings based on fair value are predicted in a different way due to uncertain future events and it is considered as a major drawback in preparing budgets and forecasts and in managing expectations of analysts (Hague, 2002). Yet many of the critics of subjectivity of fair value are not able to see the real point. The idea of reliability was reconstructed in front of them through a shift in focus from transaction methods to economic valuation methods (Poon, 2004) and by providing a firmer institutional footing to these methods.

## **2.9. Proponents of Fair Value**

Not many will question about the relevance of information that are based on market prices because the information of historical cost is based on market prices where assets are initially acquired and liabilities are initially incurred. However, fair value system is based on current market prices. Fair value system reflects changes in conditions of market and change in market conditions are reflected by changes in fair value. Information in historical cost method shows the

effects of conditions that were in existence when transaction took place, and price changes are reflected when they are realized. Fair value incorporate information about current situation of market and expectations, superior basis for prediction are expected than out-dated cost figures as out-dated conditions of market and expectations are reflected by out-dated cost figures (Poon, 2004). Supporters of fair value often appeal to notions related to telling things as they are and improving transparency. Areas such as savings, pension accounting, and loans were pointed out by them where problems would arise much earlier in using fair values thus enabling correction.

### **2.10. Hypotheses**

H1: There is a positive role of fair value accounting in financial statement quality

H2: There is a significant role of FVA in the recent financial crisis in the banking sector

## CHAPTER 3: METHODOLOGY

### 3.1. *Introduction*

The present study deals with the various elements of a research methodology and their implementation in the context of the conducted study. It incorporates the appropriate research philosophy and design on the basis of the nature of the study. Moreover, it also encompasses research approaches, type of investigations and sampling type employed in the study. Subsequently, the latter sections of the chapter deals with the sample size, data collection and analysis plan specifically formulated for the conducted research whereas the terminating section discusses the essential ethical limitations, accessibility issues and research constraints associated with the study.

### 3.2. *Research Paradigm*

This study aims to investigate the impact of fair value accounting on financial statement quality in the banking sector. The study makes use of participant interviews conducted from the four big banks in the UK, hence the topic requires significant contribution of the observer's perspectives. Furthermore, interpretivist philosophy is employed in the present study as it is purposed to extract findings and conclusions through participant interviews and financial statements of the selected banks. Furthermore, positivist philosophy was not preferred in the study as it deals with observer's perspective which antagonizes positivism.

### 3.3. *Research Design*

The present study deals with qualitative data which was selected through various interviews conducted from major investors of the selected four big banks in the UK. Moreover, the researcher also made use of financial statements from which the information was qualitatively and quantitatively selected and analyzed.

### 3.4. *Types of Investigation*

The nature of research investigations comprehends the overall study dimension and explains the reader about the purpose of the study. The study can either serve to describe an already existing phenomenon, explain it in more detail or to explore a newer perspective or dimension of a problem. Myers, Well and Lorch (2010, p.124) narrated that there are three main investigation types which include: descriptive, explanatory and exploratory investigations. Exploratory studies deal with the development of hypothesis for a specific research problem when the initial understanding is significantly insufficient. Blessing and Chakrabarti (2009, p.76) declared that it deals with addressing the questions of *where, who and what*. On the other hand, explanatory studies deal with the potential questions of *why and how*. Lastly, the descriptive findings are aimed to narrate a basic outline of the phenomenon as naturally observed (Kumar, 2010).

In the context of the present study, it has been observed that it does not concern the exploration of a newer dimension or area of existing research studies. Moreover, the study deals with the establishment and explanation of relationship between fair value accounting on financial statement quality in the banking sector in the UK and determine the impact of both the variables,

i.e., fair value accounting and financial statement quality on each other. Hence, explanatory investigation approach is preferred in this study.

### 3.5. *Research Approach*

A research approach is one of the necessary elements of a research methodology and enumerates the overall research plan. Strategically, there are two main research approaches: inductive and deductive. According to Hinkin (2005, p.164), deductive approach deals with data collection through theoretical understanding of the research problem and in-depth literature review. The hypothesis is formulated on this basis and is then analyzed and assessed for validity and authenticity. Oppositely, inductive approach concerns the exploration of participant perceptions and helps to solve research problems where limited or non-objective data is available to the researcher about the research problem (Hinkin, 2005, p.165). These studies are then terminated by the formulation of a tentative hypothesis on the basis of the non-objective data collected and behavioural studies.

The research approaches have been variably annotated and a multitude of explanations have been provided by various authors from time to time. In another instance, Bhattacharjee (2012) aimed to explain the difference between both these approaches and narrated that on the basis of nature and scheme of progression, deductive approach can also be termed as theory testing approach whereas inductive approach can be comprehended as theory building research. In the present study, subjective data has been collected from 20 main investors of four major banks in the UK which was then analyzed and then research findings were concluded. Hence, the study follows inductive approach.

### **3.6. *Sampling Method, Technique and Size***

Sampling in academic research can be considered as a means to collect data from the research participants. Sampling can be classified into probability and non-probability sampling wherein probability sampling depicts equal chances of selection of individual samples within the sample frame (Gray, 2014). On the other hand, non-probability sampling declares that there is an ambiguity in determining the probability of selection of samples within a population of unequal distribution. The present study employs non-probability sampling as the probability of selection of investors of four major banks of England cannot be precisely determined. Moreover, on the basis of accessibility and easy availability of information, the researcher has utilized convenience sampling technique and a sample size of 20 investors was fixed.

### **3.7. *Data Collection Methods***

Data collection methods can primarily be distributed into primary and secondary data (Battaglia, 2010). Primary data can be regarded as the selection and collection of original data by the researcher. This data can be collected through various participant interviews, survey questionnaires etc. On the other hand, secondary data allows the researcher to make use of previous researches, publications, articles and peer-reviewed journals in order to conduct the study. However, this kind of study does not depict the researcher's original contribution to the field of research (Hair et al., 2015, p.186).

The present study makes use of both the primary and secondary data wherein primary data was collected from interviews from bank investors and secondary data was collected from various publications and financial statements of the banks.

### **3.8. Data Analysis Plan**

The data attained in the present study was analyzed through content analysis techniques where the financial statements, interviews and literature review was integrated and assessed. Moreover, interview results are thematically analysed to extract patterns and meaningful explanations from them based on the views of research participants.

### **3.9. Research Instrument**

The research instrument comprises of unstructured interviews which were conducted from 20 investors of four major banks of England.

### **3.10. Accessibility Issues and Ethical Considerations**

The researcher faced certain issues in accessing the research participants and considerable time and effort were devoted to conduct the required number of interviews. Additionally, much of the secondary sources and financial statements had limited or paid access. The ethical consideration of informed consent, participant confidentiality and anonymity was ensured. Furthermore, the respondents were given a free hand to leave the study as per their will.

### **3.11. Research Limitations**

The basic limitations in the present study include time and cost constraints as well as the influence of external variables and financial factors. Moreover, there were only a limited number of respondents on the basis of which the results have been derived. This may haul the generality and validity of the study.

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## CHAPTER 4: DISCUSSION AND ANALYSIS

### *4.1 Introduction*

This chapter presents results of primary research conducted in this study as explained earlier primary research was based on interview analysis. This chapter presents all the results derived from interview questionnaire.

### *4.2 Thematic Analysis*

Thematic analysis is a qualitative method which is used for the identification, analysis and reporting of patterns that exist within data. It organizes and explains a data set in in very rich detail. After conducting thematic analysis on interview transcripts this study identified the following themes:

#### *4.2.1 Difference between fair value accounting and cost-based approach in banking sector*

Three of the participants explained that historical cost or cost based accounting and fair value accounting are 2 approaches that are used to value or record assets and liabilities in the financial statements of banks. The historical approach measures the asset at its original cost; on the other hand, fair value measures or values the asset at its current market value. Another participant stated that fair value has a lot of definitions and it can be defined as the value that a business would procure for an asset in an arm's length transaction on the date on which the financial statements are prepared. The interview respondent further explained that this method of accounting abandons the practice of employing the transaction price for a given asset or liability as its initial value. Thus it can be said that fair value or market value is not based on what is paid

for something; it is rather based on what an asset can be sold for or the value at which a liability can be exchanged or extinguished. Valuation is, in a sense, determined from the point of view of a skeptical buyer, rather than an optimistic one. The different models and techniques that are used in fair value method of accounting need inputs which are reflective of the assumptions that would be used by market participants in order to value an asset or liability. Observable inputs that are used in the fair value method are based on data that is obtained from the market usually by using multiple independent sources, like using price data from the stock exchange. In cases where an active market for the relevant asset or liability does not exist, unobservable inputs are used which are based on the reporting entity's assumptions.

Two of the participants described that in historical accounting assets are stated in the financial statements based on the value that they were purchased. This approach relies on the past transactions of the company and in a sense it is conservative. However, several participants claimed that historical cost is easy to calculate and is reliable. The problem with this kind of accounting is that it may not be relevant. As an example if a company bought a building 30 years ago, the fair or market value of this building could be much more than what is indicated by the statement of financial position.

#### *4.2.2 The impact of FVA on quality of information in financial statements of banking sector*

Two of the participants were of the opinion that fair value is now used more often in financial reporting. It is used for measuring numerous financial instruments at their fair value which has made a significant impact on the financial statements of banks as they invest heavily in different types of financial instruments. Another participant explained that the use of fair value in business

reporting also has an effect on the calculation of impairment losses. If the fair value of a financial instrument declines significantly then it will have to be tested for impairment. On the other hand, if the cost model is used then the instrument will be stated at cost in the balance sheet and the cost of the instrument will not change. Moreover, the recognition of assets and liabilities that are acquired in a business combination is also impacted a great deal if banks opt for the fair value model in valuing their assets and liabilities.

#### *4.2.3 FVA, reliability and relevance of financial information in financial statements*

Two participants explained that today financial markets are very dynamic and quite volatile. Whether it is a buying or selling decision people and investors want to know how much an asset is worth in the present time. The advantage of fair value over cost model is that it is more transparent. It can be said that if banks used this approach to measure all financial instruments, regulators and investors may have attained greater market discipline and could have avoided the losses that they had to bear during economic downturns. Another participant explained that accountants use many methods of accrual and deferral in the preparation of financial statements. Preparers of the financial statements should concentrate on adjusting and incorporating the overall economic value while measuring economic productivity. He emphasized that this meant stating assets and liabilities at their fair value. It is difficult to criticize the theoretical qualities of this method as the relevant measurement characteristic. Those who argue that accounting should be reflective of the true economic substance of the transaction fair value would definitely be the better method.

A participant stated that much of the debate over the fair value method of accounting focuses on the issues of reliability and relevance. He further explained that reliability is usually defined as the quality of information which makes sure that the information is free from mistakes and bias of the preparer and faithfully represents what it claims to represent. Moreover, fair value is an estimation of the exit value under prevailing market conditions. In cases where a liquid market does not exist, it would involve predicting future cash flows and use of a suitable discount rate. These estimates usually rely on the assumptions of management and measurement error. However, the participant added that the use of assumptions has the potential to conceal intentional manipulation and miscalculation of the numbers.

Three participants explained that fair value method and its relevance and reliability is usually defended by leveling criticism at the historic cost model. They further mentioned that it has to be kept in mind that the supporters of fair value place a greater emphasis on relevance, on the other hand, the supporters of historical cost approach place more emphasis on reliability. These participants stressed that reliability is equally important as relevance and its importance cannot be understated. This is because if a relevant piece of information is not reliable then it is meaningless to an investor or any other decision maker. As a result reliability should be given an equal standing.

One participant claimed that achieving fair value is hampered when it comes to public companies as their disclosures require disclosure of numerous valuation assumptions. Another argument against this method is that the measurement of market movements on a frequent basis introduces a great deal of volatility in the bank's financial statements.

#### *4.2.4 The benefits of FVA in valuating assets and liabilities*

There are several benefits of using fair value accounting. A main benefit of this method of valuation is that it gives an accurate value for assets and liabilities on an ongoing basis. This is very helpful and important to users of financial statements. When the value of an asset is expected to increase the bank marks up the value of that asset to the price that is prevailing in the market at the relevant time. This reflects the amount that the bank will receive if it were to sell the asset. This method of accounting also restricts the bank's ability to manipulate its net income figure. There are times when management deliberately engages in certain sales transactions in order to use the gain or loss on that transaction to either increase or decrease its reported earnings. Fair value approach restricts this manipulation and gains or losses that arise from any price change are reflected in the period in which they occur.

#### *4.2.5 The limitations of FVA in valuating assets and liabilities*

There are many limitations of fair value method of accounting. First of all it has the potential of creating large swings and variations in the value of assets and liabilities. This can happen multiple times in a year. There are many different type of business organizations that do not benefit from this method of accounting at all. These companies usually have investments in assets that fluctuate by a huge amount and these fluctuations occur many times in a year. Volatile assets trigger changes in a company's income that are not accurate in the context of the long term financial setting. If one bank is witnessing a reduction in income due to the fluctuation in the fair value of the assets then this triggers a domino effect which permeates throughout an industry. Downwards valuations of assets are contagious in nature and can lead to unnecessary selling.

#### *4.2.6 The role of FVA in last financial crisis of banking sector*

Fair values play a moderate role in the income statements of banks, except for those banks that had very large trading positions. In the case of these banks, investors were worried with respect to the exposure in the subprime mortgages and they made their own decisions and judgments related to these decisions. This was the case in the absence of disclosures that are relevant to fair value. Empirical evidence suggests that during the crisis investors were of the view that banks used their discretion to substantially overstate their asset's values. As a result the lack of and concerns about transparency created a bigger problem than the contagion effects from the implementation of fair value method of accounting.

#### *4.2.7 FVA and decision making process of banking investors*

The participants were of the view that adopting the fair value approach to accounting in preparing bank's financial statements enhances their relevance, transparency and reliability. They contended that this method of accounting gives a more accurate picture of a bank's assets and liabilities and therefore, gives a more accurate reflection of the banks resources. As a result decisions made on financial statements prepared using fair value model are likely to be more accurate as opposed to decisions that are taken on the basis of financial statements that are prepared on the cost basis of accounting.

### **4.3 Quantitative Analysis**

#### **4.3.1 People who determine fair values have sufficient experience**

Out of the 20 people who were interviewed 11 strongly believe or agree that people who determine fair values have sufficient experience and expertise. These 11 people represent fifty

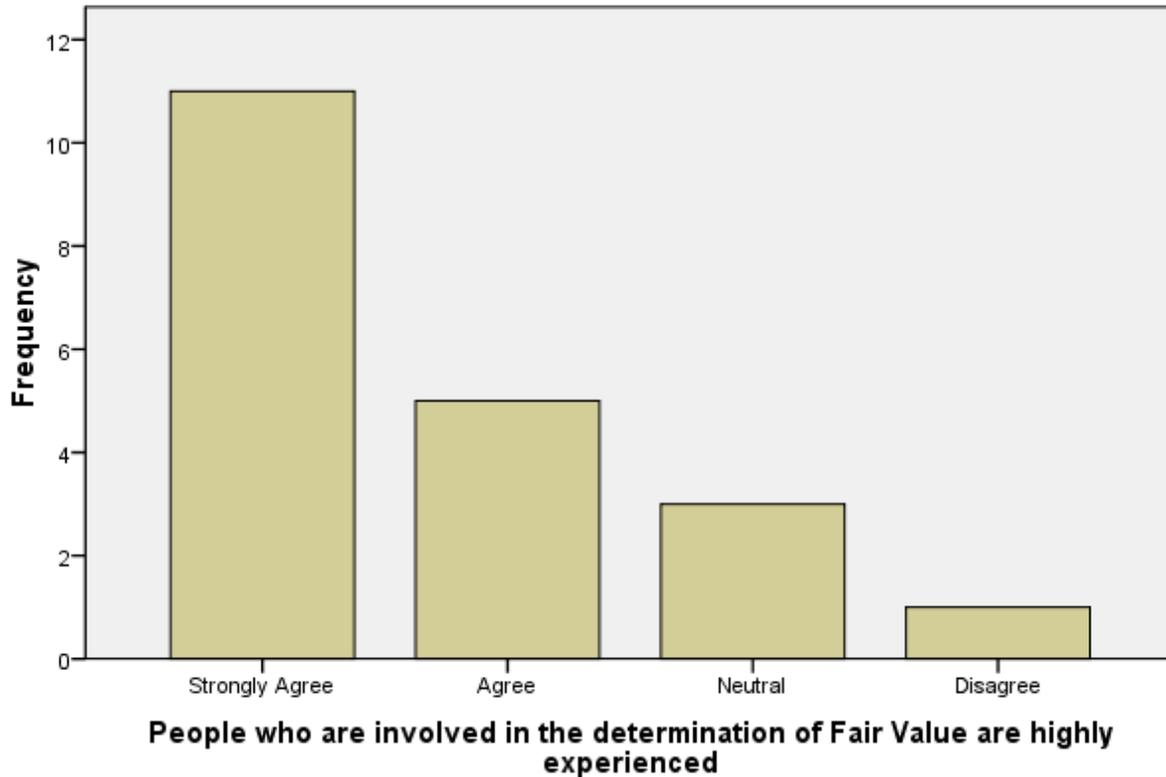
five percent of the population. Moreover 5 people agreed with this position and they represent twenty five percent of the population. So in total eighty percent of the participants strongly agree or agree with this contention. The number of participants who were neutral in this regard were 3 and only 1 participant disagreed with this position. The results are summarized in the table and chart below:

**People who are involved in the determination of Fair Value are highly experienced**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Strongly Agree	11	55.0	55.0	55.0
Agree	5	25.0	25.0	80.0
Neutral	3	15.0	15.0	95.0
Disagree	1	5.0	5.0	100.0
Total	20	100.0	100.0	

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**People who are involved in the determination of Fair Value are highly experienced**



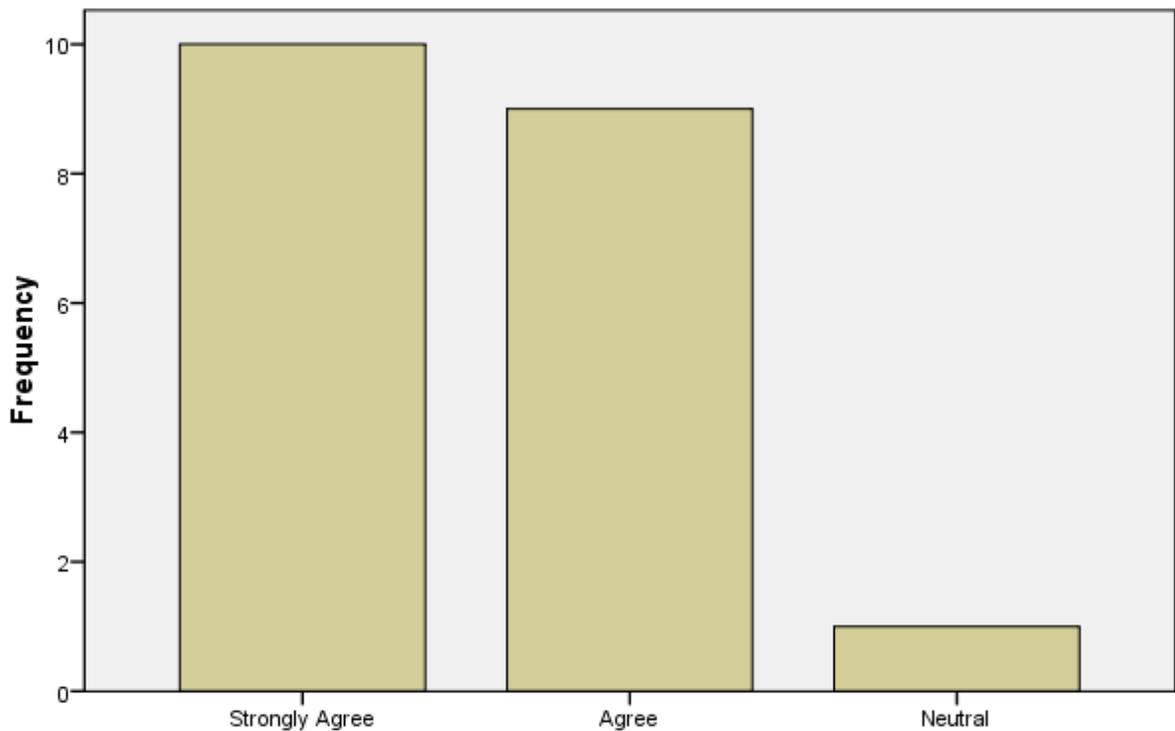
#### 4.3.2 Use of advanced methods for fair value determination

On the question of whether companies should use advanced methods for the calculation or determination of fair value, the results were quite one sided and half the participants strongly agreed with this contention. In addition 9 participants which represent forty percent of the population agreed with this position. So in total ninety five percent of the participants strongly agree or agree with this contention. This is an overwhelming percentage. This left us with only 1 participant who was neutral in this regard. As a result, none of the participant disagreed with this stance of companies using advanced methods for determining fair values. The results are summarized in the table and chart below:

**Advanced methods of determining fair value should be used by companies**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Strongly Agree	10	50.0	50.0	50.0
Agree	9	45.0	45.0	95.0
Neutral	1	5.0	5.0	100.0
Total	20	100.0	100.0	

**Advanced methods of determining fair value should be used by companies**



**Advanced methods of determining fair value should be used by companies**

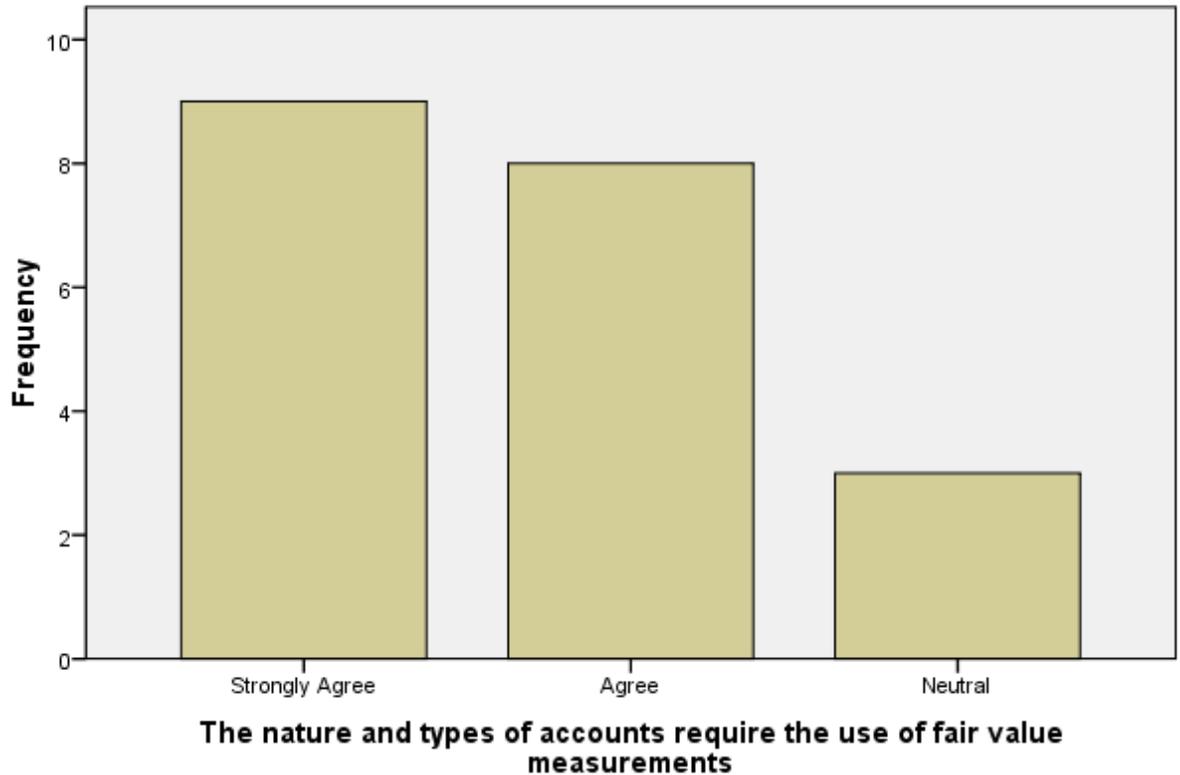
**4.3.3 Nature of account requires fair value determination**

Out of the 20 people who were interviewed 9 strongly believe or agree that the nature and type of account requires companies to use fair value measurements. These 9 people represent forty five percent of the population. Moreover 8 people agreed with this position and they represent forty percent of the population. So in total eighty five percent of the participants strongly agree or agree with this contention. The number of participants who were neutral in this regard were 3 and no one disagreed with this proposition. The results are summarized in the table and chart below:

**The nature and types of accounts require the use of fair value measurements**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Agree	9	45.0	45.0	45.0
	Agree	8	40.0	40.0	85.0
	Neutral	3	15.0	15.0	100.0
	Total	20	100.0	100.0	

### The nature and types of accounts require the use of fair value measurements



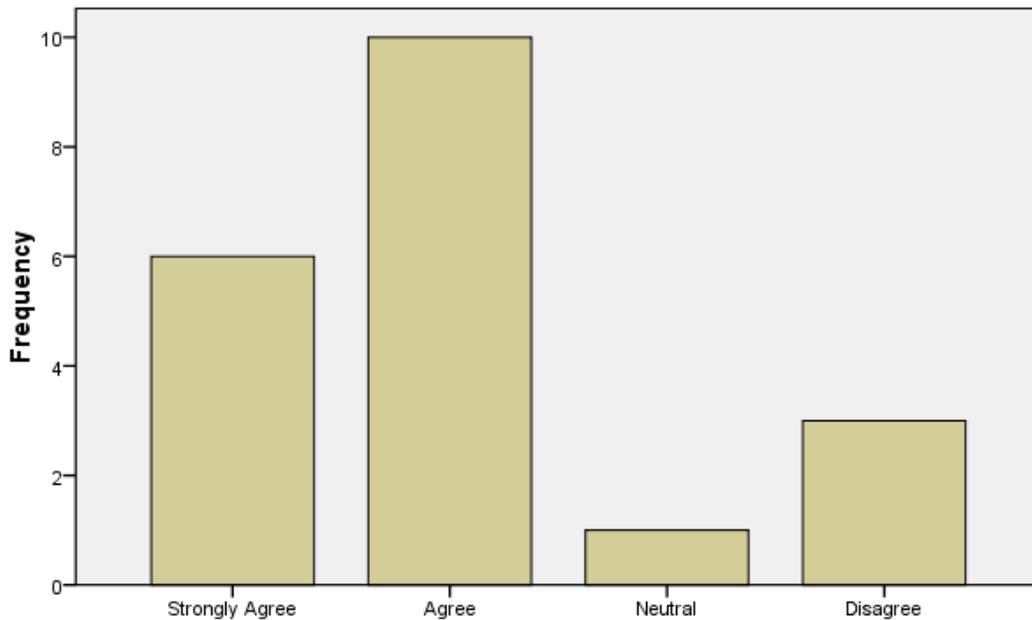
#### 4.3.4 Fair value and high value prediction

With regards to financial statements prepared on the basis of fair value providing information which is characterized by high value prediction 6 participants representing thirty percent of the population strongly agreed with this view. The largest percentage of people that is 9 participants out of 20 agreed with this view. There was only 1 neutral participant in this case and 3 participants who made up fifteen percent of the population expressed disagreement with this view. The results are summarized in the table and chart below:

**Financial statements based on a fair value basis; provide information, characterized by high value prediction**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Strongly Agree	6	30.0	30.0	30.0
Agree	10	50.0	50.0	80.0
Neutral	1	5.0	5.0	85.0
Disagree	3	15.0	15.0	100.0
Total	20	100.0	100.0	

**Financial statements based on a fair value basis; provide information, characterized by high value prediction**



**Financial statements based on a fair value basis; provide information, characterized by high value prediction**

**4.3.5 Fair value and creditors**

On the question of whether financial statements that are prepared on the basis of fair value helps creditors and banks in making credit decisions an overwhelming majority of the

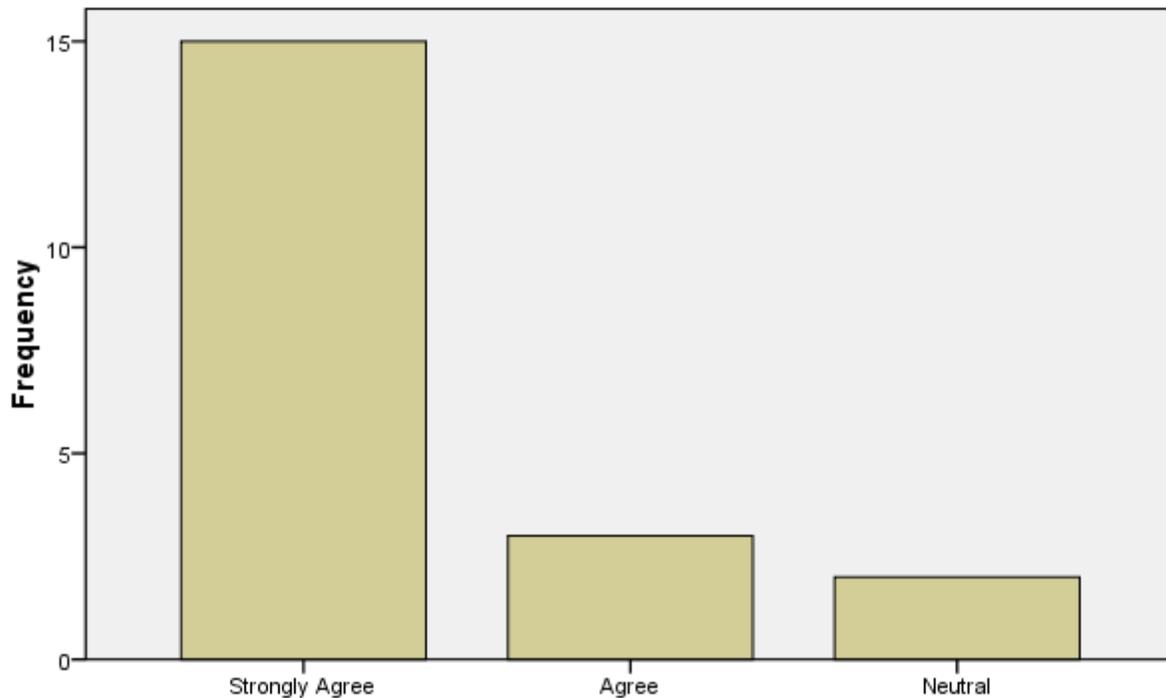
participants that is 15 participants strongly agreed with this notion. These participants represent seventy five percent of the population. In addition out of the remaining 5 participants 3 agreed with this position and as a result this left us with only 2 candidates who were neutral in this regard. So the opinions on this question were one sided with the majority of the participants agreeing with the proposition. The results are summarized in the table and chart below:

**Financial statements that are prepared on a fair value basis, help creditors and banks, in making credit decisions**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Strongly Agree	15	75.0	75.0	75.0
Agree	3	15.0	15.0	90.0
Neutral	2	10.0	10.0	100.0
Total	20	100.0	100.0	

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**Financial statements that are prepared on a fair value basis, help creditors and banks, in making credit decisions**



**Financial statements that are prepared on a fair value basis, help creditors and banks, in making credit decisions**

**4.3.6 Fair value and investors**

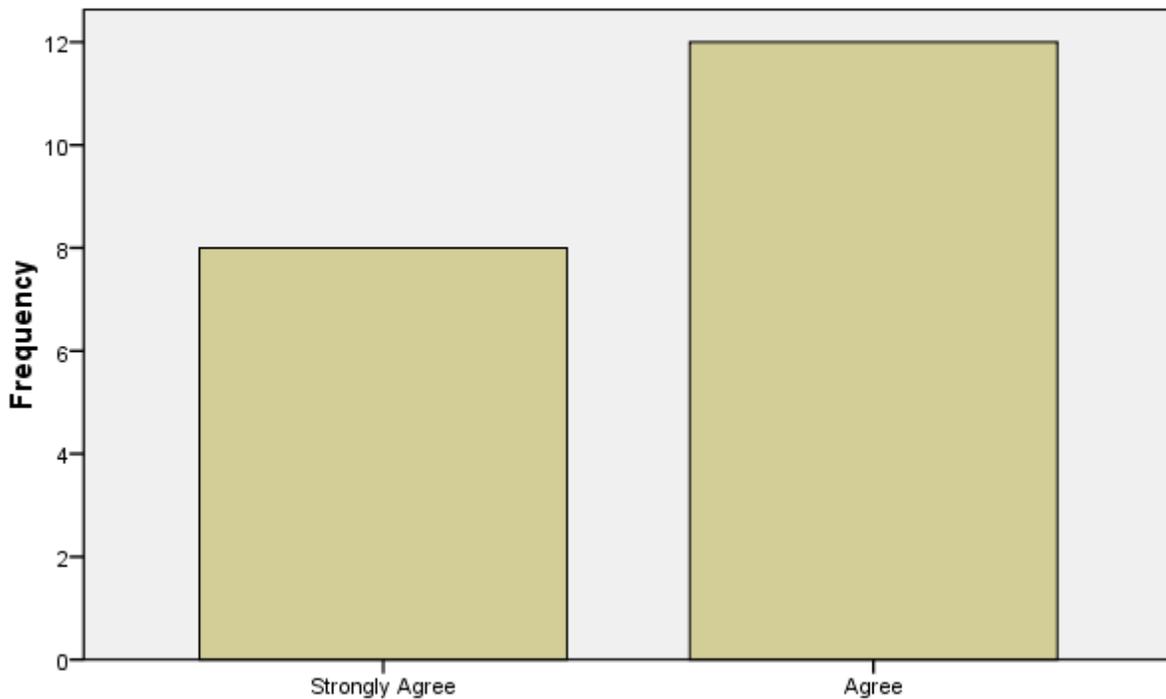
On the question of whether financial statements that are prepared on the basis of fair value help investors in making investment decisions the opinions were again very one sided with majority of participant in favour of the position. 8 participants, representing forty percent of the population strongly agreed with the position. Most of the participants that is 12 agreed with the position leaving no neutral or disagreeing participants. The results are summarized in the table and chart below:

**Financial statements that are prepared on a fair value basis, help investors make investment decisions**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Agree	8	40.0	40.0	40.0
	Agree	12	60.0	60.0	100.0
	Total	20	100.0	100.0	



**Financial statements that are prepared on a fair value basis, help investors make investment decisions**



**Financial statements that are prepared on a fair value basis, help investors make investment decisions**

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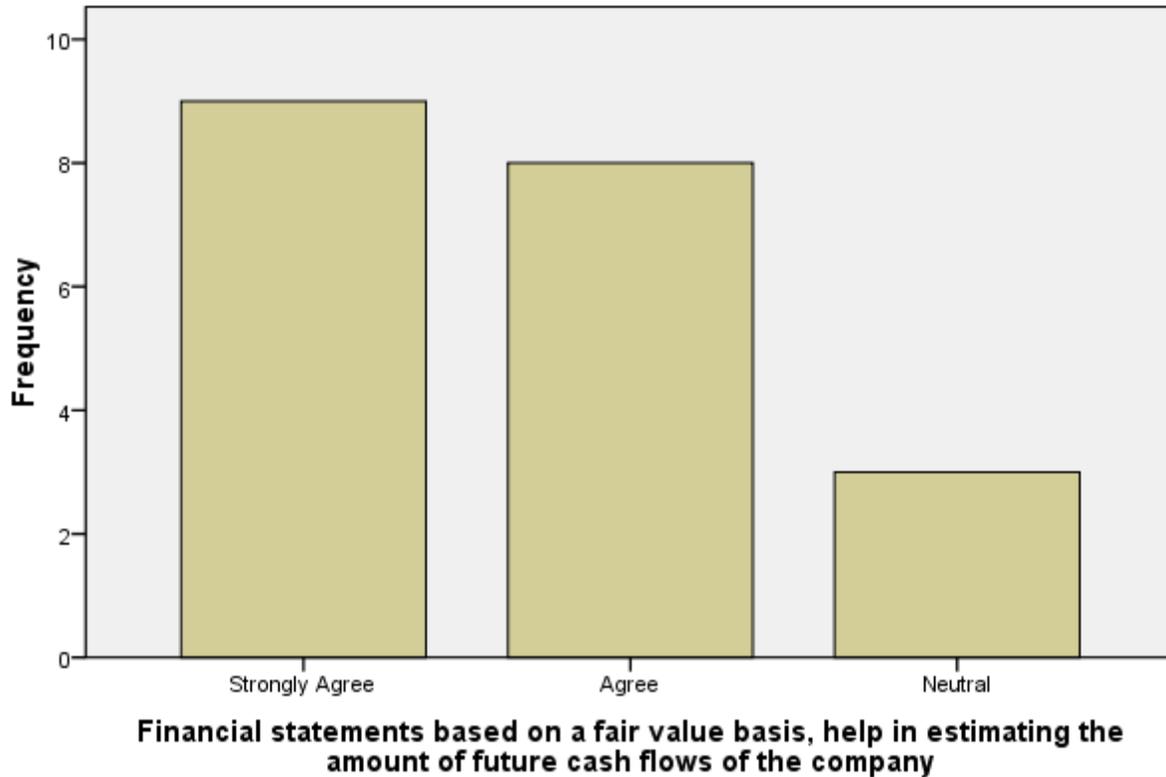
#### 4.3.7 Fair value and future cash flows

With regards to financial statements prepared on the basis of fair value helping in estimating the amount of future cash flows of a company 9 participants representing forty five percent of the population strongly agreed with this view. 8 participants agreed with this view and 3 participants were neutral in this regard. So the opinions on this question were one sided with the majority of the participants agreeing with the proposition. The results are summarized in the table and chart below:

**Financial statements based on a fair value basis, help in estimating the amount of future cash flows of the company**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Strongly Agree	9	45.0	45.0	45.0
Agree	8	40.0	40.0	85.0
Neutral	3	15.0	15.0	100.0
Total	20	100.0	100.0	

**Financial statements based on a fair value basis, help in estimating the amount of future cash flows of the company**



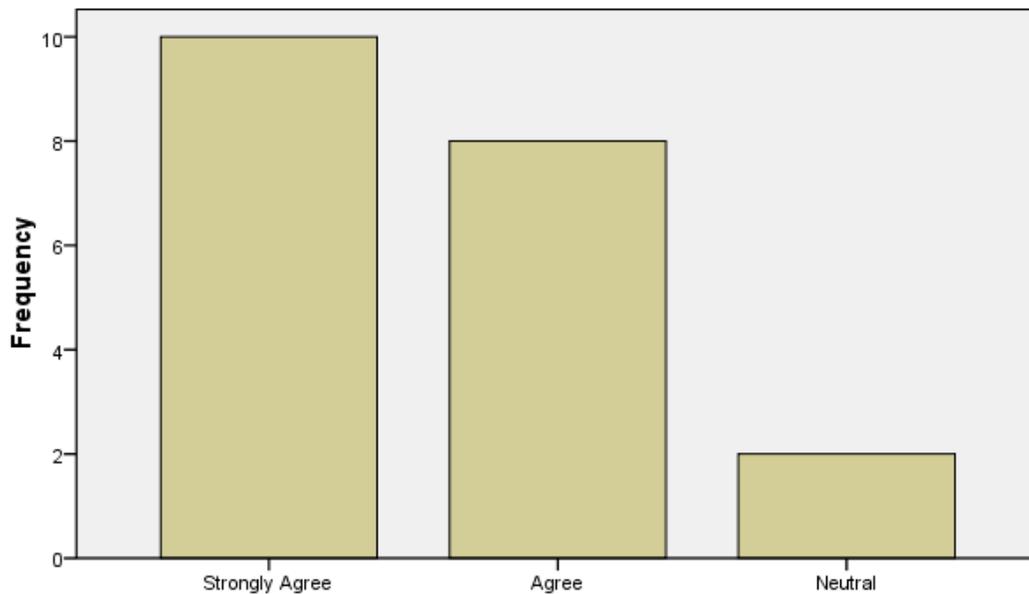
#### 4.3.8 Fair value reflective of latest information

On fair value accounting providing timely information because they are reflective of the latest fair assessment of the income statement and balance sheet the results were again tilted in favour of the position. Half the participants expressed strong agreement with this point of view. Forty percent of the participants agreed with this point of view. Only 2 out of 20 participants were neutral. This again shows that a staggering majority of the participants are in favour of the fair value method of accounting. The results are summarized in the table and chart below:

**A fair value basis, check the feature of timely accounting information because they reflect the latest fair assessment to the terms of the balance sheet and income statement**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Strongly Agree	10	50.0	50.0	50.0
Agree	8	40.0	40.0	90.0
Neutral	2	10.0	10.0	100.0
Total	20	100.0	100.0	

**A fair value basis, check the feature of timely accounting information because they reflect the latest fair assessment to the terms of the balance sheet and income statement**



**A fair value basis, check the feature of timely accounting information because they reflect the latest fair assessment to the terms of the balance sheet and income statement**

**4.3.9 Fair value, decision making and financial analysis**

On the question of whether fair value is more suitable in making decisions and conducting financial analysis, the results were mixed. The participants who expressed strong agreement with this point of view were only 3. However, 9 participants agreed with this position

which represented forty five percent of the population. The neutral participants in this case were quite high with 6 participants accounting for thirty percent of the population. 2 participants disagreed with the position. The results are summarized in the table and chart below:

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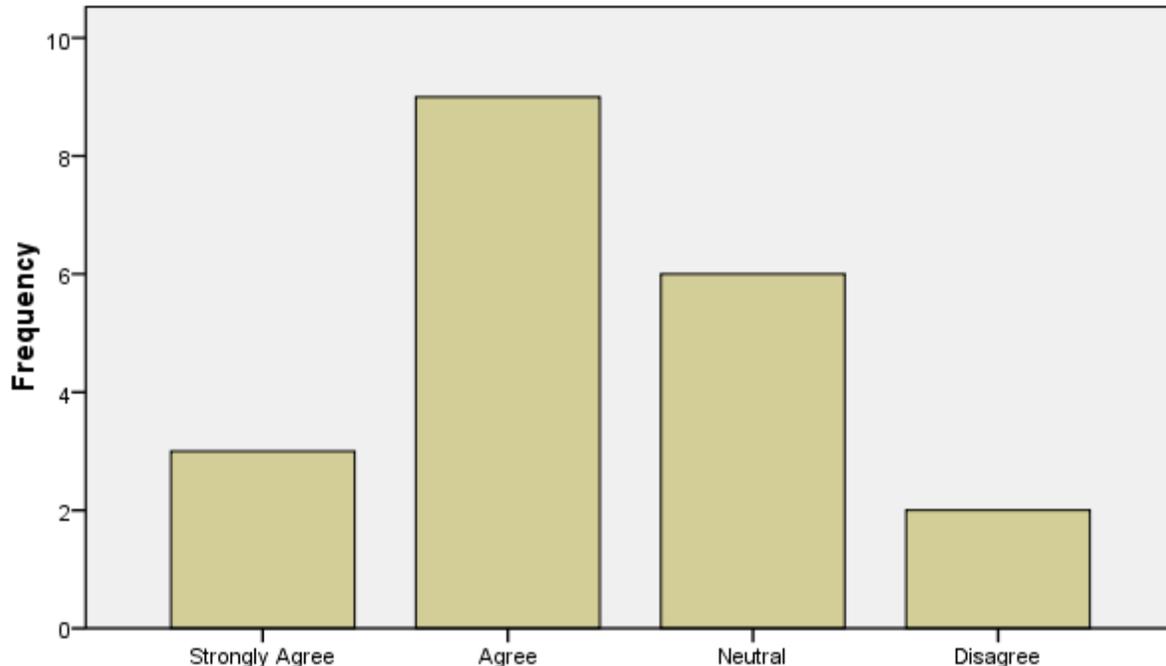
**Standard fair value, is more appropriate to make decisions, and  
 conduct financial analysis and a better basis for the predictions of the  
 results of the business and cash flows**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly	3	15.0	15.0	15.0
	Agree				
	Agree	9	45.0	45.0	60.0
	Neutral	6	30.0	30.0	90.0
	Disagree	2	10.0	10.0	100.0
	Total	20	100.0	100.0	

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**Standard fair value, is more appropriate to make decisions, and conduct financial analysis and a better basis for the predictions of the results of the business and cash flows**

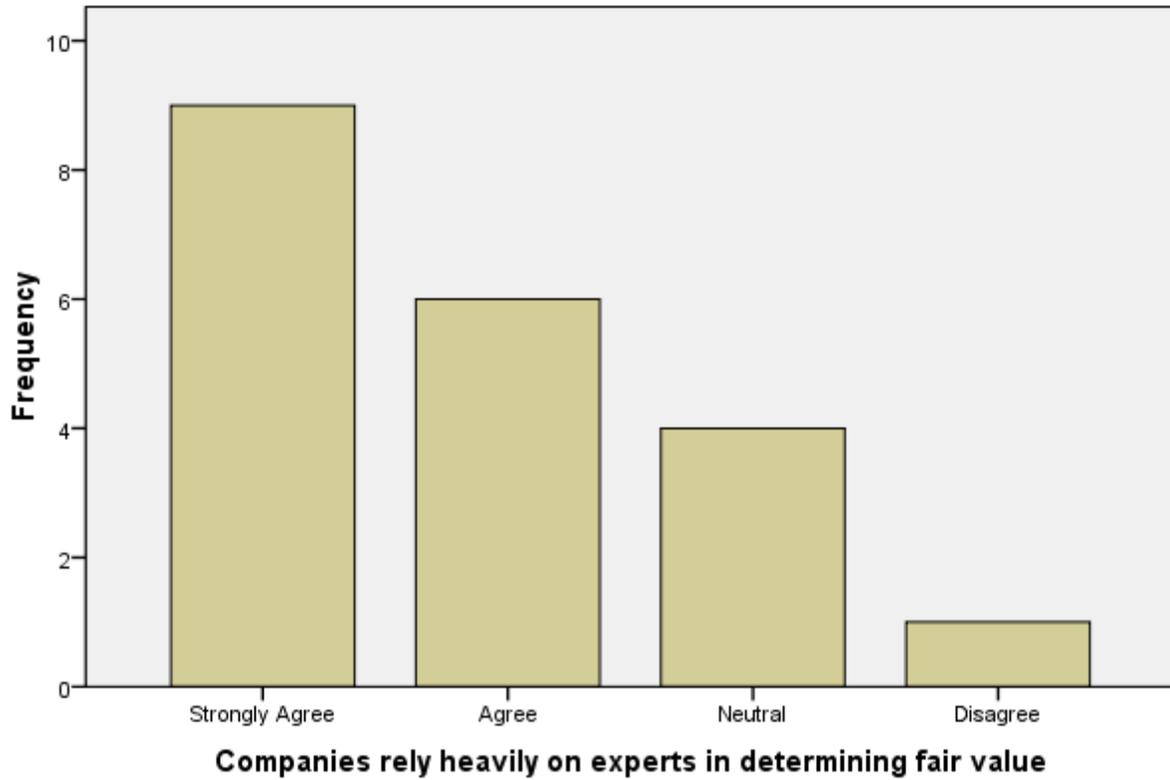


**Standard fair value, is more appropriate to make decisions, and conduct financial analysis and a better basis for the predictions of the results of the business and cash flows**

#### 4.3.10 Reliance on experts

Of the 20 participants 9 strongly agreed with the point of view that company place heavy reliance on experts in the determination of fair value. This represents a very significant percentage of the total population. 6 participants agreed with this view, representing thirty percent of the population. 4 participants were neutral in this case. Only 1 participant disagreed with this notion. The results are summarized in the chart below:

### Companies rely heavily on experts in determining fair value



#### 4.3 Discussion

The first aim of the study was to determine the impact of fair value accounting on financial statement quality in big four banks of the UK. This study showed that by using fair value method of accounting the relevance, transparency and reliability of information in the bank's financial statements is enhanced. The next aim of the study was to evaluate the role of FVA in the recent financial crisis in the banking sector. The study showed that the fair value method of accounting

had a moderate role to play in the financial crisis of 2008, however, it cannot be solely blamed for the meltdown and other factors were equally to blame for the crisis.

#### *4.3.1 Impact of fair value accounting on financial statement quality*

The use of fair value model requires companies to refresh, on a more frequent basis, their policies and procedures related to measurement. Banks are also made to analyze how they would make a determination of fair value in cases where no active market, for the specific asset, exists. They will also have to develop procedures to draft the relevant disclosures. To achieve this valuation experts may have to be engaged. The banks would also need to ensure that appropriate disclosures in the financial statements have been provided that provide information to investors about measurement techniques and also disclose the uncertainty in fair value measurements. Finally the need for updated disclosures may trigger the establishment of new databases and procedures in order to report the relevant information. The implementation of these new requirements would result in information that is more accurate and timely and as a result this improves the quality of information (Blankespoor et al, 2013).

#### *4.3.2 Role of FVA in the recent financial crisis in the banking sector*

According to some fair value method of accounting was the main reason which triggered the melt down of the United States financial system in 2008. For people who are not well versed in accounting and financial jargon fair value accounting involves stating an asset at its fair value or market value. This is the value the asset would yield if it were sold in the open market. The banks revalue an asset to its market value on a quarterly basis. Numerous bankers criticized this approach to accounting when the credit crisis in 2008 caused the asset prices to fall to extremely

low levels. It is argued that fair value approach to accounting pushed a lot of banks and financial institutions toward bankruptcy and in a sense coerced them to sell assets at extremely low prices and this caused the prices to plummet even further (Griffin et al, 2014).

Yet there are proponents to this method of accounting who claim that fair value approach to accounting was not the actual cause of the crisis. It only communicated the impacts of poor decisions which include the provision of subprime loans and issuance of credit default swaps. According to them keeping these assets at their original values is like ignoring reality. Some are of the view that this method of accounting is more needed in today's environment and information related to fair value should be available to users of financial statements. With this perspective in mind if banks did not state their bonds and other assets at their market values, this would cause uncertainty in the minds of investors and they would be very reluctant to help troubled banks and other financial institutions (Ball et al, 2013).

Neither of these 2 camps has the correct answer. He was of the view that no one would like if the banks became insolvent as a result of the drop in the value of mortgage-related assets and securities. On the other hand, no one would like to see banks hide their losses and delay the process of cleaning up of toxic assets. He thinks that in order to meet the requirements of investors and bankers, the relevant regulatory authorities should take on multidimensional approach to accounting.



#### 4.3.2 Suggestions to improve FVA (Fair value accounting)

Fair value approach to accounting should give a hierarchical structure which should give the most priority to prices that are quoted in the active market. This should be defined as “Level

1” in this hierarchical structure. On the other hand, lowest priority should be given to “Level 3” which comprises inputs that are not observable. Fair value method of accounting recognizes the current price of an asset which is prevailing in the market. This type of accounting makes the financial statements more accurate and relevant. However, this can also become a problem if the market prices undergo significant fluctuation. In the 2007 – 2008 financial crisis problems pertaining to fair value accounting were exposed.

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## CHAPTER 5: CONCLUSION AND RECOMMENDATION

### *5.1 Conclusion*

The primary aim of the study was to find out whether a relationship exists between fair value accounting and quality of financial statements. In addition, certain key objectives have been set forth by the researcher that formed the basis of entire study. Hence, the study has been able to discover the impact of fair value accounting on the quality of financial statements of top four banks in UK. Under both US GAAP and IFRS liabilities and assets of companies and banks should be measured at their fair value. The concept of fair value is not same under these two standards but both the standards carry similar framework. The aim of fair value accounting system is to replicate prices prevailing in the market and is based on the condition that whether market inputs are available for valuation or not. This suggests that financial instruments are analyzed and valued using their market prices (if a market is available) or if no market is available, using market of a similar instrument or using valuation techniques that are model-based. All of these inputs help us in determining different levels in the hierarchy of fair value.

The fair value accounting system represents a developing system that has filled the regulatory environment and it has entered into social landscape. With the introduction of complex instruments in use and globalization of capital markets, it became obvious that fair values of liabilities and assets are of more interest to stakeholders than their i.e. (assets and liabilities) historical costs. This whole scenario will become more intense as economies mature and financial markets evolve, economic borders evaporate, and the public require higher level of accountability that results from better confidence and comprehension.

Furthermore, methods of accounting which are currently in use for measuring financial instruments are of concern to standards-setters. These concerns evolve merely from observation that now markets exist for instruments themselves of the risks associated with such instruments, and availability of markets enables the firms to manage these risks and realize the market value of financial instruments.

It has been concluded that various conceptions of reliability of accounting estimate lies under the fair value system as it has transformed in recent times. Subjectivity and objectivity are not very much helpful in determining what is at stake; focus should be on the question that how particular valuation technologies become institutionally accepted (Power, 2010). However, this shift in principles of accounting will not be possible without some extra effort by capital market participants, including auditors, regulators, preparers, and users of financial statements. It is realized that reporting and accounting based on principles of fair value, as compared to principles of historical cost accounting, require more detailed and extensive analysis of assumptions and methods to determine the values that are recognized in financial statements. This will require participants of market to redesign current model of financial reporting and to inform themselves regarding application of these principles. Nevertheless, the transparency of true economic consequences which results from use of financial instruments explains the shift to a model based on fair value (Anonymous, 2002).

Certainly, there are some drawbacks of mark-to-market and especially for the derivatives. Firstly, in the case of lightly traded and complex instruments, fair value that is based on market price is not easy to determine. Such derivatives or instruments are generally measured using mark-to-model process. Secondly, a theoretical issue is also present in the arguments of banks as whether the market price represents fair value or not. Furthermore, market prices relevance can

be challenged with reference to intent. Some observers do challenge market prices relevance because their belief is that the government officials has intentions to hold the derivatives till maturity and do not want to trade them , as is usually happens in the case of derivatives which are used for hedging, then expense and time for the determination of fair value may not be useful. Still, fair value accounting system is proper for reporting of derivatives because it increases the following objectives and qualities of financial reporting and measurement; transparency, inter-period equity, risk management, consistency, and accountability (Metzger, 2010).

Inherently complex to the market, achievement of fair value would still reside in the ability of world to develop its potential. As portrayed by the financial crisis, clarity need to be enhanced and transparency and robustness regarding disclosures should be promoted as the assumptions and methods that are used in fair valuation become critical to sustaining the accuracy of information that is provided to the investors. Accounting standards simplification for these instruments may also prove to be beneficial – to broader public, to investors, to regulators, to analysts, and to the preparers. And this may be accompanied with shifting to a high quality, global, and single global standard to ensure consistent enforcement and application. Furthermore, it is imperative that market behavior is stabilized with a system that is appropriate for the confidence that the markets are seeking to re-establish.

## ***5.2 Recommendations***

Accounting system should be selected on the basis that it can produce relevant information which can be used in making rational decisions. If both historical cost and fair value provide reliable and relevant information to market then two of them should be applied in

financial statements. Many ways has been provided by accounting to present information, so that the preparers of financial statements should improve quality of financial statements by providing useful information. It is a fact that alternatives provided by accounting will increase financial statements' quality but the preparers should be concerned with costs of choosing and switching to alternatives and comparing the benefits with the costs. The solution for measuring items of firm is provided by fair value. Apart from problems of fair value measurements, fair value accounting is a plus for financial statements as well as accounting itself while historical cost may be an alternative when it is ideal for the firm to measure (Penman, 2007). However, no particular value measure can solve all problems and be used in every case; therefore the firm has to choose the measure according to the circumstances in order to achieve the objective in providing accurate and timely information to users of accounts. Fair value accounting should be used where it offers faithful representation of the situations of firm. Fair value accounting is relevant and efficiently productive. This study determines the impact of fair value accounting on 4 major banks in UK.

It is possible that rules of fair-value accounting and their implementation details could be improved. Relaxation in rules and providing more flexibility to management to avoid possible problems regarding fair-value during the period of crisis also makes way for manipulation and may affect the effectiveness of information at a crucial time. Another aspect of bank accounting at the time of financial disaster is that investors and stakeholders were of the view that banks used their own discretion to overstate the value of their assets. The absence of transparency about solvency of banks could be a major problem in during crisis than likely contagion impacts from the implementation of system of fair-value accounting.

If fair-value accounting system had made a contribution to contagion and spirals, these effects during the period of crisis need to be considered in contradiction of the effects of recognition of loss to the entity. When banks are induced to write down the assets' value as the losses incur, they have reasons to take corrective measures and to limit irrational lending, which reduce the severity of a crisis. It is of serious concern if such accounting rules are suspended or relaxed each time a crisis arise as the banks can expect such alterations, which reduces their incentives to manage risks at first. If the objective is to diminish procyclicality, it would be more beneficial to relax capital constraints in a time of crisis than to alter the accounting standards, as altering the standards could affect market discipline and transparency.

### ***5.3 Future Implication***

According to evidence and analysis, there is a possibility to consider that fair-value accounting has contribution in problems of banks during the crisis times. Fair values of assets and liabilities play limited role in income statements of banks and capital ratios, except for the banks that have large positions of trading. For such banks, even in the non-existence of disclosures of fair value, investors would have bothered about mortgages that are subprime and made their personal judgments. Furthermore, extant rules offer discretion to banks and provide safeguards, which permit them to ignore marking to biased prices of market. We have shown that banks made use of such responsiveness during the time of crisis. Currently, there is also slight evidence that prices were manipulated or that banks were induced to take write-downs during the time of crisis.

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**Appendix A: Interview Guide**

1. What is the difference between fair value accounting and cost-based approach in banking sector?
5. What is the impact of FVA on quality of information in financial statements of banking sector?
6. How does FVA improve reliability of financial information in financial statements?
7. What is the impact of FVA relevance of accounting information in banking sector?
8. What are the benefits of FVA in valuating assets and liabilities?
9. What are the limitations of FVA in valuating assets and liabilities?
10. What are the challenges to implementation of FVA in accounting standards?
11. What was the role of FVA in last financial crisis of banking sector?
12. How can FVA improve decision making process of banking investors?
13. What are ways to implement FVA in banking sector?

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