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Probing IFRS Prescription: The Effect of Fair Value Accounting on Firms' Equity

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Abstract: The prescription of the IFRS to use fair value in an entity's financial statements has a number of benefits and disadvantages to it. Although the effect of using fair value in a number of accounts in the financial statements is already presumed to be done by a number of companies, it is of a particular need to see and study if the recommendation of the IFRS to use fair values in certain accounts will have an effect on the entity's financial statements, especially when in a number of cases, the use of fair value is only a choice by an entity and not necessarily a recommendation or requirement of the standards.

This study discusses the effect of fair value on an entity's shareholders' equity, particularly in Philippine publicly-listed firms. By investigating the operationalized Tobin's q five years before and five years after the IFRS were adopted by the country, evidence is provided that fair value, specifically Level 1 fair value, may not have an effect on the financial statements of these companies. This study challenges the assumption of many studies that IFRS has an effect on the financial statements of an entity. The results of this study found no evidence that fair value accounting is evident on the financial statements of the companies being studied.

The findings would be of use to see the particular effect of the IFRS on the stock market, and also provide insights to equity investors on improving their insights and valuation of the company they are investing in.

Key Words: fair value; Tobin's q; IFRS;

1. INTRODUCTION

The adoption of the International Financial Reporting Standards (IFRS) by a number of countries could be considered as one of the greatest milestones in the history of accounting and financial reporting (Daske et al., 2008; Christensen et al., 2013). The adoption of such financial reporting standards aims at harmonizing and converging accounting conventions around the globe. We could say that the IFRS has been successful so far, because as of this writing, there are already more than 100 countries that follow the guidelines of the standards in their financial statements (Baboukardos & Rimmel, 2013; Aghimien et al., 2013). Although there still are issues arising from the standards themselves, and changes in such are still occurring, we see that the IFRS really made an impact – and continues to do so – at least in the field of financial reporting.

Probably one of the most significant prescriptions of the IFRS is the use of fair value in the face of the financial statements. The use of fair value even went as far as the standard setters coming up with a separate set of guidelines for it, which is IFRS 13. Because the IFRS focuses largely on catering the needs of capital investors, encouraging entities to report their assets, liabilities and equity at fair value aims at enabling such financial statement users to evaluate the performance and current condition of the entities being reviewed, mainly because the figures are presented at their most current amount. And even though there are disclaimers normally given in the standards to use historical cost or other measures from fair value when fair value cannot be measured reliably (see for example paragraph 53 of IAS 40 *Investment Property*), presenting items at fair value seems to prevail.

1.1 Given that, since fair value accounting is highly recommended by the IFRS, there seems to be that assumption by the standard setters that fair value has an influence over financial reporting. This study aims at studying and probing on that assumption. I aim at studying the effect of the IFRS's prescription of fair value accounting in the financial statements of entities listed in the Philippine stock market. I aim to shed light on the issue of the usefulness of fair value because of two main reasons. Firstly, there have already been a number of studies supporting and criticizing this concept. By knowing if fair value has an effect or not, we will be able to see if the ongoing debate would be of a particular importance to us. If fair value does not have an effect on the financial statements, the industry or the market, then experts could probably focus their attention on other matters on financial reporting. Next, and probably more importantly, if using fair value in the financial statements does not provide enough evidence to support the conjecture that it does change the way financial reports are presented, then financial statement preparers could just stick to historical cost accounting. That would save them a significant amount of time and resources.

Review of Related Literature

1.1.1 IFRS and Fair Value Accounting

The conceptual framework of the IFRS enumerates the qualitative characteristics of useful financial information: relevance, faithful representation, comparability, verifiability, timeliness and understandability. The first two are the fundamental characteristics, while the remaining three are enhancing qualitative characteristics. Although all of the characteristics will be discussed, the main focus of this review is on the fundamental qualitative characteristics.

IFRS 13, which became effective during 2013, sets out the guidelines regarding fair value accounting: its definition, measurements and disclosures. By setting out the guidelines for the proper financial reporting of items in the financial statements presented at fair value, it is clear that the standard setters lean towards focusing on relevance (without, of course, sacrificing faithful representation). This particular emphasis of the IFRS is supported by McAnally et al. (2010). By assessing the effect of the switch from local GAAP to IFRS on share-based compensation, they found out that 'IFRS numbers are more relevant than GAAP numbers.' This particular claim is also supported by Cairns et al. (2011) not just in share-based agreements, but also in financial instruments. However, it may not be the same case when it comes to reporting items of property, plant and equipment (PPE). The results of their study revealed that for PPE, comparability may increase at the expense of relevance.

In line with the concept of relevance is faithful representation. By scrutinizing IFRS 13, Palea & Maino (2013) raised an important issue: The use of market-based valuation techniques or basing fair values on market prices do not provide reliable information, mainly because they do not reflect the future cash flows to be realized from such assets. Although there may be a point in what they said, particularly in long-term assets, we should be wary of the fact that the main definition of 'fair value,' according to the IFRS, is 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.' So from the implication of the definition, fair value is not exclusive to represent the future cash flows embodied in a particular asset, it may also be the price that would have been received upon the liquidation of that particular asset.

Palea & Maino also continued to question whether the recommendations set out in IFRS 13 enhances comparability of information, most especially in the valuation of private equities. But although they cast their doubt on such characteristic, Cairns et al. (2011) posited that fair value measurement does enhance comparability of information, especially in the valuation of financial instruments, although in their case they are talking about publicly-traded instruments.

1.1.2 Effect of IFRS on Firms and the Market

Aside from the qualitative characteristics, transparency is also highlighted by the standard setters, as it is included in the objectives of IFRS 1. Interestingly enough, Palea (2013) claims that fair value accounting should help increase it. This objective is achieved as concluded by Pae et al. (2008). They go on to add that the effect of the IFRS on transparency is greater when information asymmetry between the management and outside users before the adoption of the standards is smaller. So, if fair value accounting provides more transparent information, which would lessen the opportunity for managers to manipulate the figures in the financial statements (Ball, 2006). And if manipulation is minimized or even mitigated, there would be less control over income smoothing; therefore net income will be more volatile throughout the years (Beisland, 2014). This particular claim is also being supported by McAnally et al. (2010), this time taking into account the prescription of fair value accounting by the IFRS, concluding that volatility of net income (as well as stock price) increases only because it mitigates earnings management. However, Ahmed et al. (2013) disagrees, arguing the opposite of the findings of McAnally and her team, even going to claim that accounting quality decreased because of IFRS, adding that discretionary accruals increased because of the adoption of the standards. Still, their conclusion on the quality of information is also opposed by Barth et al. (2008) and Horton et al. (2013), and that they continued on to clarify that IFRS adoption alone is not the cause of such decrease in the quality of accounting numbers.

Focusing on the effects on the market, Christensen et al. (2013), Daske et al. (2008) and Brown (2006) are in consensus conclusion that the adoption of IFRS increased that particular country's market liquidity. Brown goes further, stating that an increase in the liquidity of the market encourages trading, which would then affect fair value accounting of such entities. Focusing on the work of Daske et al., although there was an increase in market liquidity, IFRS-adopting countries have more liquid markets to begin with compared with the non-adopters. Apart from that, they also found out that the cost of capital of IFRS-adopting countries decreased compared with the non-adopters, but such reporting adopters are enjoyed more by the early adopters and those whose local GAAP are more different than the IFRS.

One consequence of fair value accounting, according to Beisland and Clor-Proell et al. (2014), is that it helps analysts come up with a more accurate firm valuation of a company, although the latter clarifies that it depends on the salience of the information, meaning that firm valuation becomes more effective with the use of fair value only when such information is presented clearly and conspicuously, as in the notes to the financial statements. On a similar note, Horton et al. (2013) found that analysts' forecasts improved more for mandatory IFRS adopters than voluntary adopters, although they did not say if the improvement is caused partly or significantly by the prescription of the IFRS to use fair value accounting. McAnally et al. further adds that IFRS adoption also helps the predictability of an entity's tax items. However, IFRS may not be as beneficial as it may be to the adopters, because along with its adoption comes an increase in the audit fees (George et al., 2013). This particular additional increase in assuring the objectivity of the figures in the financial statements is worsened by the extent of the country's transitional adjustment to IFRS. George et al. also argued that smaller firms are the ones more affected by the adoption of the IFRS when it comes to audit fees, experiencing up to an increase of 30% in such expenses.

1.1.3 Other Factors Affecting and Affected by Fair Value Accounting

Finally, zeroing on fair value accounting, Baboukardos & Rimmel (2014) posited that it increases decision usefulness, and it is improved even more by a high level of compliance by the entities. And such development does not help external users alone, because normally fair value accounting is associated with financial accounting, which is focused on providing the needs of the external financial statement users, but the entity's management as well. Still, even though fair value accounting influences managerial decisions, managerial decisions also do affect fair value accounting (Lilien et al., 2013). So by and large, fair value accounting mainly depends on the management, because it may help increase transparency, but also decrease it, as stated by Lilien et al. Given that, although fair value accounting has its own issues, particularly with Levels 2 and 3 inputs (see Palea & Maino, 2013), its usefulness to the investors and other external financial statement users depends on the use and biases of the management (Lilien et al., 2013).

1.2 Research Gap

Because of the focus of the IFRS on providing the needs of capital investors, particularly in firm evaluation, reporting of a number of items in the financial statements prescribe the use of fair value (see for example, IFRS 2 *Share-Based Payment*; IFRS 9 *Financial Instruments*; IAS 16 *Property, Plant and Equipment*, IAS 36 *Impairment of Assets* and IAS 40 *Investment Property*). The standard setters even came up with a standard laying out the guidelines in computing for and proper treatment of fair value. Without a negative bias on faithful representation, the trend nowadays in financial reporting is towards relevance, providing inputs for timely decision making of the financial statement users, whether it is for evaluation or for forecasts or prediction.

However, we see that the use of fair value accounting has already been assumed, not just by the standards, but by a number of studies as well. Although this is not entirely a bad thing, like the assumption of an efficient market in the 1960s and 1970s, although many findings at that period proved the alternative hypothesis (Fields et al., 2001), there might be a significant concept that we miss. Even fair value accounting is already assumed to be used in a number of items in the financial statements, there is limited extant research works focusing on the effect of fair value accounting on the financial statements, particularly in the shareholders' equity. And that is what I am aiming to shed light on. By finding out whether fair value has an effect on the financial statements, we will be able to see if the recommendations set out in IFRS 13 and a number of other IFRSs and IASs have an effect on the financial statements, as oppose to merely sticking to historical cost accounting.

2. METHODOLOGY

The main condition of this study is that if fair value accounting has a significant influence on financial reporting, then book values of the items presented in the financial reporting should be equal to, or at least approximate, their fair values.

H_o: The difference between Tobin's q and 1 from 2006 to 2013 will not approach 0.

H_a: The difference between Tobin's q and 1 from 2006 to 2013 will approach 0.

To provide empirical evidence on the objective, Tobin's q was used. So, if book value would at least approximate market value, then Tobin's q would approach 1, and the difference between them would approach 0. Although it has been proven that Tobin's q and market-to-book ratio are equivalent measures (Varaiya et al., 1987), the first one includes an entity's liabilities in the equation. And to make sure that all possible values will be taken into account, liabilities were included in the study as well, although the main focus will be on the entities' equity.

The Philippines is an interesting market to conduct this particular study, because all publicly-listed companies in this country are mandatory adopters of the IFRS. All corporations listed in the Philippine Stock Exchange are required to follow the IFRS in 2005, so given that, the conditions set out by the IFRS are uniformly experienced by such corporations 2005 onwards. There were no voluntary adopters, so I assume that no corporation experienced an advantage on the application of the standards over the other corporations.

Data were gathered from Osiris, and the period covered was from 2006 up to 2013. The starting period was 2006 because this is the year when the IFRS was fully implemented by all publicly-listed companies in the country. All companies, regardless whether they were delisted during the period covered or were included in the exchange during the said time frame, were included because the study will focus on the industries and the market as one, and not on the individual entities. The companies were divided into the sectors as specified by the Philippine Stock Exchange: Financials, Holding Firms, Industrial, Mining and Oil, Property and Services.

The difference of the said measure between 2013 and 2006 is taken into account. To see if Tobin's q would approach 1, then the variable of interest (difference between Tobin's q and 1) should be smaller in 2013 than in 2006. Not only that, the difference between the said periods should be significant for us to be able to conclude that fair value accounting is evident in a company's financial statements. The difference between two succeeding years is also monitored to see the progression of the standard's prescription. And lastly, to confirm the results of the T-test, a regression is also made to see the relationship between time and the variable of interest.

2.1 Data

Table 1 summarizes the statistical characteristics of the variable from 2006 to 2013. The sample consists of 1,655 observations for 292 companies from 2006 to 2013. As mentioned earlier, firms that got delisted during the period or began to be listed during the period were included in the selection, even though the data gathered from them were incomplete.

Table 1 Data Characteristics

Variable	Obs	Mean	Std. Dev.	Min.	Max.
q2013	227	15.6479			

122.641	-				1552.80
				.958	
q2012	227	12.5447	91.9453	-	975.929
				.955	
q2011	223	15.1507	149.187	-	2124.17
				.941	

q2010	220	13.2066	106.825	-.929	1275.04
q2009	210	11.7088	102.018	-.891	1270.60
q2008	208	4.81039	37.5029	-.916	406.039
q2007	213	106.186	960.699	-.882	12574.9
q2006	127	49.7573	511.476	-.868	5758.53
qoverall	165	27.23871	385.2994	-.958	12574.93

3. RESULTS AND DISCUSSION

3.1 T-test

The results of the study show that between 2006 and 2013, the difference does not approach zero. The summary of the results of the study is given in the table below.

Table 2 Empirical results

Cate-gory	T-Test Results 13 and 06	13 and 12	12 and 11	11 and 10	10 and 09	09 and 08	08 and 07	07 and 06
Market	0.23	0.62	0.41	0.56	0.56	0.82	0.06*	0.76
Financials	0.98	0.46	0.73	0.76	0.58	0.84	0.8*	0.93
Holding	0.86	0.29	0.31	0.73	0.62	0.68	0.08*	0.93
Industrial	0.97	0.20	0.85	0.47	0.56	0.95	0***	0.92
Mining and Oil	0.16	0.13	0.63	0.40	0.82	0.97	0.04**	0.16
Property	0.84	0.84	0.41	0.16	0.81	0.72	0.69	0.62
Services	0.79	0.65	0.78	0.18	0.39	0.76	0.16	0.84

Note: *, ** and *** indicate statistical significance at the 10%, 5% and 1% level, respectively.

The results show that overall there is no significant evidence to prove that the difference between Tobin's q and 1 approaches 0. It was only between 2008 and 2007 we see that the variable in the more current year is smaller than the previous period, and that does not even apply to the property and services sector. So the results of the t-test tell us that, even with the strong prescription and recommendation by the IFRS to use fair value in recording a number of items in the financial statements, it is not evident in the reports. This could arise from at least two reasons. Firstly, even if the IFRS prescribes the use of fair value, that particular guideline is not always a requirement. More often than not, with such particular items, the standards always say that such an item can be recorded at cost, if the fair value cannot be measured reliably, or if the cost of presenting the item at fair value exceeds its benefits (see, for example, paragraph 53 of IAS 40 *Investment Property*). Another reason could also stem from the fact that the IFRS merely serve as a guideline, and not something equivalent to a law, so companies can get away from diverging from the standards and not be penalized by it.

What is more surprising though is that, for the financials sector, the results (untabulated) show that the variable in focus is greater in 2013 than in 2006. This just means that for that particular sector, the difference between a company's market value and book value is greater in 2013 than it was in 2006. This particular finding may prove to be quite alarming, because there has always been a conjecture that the financials sector should be the one adhering to this prescription the most (probably because the entities in this sector is the one most affected by fluctuations in the market and are more invested in financial assets than any other companies in other sectors), but apparently is the one that is the most deviant among all the other sectors.

However, just because the financials sector's Tobin's q was significantly greater than 1 than it was in 2006 does not necessarily mean that the sector does not comply with the guidelines of the standards of measuring items at fair value. This might mean that the entities belonging to this industry may be using other inputs to measure the fair value of some of their items; Level 2 fair value measurement might be more popular than using Level 1 measurement.

3.2 Regression

To confirm the results of the previous test, the variable of interest is pooled into one and the following regression model is established:

Where:
Qoverall = difference between Tobin's q and 1 for all the companies for all the periods covered
Year = difference between 2006 and the year being covered by the study (i.e. 2013 = 7)

The results of the regression are summarized in the table below:

Table 3 Regression results

	Coefficient	Std. Error	t	P-value	R^2
Market	-4.664794	4.129639	-1.13	0.259	0.0008
Financials	-.0394767	.0509561	-0.77	0.440	0.0035
Holding Firms	-15.61151	9.131422	-1.71	0.088*	0.0089
Industrial	.0773646	.3254595	0.24	0.812	0.0002
Mining and Oil	-10.22521	15.93636	-0.64	0.522	0.0026
Property	-1.155176	2.685613	-0.43	0.667	0.0007
Services	-2.405029	15.51504	-0.16	0.877	0.0001

Note: *, ** and *** indicate statistical significance at the 10%, 5% and 1% level, respectively.

The results of the regression adhere to the findings of the previous test conducted. In general, the model states that as time progresses, Tobin's q would decrease given the coefficient of the independent variable. However, the decrease is not statistically significant, except for the holding firms sector. Another interest finding from the model is that, for the industrial sector, *qoverall* seems to increase through time, even though the relationship is not statistically significant as well.

The results gathered from the regression are consistent with the results of the t-test, albeit with a few difference. Still, regardless of the difference, we see that there is no significant evidence to say that, for the Philippine market, *qoverall* does approach zero. Also, the results of the regression say that the relationship between the passage of time has a very weak relationship with *qoverall*. At best, it could only predict 8.83% of the changes in the difference between Tobin's q and 1; for the most part, the r^2 is less than 1%. This suggests that there really are other factors that affect the ratio between the book and market value of a certain entity.

4. CONCLUSIONS

This study focuses on the effect of the IFRS instruction of fair value accounting. In particular, I focused on the effect of such prescription by the IFRS on the market and the six industries by monitoring the direction of the Tobin's q from the year that the IFRS was fully implemented in the Philippines up to the latest period available. Interestingly enough, results show that even though the difference between Tobin's q and 1 slowly approaches zero, the difference between the latest period and the beginning of the time frame is not significant enough for us to tell that fair value accounting is evident in the financial statements of Philippine publicly-listed companies.

The findings of this study may arise from three reasons. Firstly, even though we see that fair value is evident as a prescription by the IFRS in a number of standards, using such is not necessarily a requirement by the standards; it is more of a high recommendation, as mentioned earlier. Normally, the standards say that in cases where fair value cannot be measured reliably, an entity shall account for the item at cost. Given that, even though fair value accounting is being prioritized by the standard setters, it is a mere recommendation. And this fact also implies another thing: the accounting standards does not have an absolute power over the financial reporting of the entities. No matter how clear they are with their intentions and their guidelines, the IFRS is not law to be followed closely. At the end of the day, even with the overseeing of other regulatory bodies, it is still the entity that has the power over the preparation of its financial statements. And given that the Philippines has a weak enforcement when it comes to financial reporting (Ahmed, Neel, & Wang, 2013), recording certain items at fair value may not provide incentives to the reporting entity; hence, arriving at fair value might prove to be more cumbersome than beneficial. Given the fact that there is a loose enforcement of the IFRS in the country, difference in the market values and the book values of the accounts in the financial statements might differ significantly. Also, since there is a weak enforcement, fair value accounting may not be monitored, and hence presented, properly by the entities.

Arriving at fair value might prove to be more costly than beneficial, so that could also explain the reason that the difference does not approach nil. The capital market is volatile; changes in the market price happen by the minute. So, unless the price is being closely monitored, it might be difficult for the reporting entity to measure the fair value of an item at market price given such circumstances. Not only that, since the fair value that we have been talking about here pertains to the value reported in the market, other valuations of fair value also have roles to play. IFRS 13 also prescribes Level 2 and Level 3 of measuring fair value if Level 1 cannot be measured reliably. That could be a reason that the financials sector's difference is even greater in 2013 than in 2006. Unfortunately though, providing evidence on the difference between Level 1 and Level 2 or Level 3 valuation of fair value is beyond the scope of this study, but can be an interesting topic to be studied.

The last reason that could be attributed to the lack of power of fair value accounting may also be attributed to the fact that the items where fair value is highly recommended, and the guidelines exhaustive, may not make up a significant ratio in the financial statements of the entities. For example, financial instruments are very high on fair value, but they do not necessarily make up a significant amount or portion of an entity belonging in the properties industry. Such exhaustive prescription may even prove to be counterproductive for the financials sector, as seen in the results saying that the difference was even greater in 2013 compared with the difference in 2006.

Fair value accounting has always been a controversial topic, given the number of extant studies in the field. However, by showing that such concept may not be that evident in the financial statements, these particular researches may have to be refocused, particularly their practical implications. However, even though such findings are given in this study, there are still a lot to find out regarding them. Firstly, as I have mentioned, Tobin's q does approach 1 through time, so an extension of time frame could be studied. Next, other constructs can be used to replicate the study, like market-to-book ratio, or any other measures, even methodologies. This particular study can also be replicated by studying one country with a strong enforcement alongside another country with a weak enforcement. As what I have also mentioned earlier, the differences between Level 1 and other fair value computations can be studied. Lastly, studies that could control for other variables such as the strength of enforcement may be conducted to isolate the sole effect of fair value accounting on the financial statements, since the relationship between time and the construct of interest is proven to be very weak.

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