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Fundamental issues related to using fair value accounting for financial reporting

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I. INTRODUCTION

The Financial Accounting Standards Board (FASB) recently has issued several standards requiring recognition or disclosure of fair value estimates for assets and liabilities, principally financial instruments (e.g., Statements of Financial Accounting Standards (SFAS) 87, 105, 107, 115, 119, and 121). In addition, many of their current agenda items and discussion documents address recognition and measurement issues relating to fair value accounting (e.g., Discussion Memoranda Recognition and Measurement of Financial Instruments and Distinguishing Between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both). Before implementing fair value accounting on a more comprehensive basis, there is a need to explore its basic characteristics.

This paper is a response to suggestions by the FASB that academics are in a position to contribute to its standard setting process by viewing financial reporting issues in a broader context than that associated with addressing specific issues raised in their discussion documents (see FASB Status Report, August 21, 1995).(1) Thus, our goal is to investigate several fundamental issues related to using fair value accounting for financial reporting.(2) In particular, we address the following questions.

*What is meant by fair value?

*In realistic settings where fair value is not well-defined, are accounting measures based on one concept of fair value more value-relevant than those based on other concepts?

*How do fair value-based financial statements relate to firm value? In particular, does a fair value-based income statement provide value-relevant information beyond that provided by a fair value-based balance sheet?

*What are the implications for firm valuation of private information and estimation error in fair values?

*Is income realization valuation-relevant?

As does the Committee on Accounting and Auditing Measurement, 1989-1990 (Barrett et al. 1991), we assume that fair values conceptually are relevant to financial statement users in assessing firm value, and define a financial statement...