

Deconstructing the Accounting Standard AASB 13 Fair Value: Exit vs Entry Price for Assets

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Abstract

Purpose: *This paper examines the flaw in the cost price valuation technique espoused in AASB 13 as an optional method for determination of fair value of an asset.*

Design/methodology/approach: *This study employs the Deconstruction approach to the analysis and identification of theoretical perspectives imbedded with in the accounting standard that are internally contradictory.*

Findings: *The analysis highlights the existence of contradictions in the inclusion of the cost price valuation technique (entry price). With the technique being in complete contradiction to the definition of fair value stated in the standard. Since both cost price and market price (exit price) valuation techniques require the existence of a market additional criticism is made of the lack of any explanation to justify the use of one method over the other.*

Research limitations/implications: *The analysis provides some insight into the theoretical basis behind the two valuation techniques in view of the conceptual frameworks intended position of providing more useful financial information. This leads to speculation that rather than improving the information content of the financial statements the lack of consistency may conversely distort the financial information.*

Keywords: *AASB 13; fair value; accounting standards.*

JEL Classifications: G10; M40

PsycINFO Classifications: 3600

FoR Codes: 1502; 1504

ERA Journal ID #: 40840

Introduction

Fair value measurement has a long history in accounting that dates back over two decades (Power, 2010; Bromwich, 2007). Lee (2008) suggested that the origin of the term fair value could be traced back to a USA Supreme Court case in 1989 (*Smyth v Ames*) in which the ruling was that there existed an entitlement to earn a 'fair return' on the 'fair value' of the business. It should also be recognised that fair value is not a single measurement but rather a mixture of alternative approaches intended to arrive at an estimate of a value. This composite of assumptions and methods are intended to be useful for estimating a price that might be expected from a market which is further assumed to have specific characteristics. However, in circumstances where no active market for a specific asset exists the measurement becomes a matter of questionable reliability. Since reliability is no longer one of the fundamental qualitative characteristics, having been replaced by "faithful representation" which is considered to be as a subset of relevance. According to Landsman (2007) and Barth and Landsman (1995) reliability is not simply dependent on verifiability but rather the faithful representation of the real world economic phenomena it purports to represent.

Chambers (1955) arguably reignited the notion of having a consensus for the measurement of assets and this led to the development of more definitive models of valuation techniques. Edwards and Bell (1961) proposed a model based on entry prices of assets derived from market values, ideologically underpinned by the service potential of the physical capacity to maintain existing operational levels, which became known as current replacement cost. Conversely, Chambers (1966a; 1966b; 1967a; 1967b; 1970) presented a model based on the exit prices of assets derived from market values, this had as its ideological underpinning the notion of homeostasis or the ability to adapt inferring the cash equivalence supported the potential operating capability. This model became known as continuously contemporary accounting (CoCoA).

It was the Edwards and Bell model of current replacement cost that first found international favour and the name was subsequently shortened to current cost accounting. In the Australian economic environment of the 1970's double digit inflation promoted concern and prompted the Australian Accounting Research Foundation to issue Exposure Drafts on current cost accounting in 1974 and 1978 which culminated in the issue of the Statement of Accounting Practice (SAP 1) Current Cost Accounting (Walker, Clarke & Dean, 2000). However, the statement was not mandatory, and adoption was limited such was the disregard for this alternative model that compliance levels were subsequently never appropriately evaluated research of the financial information it was supposed to provide was limited (Jones & Love, 1995). By contrast the Chambers model, known as Continuously Contemporary Accounting (CoCoA) did receive acceptance in early Australian Accounting Standards, such as AAS 26 Financial Reporting of General Insurance Activities; AAS 25 Financial Reporting by Superannuation Plans; AASB 1037 Self Generating and Regenerating Assets. These were done at a time when there was a feeling within the Australian Accounting profession that industry specific accounting standards were warranted and should be tailored to meet the needs of the industry rather than follow a narrow focus. The intention was that this would provide more relevant information to users of the financial statements, and after all that was and still is a clear mandate with the Conceptual Framework (Dean & Clarke, 2003).

In the current environment of internationalisation of accounting standards, the Chambers model (CoCoA) has achieved a higher degree of recognition through the prominence given to the exit price concept in the standard enshrined in IFRS 13: Fair Value which is promulgated in Australia as AASB 13: Fair Value. With its emphasis on the exit price it is unmistakably derived from CoCoA, at least to an expert, however, the

International Accounting Standards Board provides no definitive acknowledgement of its origins in the preamble.

This paper examines the basic tenets of the Australian Accounting standard AASB 13: *Fair Value* which has a far reaching effect on the application of fair value measurement across a number of accounting standards. Fair value is used as a measure for both assets and liabilities in many AASB standards for example:

- AASB116 Property, Plant and Equipment
- AASB138 Intangible Assets
- AASB136 Impairment of Assets
- AASB 6 Exploration for & Evaluation of Mineral Resources
- AASB141 Agriculture
- AASB 9 Financial Instruments
- AASB 118 Revenue
- AASB 3 Business Combinations
- AASB 127 Consolidated & Separate Financial Statements

The approach adopted to analyse the theory of fair value within the standard is deconstruction. With so many accounting standards incorporating fair value measurement it becomes the one standard to rule them all, and the one standard to bind them. Various issues and questions have been raised by prior research concerning the validity of a standard aimed at establishing a definitive perspective of what constitutes fair value (Penman, 2007; Landsman, 2007; Benston, 2008; Georgiou & Jack, 2011; Power, 2010). With the numerous questions and concerns having been raised this paper is aimed at deconstructing the very nature of the accounting standard and its basis for claiming validity in defining fair value. It is vital to question the claim to validity since accounting standards are not necessarily easily understood by society and yet by their very existence are capable of constructing reality (Hines, 1988).

Deconstruction was first introduced by Derrida (1976; 1978; 1988), and whilst more commonly used in the disciplines of architecture, art, literature and philosophy there are various examples of it being used in the accounting discipline, see for example Arrington and Francis (1989), Francis (1990) and Laing and Perrin (2014). The analysis involves identifying paradoxes in the logic, in order to expose the pretences of truth (Norris, 1988a: 1988b; 1985). The fair value model relies on assumptions to justify the context that is developed in the standard which in turn is intended to provide guidance for application. This is consistent with formulation of the International Accounting Standards Board framework from which all accounting standards are expected to be derived.

The Deconstruction analysis employed in this study is derived from the approach espoused by Laing and Perrin (2014) which identifies three basic steps in the process of deconstruction:

1. Identify the key element or elements that underly the theory or argument of the matter to be deconstructed.
2. Identify any faults or assumptions that lie within the key element or elements themselves.
3. Examine the arguments, explanations, and terminology used within the matter being deconstructed.

AASB 13 – Fair Value

The accounting standard was promulgated in 2004 and is based primarily on the International Accounting Standard IAS 13 (Locke, 2012). The standard applies to the measurement of both assets and liabilities and therefore has a far reaching effect in the accounting profession.

Step One of Deconstruction – identify key elements

The main objective of the concept being deconstructed is to be found in the standard itself under the heading “objective” in paragraph 1 which summarises the objective as:

- to define fair value
- to establish a framework for measuring fair value
- to require disclosures about fair value measurement.

The definition of fair value is provided at paragraph 9 in the standard:

“This Standard defines fair value as 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.”

There are three key elements embodied in this definition:

1. The price that is referred to is a current exit price;
2. The asset to be sold or liability is expected to be transferred in an orderly transaction;
3. The transaction is considered to be between market participants.

These elements are the starting point for the deconstruction process that is to follow. The first key element which is that of a Current Exit Price is enshrined in that part of the definition that states:

“...the price that would be received to sell an asset or paid to transfer a liability”.

It is this key element of “current exit price” that is arguably most dominant since it clearly establishes the method for the measurement of the fair value. In essence, it should be the point of reference for all further considerations in this standard.

The notions of an “orderly transaction” and “market participants” are further explained in paragraphs 15 and 16.

However, Appendix A provides a definition of an “orderly transaction” which is explained as:

“a transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities”.

Paragraph 16 clarifies that there is an assumed link between the transaction and the participants in a market:

“A fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place either:

- (a) *in the **principle market** for the asset or liability; or*
- (b) *in the absence of a principal market, in the **most advantageous market** for the asset or liability.”*

Appendix A provides further explanation on the intended meaning of a market participant and all four criteria must be met.

- (a) Must be independent from each other;
- (b) Must be knowledgeable about the asset or liability;
- (c) Must have the ability to enter into the transaction;
- (d) Must not be forced or compelled to enter into a transaction.

For non-financial assets the valuation premise is based upon the highest and best use (paragraph 27). Fair value is measured by considering the highest and best use of an asset.

Determination of the appropriate valuation technique is covered in paragraph 61 with the identification of three possible techniques being the market approach, the cost approach, and the income approach. Paragraph 62 states that *“the objective of using a valuation technique is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions.”* This objective is almost a restatement of the definition of fair value made in paragraph 9, however it has omitted the words *“the price that would be received to sell”*. This is a notable omission and whilst one which of itself does not contradict the definition of “fair value” does allow for a valuation technique which does contradict the notion of “exit price”.

Step Two of Deconstruction – identify faults or assumptions in key elements

The ramification of this divergence becomes apparent when examining the three possible valuation techniques as provided in Appendix A:

1. The market approach

“uses prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets, liabilities or a group of assets and liabilities, such as a business.”

Conceptually, this is based on the “exit price” which is the price that would be received to sell an asset or paid to transfer a liability.

2. The cost approach

“reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).”

Conceptually, this is based on the “entry price” which is the price paid to acquire an asset or received to assume a liability in an exchange transaction.

3. The income approach

“converts future amounts (e.g. cash flows or income and expenses) to a single current (i.e. discounted) amount. Fair value measurement determined on basis of value indicated by current market expectations about those future amounts.”

Conceptually, this is “value-in-use” employing net present value of expected future cash flows from the use of the asset.

Step Three of Deconstruction – examine the arguments, explanations, and terminology

The fault in the standard lies in the inclusion of the “cost approach” as a valuation technique. By its very definition the cost approach is an “entry price” not an “exit price” valuation technique and this is clear violation and contradiction to the key element in the definition of fair value.

Consider the theoretical constructs that underpin the two different valuation techniques from their philosophical perspective of the principles pertaining to capital

maintenance and unit of measurement. Exit price versus entry price have some very pertinent contrasting views and these are summarised in Table 1.

Table 1.
Exit Price vs Entry Price

	Unit of Measurement	Capital Maintenance	Principal Objective
Exit Price	Current cash equivalent	Financial value	Availability of cash for potential operating capability
Entry Price	Current replacement cost	Physical capability or service potential	Continued existence of present operations capacity

Capital maintenance, is an approach used to justify elements in the balance sheet, it is measured as the amount of cash that could be presently raised for an entity's assets. This financial view is in keeping with historical cost accounting but does not address the fundamental question concerning what attribute should be recognised and reported. An alternative argument is to maintain a physical operating capacity thus introducing an alternative attribute. Which of these is more relevant to reporting of the financial position of a firm at a particular point in time, is not laid to rest by the argument put forward by Chambers (1966: 114). For the purpose of the clarification in regards to fair value proposed within the accounting standard the distinction is a valid point of conjecture, since exit price differs conceptually from entry price on all three aspects (units of measurement; capital maintenance; and principle objective).

The conceptual framework specifically addresses the need for financial information to be useful for decision making. Financial information must poses two fundamental qualitative characteristics the first is “relevance” (paragraphs QC6 to QC 11) and “faithful representation” (paragraphs QC12 to QC16). It is the need for faithful representation that stands in conflict with fair value measurement or at least that is how it would appear at first glance. However, the interpretation provide by the Board under the Basis for Conclusions on Chapter 3: Qualitative Characteristics of Useful Financial Information in paragraph BC3.23 and BC3.24 seems to infer that relevant information takes precedence over any concerns and faithful representation is a better means of conveying the notion of quality in the information. This supports the approach to application of the fundamental qualitative characteristics in the conceptual frame work (paragraphs QC17 to QC18). Basically, the relevance criterion takes precedence and is therefore the first consideration for reaching a determination. This is followed by the criterion of faithful representation which is only concerned with how to depict the phenomenon in the financial statements. In this way it is assumed that they work together to provide a seamless meshing of useful financial information. Unfortunately, this ubiquitous set of statements hardly provides adequate guidance or justification for the selection of the appropriate valuation technique.

Summary

Whether the financial position of a firm is represented by accounting information is a contentious point that requires substantiation, the mere existence of such information is not evidence to be accepted at face value. This is long held presumption of the Historical Cost Model which was accepted as ‘truth’ without question at least by accounting practitioners in the not so distant past.

To privilege current cash equivalent prices of assets over all other forms of valuation is to ignore the adaptability of human behaviour for potentially using all forms of information. After all, accounting information can hardly claim to be the only information of value to the decision making process.

There is no explanation given in AASB 13 or the conceptual framework to indicate when the cost approach should be used and as both the market approach and the cost approach rely on the existence of a market there can be no logical justification for choosing one over the other. What does however, stand out as a means for making a logical choice is the definition of fair value which specifically states that it is to be the selling price not the buying price.

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