MACROECONOMIC OUTLOOK THROUGH THE EYES OF INVESTORS: FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENT

Olivera Ecaterina OROS[*]

Abstract

A country's economy growth is depending on the investments, either direct or indirect, made in it. Also, the level of the foreign direct investments is a relevant indicator for other potential investors.

While lenders are looking at the financial statement to understand the company's ability to repay debt, the investors are looking at the financial statements to understand the company's ability to grow.

The IASB's Conceptual framework for financial reporting offers a standardized model of financial statement that is about to change.

Keywords: *economic decision, investor, financial statement, fair value, financial instrument.*

1. Introduction

Based on the IASB's *Conceptual Framework for Financial Reporting,* the companies are using one standardized model in preparing the balance sheet, the income statement, and the notes to the financial statements. Investors, at their turn have learned one common way to read this information.

"The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions."[1] Financial statements should be understandable, relevant, reliable and comparable. Reported assets, liabilities, equity, income and expenses are directly related to an organization's financial position. Financial statements are intended to be understandable by readers who have "a reasonable knowledge of business and economic activities and accounting and who are willing to study the information diligently."

Also, mandatory IFRS adoption is improving comparability and thus leading to capital market benefits by reducing insiders' ability to exploit private information[2].

Reading the annual report – which must be independently audited – is a chance for investors to examine the company's financial strength and performance over the past year and to consider what opportunities there are for future growth.

A major potential benefit from the global move towards IFRS is an increase in accounting comparability. However, many commentators question the potential for IFRS to increase comparability because the same accounting standards can be implemented differently and in the absence of suitable enforcement mechanisms real convergence and harmonization

---

[*] PhD Candidate, Faculty of Economic Sciences - Accounting, Valahia University, Targoviste, Romania (e-mail: olivera.ecaterina@gmail.com).

[1] "The Framework for the Preparation and Presentation of Financial Statements" International Accounting Standards Board.

[2] Francois Brochet, Alan D. Jagolinzer, Edward J. Riedl, working paper *Mandatory IFRS Adoption and Financial Statement Comparability, 2012.*

is unlikely IFRS adoption is likely to generate both information and comparability effects and improve the quality of information intermediation in capital markets; a key market institution that facilitates efficient allocation of resources towards its most productive uses[3].

2. Content

Currently, IAS 39 *Financial Instruments: Recognition and Measurement* recognizes impairment of financial assets using an incurred loss model. The model assumes that all loans will be repaid until evidence to the contrary (known as a loss or trigger event) is identified. Only at that point is the impaired loan (or portfolio of loans) written down to a lower value.

IFRS 9 *Financial Instruments* includes requirements for recognition and measurement, de-recognition and hedge accounting. The IASB is adding to the standard as it completes the various phases of its comprehensive project on financial instruments, and so it will eventually form a complete replacement for IAS 39 *Financial Instruments: Recognition and Measurement*.

This project, to be included in IFRS 9, is considering various forms of the 'expected loss' approach, whereby expected losses are recognized throughout the life of a loan or other financial asset measured at amortized cost, not just after a loss event has been identified. Under the expected loss approach, losses are recognized earlier than the incurred loss model. Proponents of the expected loss model believe it better reflects the lending decision.

The IASB continued to discuss the *impairment model* and many requirements under ED /2013/3 Financial Instruments: Expected Credit Losses (the impairment ED) were reconfirmed. The key areas in which the IASB made tentative decisions to amend or refine proposal in the impairment ED are mainly the following:

- timing of recognition of lifetime expected credit losses. The assessment of significant increases in credit risk could be more simply by establishing the initial maximum credit risk for a particular portfolio or financial instruments with similar credit risk on initial recognition (by product type and/or region) and then comparing the credit risk of financial instruments in that portfolio at reporting date with the origination credit risk.
- the proposed description of law credit risk will be modified
- the expected credit losses (ECL) would be discounted at the effective interest rate or an approximation thereof.
- for revolving credit facilities, the expected credit losses would be estimated for the period over which an entity is exposed to credit risk and over which future draw-downs cannot be avoided, while the ECL on the undrawn and drawn portions of a facility would be discounted using the same EIR. The provision for the ECL on the undrawn facility would be presented together with the loss allowance on the drawn facility if an entity cannot separately identify those two components.
- In October 2008, the International Accounting Standards Board amended IAS 39 to allow banks to retroactively reclassify financial assets that previously were measured at fair value to amortized cost. By reclassifying financial assets, a bank can potentially avoid recognizing the unrealized fair value losses and thereby increase its income and regulatory capital during a market downturn[4]

In terms of transition, an entity could approximate the credit risk on initial recognition by considering the best estimation that is available without undue cost or effort. If an entity is not able to determine or approximate the credit risk on initial recognition, then it would

[3] Joanne Horton, George Serafeim, Ioanna Serafeim, research paper Does Mandatory IFRS Adoption Improve The Information Environment? .

[4] Chee Yeow, Lim Chu, Yeong Lim, Gerald J. Lobo, research paper IAS 39 Reclassification Choice and Analyst Earnings Forecast Properties.

measure the loss allowances based on the credit quality at each reporting date until that financial instrument is de-recognized.

In terms of *classification*, IFRS 9 divides all financial assets that are currently in the scope of IAS 39 into two classifications - those measured at amortized cost and those measured at fair value. Classification is made at the time the financial asset is initially recognized, namely when the entity becomes a party to the contractual provisions of the instrument[5]. For this purpose, a business model should be used.

The term business model should refer to the way in which financial assets are managed. The business model assessment should result in financial asset being measured in a way that would provide the most relevant and useful information. Of course, the business model should be assessed at a level that reflects groups of financial assets that are managed together to achieve a particular objective.

The final standard would make the following clarifications:

- The business model is often observable through particular activities that are undertaken to achieve the objectives of that business model
- These business activities usually reflect the way in which the performance of the business is evaluated and reported, as well as the risks that typically affect the performance of the business model; and how those risks are managed.
- An entity should consider all relevant and objective information, but not every „what if" or worst case scenario
- A change in business model would occur only when an entity has either stopped or started doing something on a level that is significant to its operations. This would generally be the case only when the entity has acquired or disposed of a business line.
- Held-to-collect business model:

    - The current held-to-collect "cash flows (value) realization" concept would be reinforced by providing examples and guidance
    - Insignificant and/or infrequent sales may be consistent with the held-to-collect business model, regardless of the reasons for those sales.
    - Historical sales information and patterns could provide useful information, but this sales information would not be determinative
    - Sales to minimize potential credit risk due to credit deterioration are integral to the held-to-collect objective
    - Sales made in managing concentrations of credit risk would be assessed in the same way as any other sales made in the business model.

- The application guidance in the final standard would include the following clarifications:

    - Sales to not drive the business model assessment
    - Historical sales information would help an entity support and verify its business model assessment
    - Fluctuations in sales in a particular do not necessarily mean that the entity's business model has changed
    - If cash flows are realized in a way that is different from the entity's expectations, then this would neither result in a restatement of prior period financial statements, nor change the classification of the existing financial assets in the business model as long as the entity considered all relevant and objective information that was available at the time that it made its decision.

---

[5] IFRS 9, paragraph 4.1.1.

FVTPL[6] *measurement category*. The FVTPL measurement category would be retained as the residual category and the final standard would clarify the following:

- When financial assets are either held for trading or managed and evaluated on a fair value basis, the entity makes decisions about whether to hold or sell the assets based on changes in, and with the objective of realizing the assets' fair value.
- The activities that the entity undertakes are primarily focused on fair value information, and key management personnel use that information to assess the assets' performance and to make decisions accordingly.
- Another indicator is that the users of the financial statements are primarily interested in fair value information on these assets to assess the entity's performance

FVOCI[7] *category*. The final standard would clarify the following in respect to the fair value through other comprehensive income:

- Managing financial assets both to collect contractual cash flows and for sale would reflect the way in which financial assets are managed to achieve a particular objective, rather than the objective in itself.
- The application guidance would more clearly articulate that FVOCI provides relevant and useful information when both the collection of contractual cash flows and the realization of cash flows through selling are integral to the performance of the business model
- The application guidance would describe activities that are typically associated with such a business model
- There would be no threshold for the frequency or amounts of sales.

It was reconfirmed that entities would be permitted to apply the fair value option to a financial asset that would otherwise be mandatorily measured at FVOCI if such a designation eliminates or significantly reduces an accounting mismatch.

A finalized additional chapter of IFRS 9 *Financial Instruments* is expected in the second quarter of 2014, but considering the changes implied, the IASB tentatively decided at its February 2014 meeting to select an effective date of 1 January 2018 as the effective date for mandatory application of IFRS 9.

If IFRS 9 *Financial Instruments* applies starting 2018, IFRS 13 *Fair Value Measurement* is already in force. IFRS 13 was originally issued in May 2011 and applies to annual periods beginning on or after 1 January 2013.

Therefore the financial statements for year 2013, currently under elaboration, are based on the provisions of this standard. Bothe companies and investors must quickly adapt to new financial statement model.

It is worth saying that during time, also some negative effects were envisaged regarding the potential wider application of fair values, that could unduly increase the volatility of banks' balance sheets, possibly reducing their ability to react to adverse shocks[8]. In the ECB Occasional paper series no.13/April 2004 „Fair Value Accounting and Financial Stability", it was said that „given the proliferation of different internal valuation models, the comparability of balance-sheet data across financial institutions could be severely jeopardized".

---

[6] Fair Value through profit and loss.

[7] Fair Value through other comprehensive income.

[8] Andrea Enria, Lorenzo Cappiello, Frank Dierick,Sergio Grittini, Andrew Haralambous, Angela Maddaloni, Philippe Molitor, Fatima Pires and Paolo Poloni, *ECB Occasional Paper Series No. 13 Fair Value Accounting And Financial Stability,* 2004.

IFRS 13 *Fair Value Measurement*[9] applies to IFRSs that require or permit fair value measurements or disclosures and provides a single IFRS framework for measuring fair value and requires disclosures about fair value measurement. The Standard defines fair value on the basis of an 'exit price' notion and uses a 'fair value hierarchy', which results in a market-based, rather than entity-specific, measurement. Any changes from adjusting valuation techniques at the date of adoption are recognized in the period of adoption, either in profit or loss, or in other comprehensive income, depending on the requirements of the underlying standard. The standard applies to all companies, with no exceptions for nonpublic entities.

The key term that drives this process is *fair value*: 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. Being an exit price, it embodies expectations about the future cash flows (inflows and outflows) associated with the asset or liability from the perspective of a market participant (based on buyers and sellers who have certain characteristics, such as being independent and knowledgeable about the asset or liability)

Fair value is a market based measurement, rather than an entity specific measurement, and is measured using assumptions that market participants would use in pricing the asset or liability, including risk. As a result, an entity's intention to hold an asset or to settle or otherwise fulfill a liability is not relevant in measuring the fair value.

Relative to historical cost, MTM incorporates more timely information in financial statements. The primary effect of more timely disclosure most likely is to reduce information asymmetry[10].

Fair value is measured assuming the transaction in a principal market (the market with the highest volume and level of activity). In the absence of a principal market, it is assumed that the transaction would occur in the most advantageous market. This is the market that would maximize the amount that would be received to sell an asset or minimized the amount that would be paid to transfer a liability, taking into account transaction and transportation costs. In either case, the entity needs to have access to the market, although it does not necessarily have to be able to transact in the market at the measurement date.

The fair value measurement is made up of one or more inputs, which are the assumptions that market participants would make in valuing the asset or liability. The most reliable evidence of fair value is a quoted price in an active market. When this is not available, entities use a valuation technique to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs.

These inputs also form the basis of the fair value hierarchy, which is used to categorize a fair value measurement into one of three levels. This categorization is relevant for disclosure purposes. The disclosure about fair value is extensive, with more disclosures being required for the measurement in the lowest category (level 3) in the hierarchy.

A summary of the steps to be undertaken in order to correctly measure the fair value, is presented in the below table:

Establish the parameters	Identify the unit of account and unit of valuation
	Identify the market
Establish valuation approach	Market approach: quoted prices
	Income approach: discounted cash flows
	Cost approach: depreciation replacement cost
Establish the input of the measurement	Level 1: quoted prices for identical asset in the market
	Level 2: quoted prices for similar asset in the market
	Level 3: discounted cash flows

[9] IFRS 13 is effective for annual reporting periods beginning on or after 1 January 2013. This means that companies with a calendar year-end will be applying the Standard for the first time in 2013.

[10] Ray Ball, Sudarshan Jayaraman, Lakshmanan Shivakumar, working paper, *Mark-to-Market Accounting and Information Asymmetry in Banks*, 2012.

Measure the fair value	Fair value at initial recognition
	Highest and best use approach[11]
	Portfolio measurement exception
	Inactive markets

Unit of account. The unit of account is the level at which an asset or liability is aggregated or disaggregated for recognition purposes. It is also the level at which an asset or liability is generally aggregated or disaggregated for the purpose of measuring the fair value. When these two units differ, the term unit of valuation is used to describe the unit used for measurement.

The unit of account (unit of valuation) for financial instruments generally is the individual financial instrument. However, an entity is permitted to measure the fair value of a group of financial assets and financial liabilities on the basis of the net risk position. - section L exceptions

Portfolio measurement exceptions. An entity that holds a group of financial assets and financial liabilities is exposed to market risks (i.e., interest rate risk, currency risk, price risk) and to the credit risk of each counterparties. If certain conditions are met, an entity is permitted to measure the fair value of a group of financial assets and liabilities with offsetting risk position on the basis of its net exposure.

Under the exception, the fair value of the group is measured on the basis of the price that would be received to sell a net long position, or paid to transfer a net short position, for a particular risk exposure in an orderly transaction between market participants. Therefore, application of portfolio measurement exception is considered to be consistent with the way in which the market participants would price the net risk position at that measurement date.

In my view, application of the portfolio measurement exception changes the unit of valuation from the individual financial asset or liability to the net position for a particular risk exposure.

In order to allow an offsetting, the market risks being offset have to be substantially the same with regard to both their nature (interest rate risk, currency risk, price risk) and duration. For example, an entity could not combine the interest rate risk associated with a specific financial asset with the commodity price risk associated with a derivative liability. Any basis risk resulting from market risk parameters that are not identical is reflected in the fair value of the net position (e.g. difference in the interest rate bases: LIBOR and U.S. treasury, duration differences, etc.).

The net portfolio measurement exceptions do not relate to financial statement presentation, it does not change the requirements for presentation in the balance sheet. As a consequence, application of the exception may result in a measurement basis that is different from the basis of presentation of the financial instrument in the balance sheet. The allocation on individual financial asset or liability, for presentation and disclosures purposes, must be done on a reasonable and consistent basis using an appropriate methodology and the appropriate allocation method is affected by the fair value hierarchy of the financial instruments in the portfolio.

Valuation approaches and techniques. An entity selects those valuation approaches and techniques that are appropriate and for which sufficient data is available to measure fair value. The techniques chosen should maximize the use of relevant observable inputs and minimize the use of unobservable inputs. Valuation techniques used to measure fair value fall under three approaches:

- Market approach (quoted prices in an exchange market for equity securities, futures;

[11] Highest and best use is a valuation concept that represents the use of a nonfinancial asset by market participants that would maximize the value of the asset.

quoted prices in dealer markets; market multiples derived from a set of comparable assets)

- Income approach: present value techniques for unlisted products, Black-Scholes-Merton model for OTC[12] options, relief-from-royalty method for intangible assets expected to be used actively
- Cost approach: depreciated replacement cost (DRC) for factory plant and equipment. It estimates the replacement cost of the required capacity rather than the actual asset.

Inputs to valuation technique. These are the assumptions that market participants would use in pricing the asset or liability. Inputs are categorized in 3 levels:

- Level 1 inputs: unadjusted quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date
- Level 2 inputs: other observable inputs for the asset or liability, either directly (as prices), or indirectly (derived from prices)
- Level 3 inputs: unobservable inputs for assets and liabilities.

The fair value measurement objective remains the same regardless of the level of the inputs to the fair value measurement. Unobservable inputs also reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. An entity should select inputs that are consistent with the characteristics of the unit of valuation for the asset or liability that market participants would take into account.

The fair value hierarchy is made up of the same three levels, with level 1 being the highest.

A particular situation can be detected when measuring the *fair value at initial recognition.* If an asset is acquired or a liability assumed, the transaction price normally reflects an entry price. Although conceptually different, in many cases the exit and entry price are equal and therefore fair value at initial recognition generally equals the transaction price. If there is a difference, it is necessary to consider whether a day one gain or loss should be recognized. The transaction price might not represent the fair value at initial recognition if:

- The transaction was entered into in a market other than the principal and most advantageous one
- The transaction price is not the price within the bid-offer spread that is most representative for fair value. (when an entity uses the bid process for assets and ask prices for liabilities)
- The transaction is between related parties
- The transaction takes place under duress or the seller is force to accept the price
- The unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value.

3. Conclusions

In order to align to the new view of the financial statements, efforts must be made both by the companies and the investors.

From a company point of view, the changes imply costs and time in order to align and enhance the IT systems in order to support the new methodologies of computations required in order to obtain the fair value of their portfolios. Apart for the IT updates, a special attention must be paid to the market information, and companies must find the relevant markets and relevant data. All the data must be correctly retrieved from outside the company and stored in order to be used in the fair value calculations.

---

[12] Over the counter.

Investors expected net benefits to IFRS adoption in Europe associated with increases in information quality, decreases in information asymmetry, more rigorous enforcement of the standards, and convergence[13]

Investors must learn the meaning of this new data provided in the notes to the financial statements. Since it is a completely new and different concept, I envisage a 'transition period'. It may be that 'transition' here is not used in its first meaning, but, for sure, at the beginning, at least for a year, the majority of the investors will keep looking at the other information in the financial statement, more 'familiar' to them, and tend to avoid or ignore in their analysis, the information provided by the fair value.

Also, it is unclear how investors would react to these changes in financial reporting, and both positive and negative reactions are likely.

References

- Francois Brochet, Alan D. Jagolinzer, Edward J. Riedl, working paper *Mandatory IFRS Adoption and Financial Statement Comparability*, 2012
- Joanne Horton, George Serafeim, Ioanna Serafeim, research paper Does Mandatory Ifrs Adoption Improve The Information Environment?
- Christopher S. Armstrong, Mary E. Barth, Alan D. Jagolinzer, Edward J. Riedl, research paper *Market Reaction to the Adoption of IFRS in Europe*
- Andrea Enria, Lorenzo Cappiello, Frank Dierick, Sergio Grittini, Andrew Haralambous, Angela Maddaloni, Philippe Molitor, Fatima Pires and Paolo Poloni, *ECB Occasional Paper Series No. 13 Fair Value Accounting And Financial Stability*, 2004
- Chee Yeow, Lim Chu, Yeong Lim, Gerald J. Lobo, research paper IAS 39 Reclassification Choice and Analyst Earnings Forecast Properties
- Ray Ball, Sudarshan Jayaraman, Lakshmanan Shivakumar, working paper, *Mark-to-Market Accounting and Information Asymmetry in Banks*, 2012
- IFRS 9 Financial instrument
- IAS 39 Financial Instruments: Recognition and Measurement
- IFRS 13 Fair Value measurement
- Exposure Draft /2013/3 Financial Instruments: Expected Credit Losses
- http://www.iasplus.com/en/standards/ifrs/ifrs9
- http://www.iasplus.com/en/standards/ifrs/ifrs13

[13] Christopher S. Armstrong, Mary E. Barth, Alan D. Jagolinzer, Edward J. Riedl, research paper *Market Reaction to the Adoption of IFRS in Europe.*