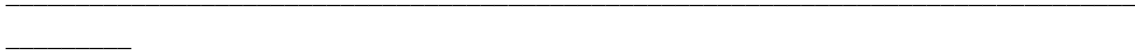


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Fair Value Accounting

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1. INTRODUCTION

Among the traditional models for valuing financial instruments, the most widely used has been the so-called mixed model, in which instruments held for trading purposes are marked to market (i.e. valued at market price) while the rest are registered at their historic cost. Against this is the so-called fair value method, in which the majority of financial instruments are recorded at their market value. In the case of credit institutions the application of one method or the other is of fundamental importance as the lion's share of their balance sheet consists of financial instruments.

In the last few years legislators at national and international level have taken steps to extend the application of the fair value principle to an ever greater range of assets and liabilities.

This paper aims to review the debate that has arisen as a result of the widespread application of fair value in accounting and its application to financial instruments in particular. It also looks at the practical aspects established by the regulations relating to it. It is subdivided as follows: first of all it presents the background to the debate on the application of the principle of fair value; it then goes on to outline the concept and the advantages and drawbacks of its widespread application. Then, the subtleties that need to be taken into account when applying fair value to financial statements are discussed, focusing on the specific practical criteria laid down by the regulations for the registration, valuation and presentation of financial instruments. Finally, by way of a conclusion, the paper rounds off with a summary.

2. BACKGROUND

In the 1980s, financial instruments referred to generically as "derivatives" underwent significant development as they came to be used to hedge against interest and exchange rate risks. This followed in the wake of the abandoning of the system of fixed exchange rates and the replacement of interest rates by money supply as the instrument of control used by the monetary authorities, with the consequence that the volatility of exchange and interest rates became much greater. Additionally, derivatives started to be used by credit institutions as a source of business with which to supplement their traditional activities.

The large-scale utilisation of instruments of this kind by large and medium-sized financial and non-financial corporations, together with the ever growing importance of capital markets as a source of investments and finance, has led to major changes in the traditional practices used to prepare financial statements intended for an external audience.

Indeed, following the stock market crash of 1929 a year's profits came to be calculated as the difference between the income accrued and costs incurred. In this context, revaluations, i.e. changes

in value other than those resulting from transactions, were not considered a realised profit and profits should only be recognised when the whole production cycle had been completed, which was something that only took place when it could be shown that there had been: a) a sale or other form of disposal, b) an increase in liquid assets. Nevertheless, in accordance with the prudence principle, unrealised losses were recorded in the year's profit and loss account.

This traditional measure of the profits obtained did not prove adequate to the task of registering and valuing the financial instruments in most widespread use in the second half of the eighties. In some cases this was because there was no cost associated with trading in them¹, or more correctly, they were zero cost (e.g. an interest-rate swap contract) and, therefore, could not be recorded on the basis of their historic cost; and in other cases, because the existence of fairly liquid markets and the development of valuation methodologies that were accepted and used by participants in financial markets to set asset prices had undermined the credibility of the historic-cost based information about these instruments given in the financial statements. In view of this situation, in the early nineties the various bodies setting financial reporting standards took a position by issuing various pronouncements which, initially, sought to tackle the problem of what at that time were called "off-balance-sheet transactions", so as to subsequently deal with issues such as information about credit and market risk, the treatment of financial coverage of these risks, etc.

These bodies agreed that the solution in accounting terms to achieve information transparency for financial instruments was fair value. However, there was, and remains, a considerable amount of controversy about how appropriate this valuation method is, given that introducing it in a "simplistic" form allows for a high degree of subjectivity, as the fair value of a large proportion of financial instruments is estimated, particularly those for which there is no active market, and as a result can lead to valuations, and therefore financial statements, that are somewhat unreliable.

The United States was the pioneer in the application of fair value, with the appearance in 1992 of SFAS² 107. With this standard the FASB obliged institutions to publish the fair value of all their financial instruments in notes to the financial statements. This included the valuation of the portfolio of loans, deposits and any other off-balance-sheet items banks could contract. Moreover, SFAS 115 obliged institutions to include the fair value of some of their negotiable securities on the balance sheet and profit and loss statement. Although the standards were criticised by the banking industry and banking supervisors, standards in other countries moved in the same direction. Thus, in the United Kingdom the Accounting Standards Board published a consultation document in 1996 in which it concluded that the mixed model was not satisfactory, proposing instead the valuation of all financial instruments at their fair value.

¹ Without taking into account the possible initial commissions or guarantees.

² Standards issued by the FASB (Financial Accounting Standards Board, the accounting standards issuing body in the US).

The International Accounting Standards Committee (IASC), later replaced by the International Accounting Standards Board (IASB), joined this trend in 1999 with issuing of an accounting standard (IAS 39, Financial instruments: recognition and measurement) which required the use of fair values in the case of certain financial instruments, particularly derivatives, as well as shares and other securities, whether held for trading purposes or for sale. This standard, which was to have particular impact on financial institutions, was sharply criticised and was felt to be premature.

In December 2000 the accounting standards bodies' Joint Working Group (JWG), on which both the IASB and national accounting standards bodies were represented, proposed an integrated and harmonised standard for the application of fair view to all financial instruments, including deposits and loans and independently from the purpose for which they were held. This proposal to make full use of fair value was greeted with scepticism by the banking sector and investors. The standard was not adopted, but the trend towards the more general use of fair value was not abandoned.

In August 2001 the IASB began a project to modify IAS 39. In 2002 it published a draft proposal, together with a call for comments. After the criticism received, in August 2003 a new draft proposal was published for public consultation and in December 2003 the IASB published the revised version of IAS 32 (Financial instruments: disclosure and presentation) and IAS 39 (although small modifications have since been made).

Within the European Union, given the need to overcome the differences between the accounting frameworks in the various Member States in order to achieve a uniform accounting framework, in July 2002 the European Parliament and Council adopted a Regulation requiring publicly listed companies, including credit institutions, to prepare consolidated financial statements in accordance with international financial reporting standards³ as of 2005.

Spanish regulations regarding the valuation of financial instruments, as far as credit institutions are concerned, are laid down by Banco de España Circular 4/2004, the object of which was to modify the accounting regime applicable to these institutions so as to adapt it to the new accounting environment deriving from the adoption of international financial reporting standards (IFRS) by the European Union.

The principles guiding this Circular are:

1. To extend IFRS beyond the scope of application of community regulations, taking them as an instrument with which to minimise the costs and uncertainties that a multiplicity of accounting criteria would impose.
2. To give management a more central role in setting the company's accounting policy. Greater flexibility means greater responsibility on the shoulders of the company's managers when setting

³ Up until 2001 the standards issued by the IASB were called international accounting standards; as of 2001 they have been known as international financial reporting standards.

accounting policy. This represents a break from the traditionally rigid and deterministic Spanish accounting model.

3. Another, equally important, aspect is that of transparency, referring not just to the content of this Circular but also to the IFRS as a whole. Again, this greater transparency calls for the managers to take more responsibility for the accounting policy adopted, to explain it, to disclose it to the market and back it up with specific information where necessary.
4. In relation to the application of fair value in the Circular, the aim pursued was to encourage those uses of fair value that facilitate proper risk management by institutions and limit its application in the case of balance-sheet items for which there is no deep market, and therefore, where the estimate of fair value is not sufficiently reliable. Thus, as well as allowing institutions to carry out solid risk management, it avoids artificial volatility in the figures balance sheet and profit and loss statement with the consequent harm to institutions' depositors and shareholders this might cause.

3. THE FAIR VALUE MODEL

3.1 DEFINITION

According to IAS 39, fair value is the amount for which an asset could or a liability settled, between knowledgeable, willing parties in an arm's length transaction .. The FASB's definition (SFAC 7.- Using Cash Flow Information and Present Value in Accounting Measurements) is very similar, and defines fair value as the total for which an asset can be sold in a real transaction between independent parties undertaking the transaction in a situation other than that of a liquidation or forced sale. This definition refers to the going concern principle so as to distance fair value from the value at liquidation.

Thus, the fair value is an estimate of how much an asset or liability could be liquidated for in a transaction taking place under market conditions. At least in theory, all assets and liabilities should have a fair value, although it will not always be easy to determine.

Starting out from the idea that the best estimate of the fair value is the market price of the asset or liability in question, and bearing in mind that this price does not exist for all items, or if it does exist it may not always be reliable, it is necessary to lay down some ordered guidelines that institutions can follow when making their estimates. According to IAS 39:

- The existence of published prices in an active market is the best evidence of fair value and when it exists, should be used to value the financial asset or liability. A financial instrument is deemed to be quoted on an active market if the listed prices are easily and regularly available.
- If the market for a financial instrument is not active, the institution should determine the fair value using a valuation technique incorporating all the factors that participants in the market would consider when establishing the price and which is consistent with accepted economic methods used to set the prices of financial instruments.

- An institution is excluded from valuing the instrument at fair value when the range of acceptable estimates of this value is significant and different estimates are likely which cannot be reasonably evaluated.

Circular 4/2004 also sets out a hierarchy of criteria with which to determine fair value. These rules are:

- First of all, reliable values from active markets should be applied
- Failing this, valuation mechanisms should be used
- If neither of the above can be used, presumed value or objective criteria should be applied.

According to Circular 4/2004 a market is active when:

- The assets traded are uniform
- Buyers and sellers willing to trade the assets can be found at almost any time.
- Prices are public.

The requirements of the definition should be understood in the context of the class of asset or liability in question. Thus, the requirement for uniformity or published prices cannot mean the same thing when we are talking about real estate or intangibles as when we are talking about financial assets.

What does not change, however, is that it must be possible to carry out the potential transaction without a significant time delay and that the price must be accompanied by at least a minimum trading volume, i.e. it must be representative.

In the case of financial instruments, it needs to be borne in mind that all instruments for which there is an active market will be listed instruments, although it is necessary to highlight that:

- The opposite is not automatically the case. A listed instrument does not necessarily have to have an active market.
- The price does not have to be listed on an organised market. The requirement for publication of prices means that they must be accessible to operators without effort, for example via computer screens.

The depth of the listing on a financial market implies that the standardisation of the asset must be virtually total. In particular, prices from wholesale or liquid markets may not be transferred to retail or non-liquid ones.

3.2 ARGUMENTS IN FAVOUR OF FULL FAIR VALUE

The so-called full fair value model proposes accounting for all financial instruments at fair value, and registering any variations in their value immediately on the profit and loss account.

Valuing all financial instruments by their fair value will allow users of financial statements to obtain a truer and fairer view of the company's real financial situation as only fair value reflects the prevailing economic conditions and the changes in them. By contrast, historical cost-based accounting shows the conditions that existed when the transaction took place and any possible changes in the price do not appear until the asset is realised.

Moreover, the widespread application of fair value offers a more consistent and comparable valuation framework, as instruments are valued at the same time and according to the same principle. The traditional model, on the other hand, does not allow comparisons to be made easily. Two companies with identical financial instruments, the same cashflows and risks, could show different values on their financial statements according to the moment in time when they bought them.

Defence of the full fair value model is drawn upon the criticisms that may be levelled against the mixed valuation model, where some instruments are recorded at historical cost and others according to their fair value. In the mixed model the criteria for valuing an instrument at its cost or market value do not depend on the characteristics of the instrument but on whether the institution intends to hold it long term or trade it; this is closely related to the distinction between the instruments pertaining to traditional banking activities (the credit portfolio) and the proprietary trading portfolio.

Thus, if the mixed model is applied, identical instruments may be valued differently and have a different effect on the balance sheet and profit and loss statement. Moreover, the separation between the credit portfolio and the trading portfolio may vary from one institution to the next, and therefore make it hard to compare financial statements.

Lastly, the mixed model creates opportunities for a degree of accounting arbitrage, that is to say, that the classification rules might be interpreted so as to categorise assets and liabilities so that it is possible to apply the most beneficial valuation criteria, in detriment to the quality of the information and, in short, the ability of financial statements to reflect the economic reality of the institution objectively and reliably,

3.3 CRITICISMS OF THE FAIR VALUE MODEL

There is a fairly wide consensus as to the appropriateness of applying the criteria of fair value to instruments held in the trading portfolio. Nevertheless, this method is forcefully rejected for the valuation of the credit portfolio and financial liabilities. In order to be useful as the basis for rational economic decision-making, financial information must be relevant, reliable and comparable. The criticisms focus on these characteristics and the impact using the fair value method would have on the stability of the system as a whole.

3.3.1 Relevance of fair value for banks' accounting practices

Financial information is relevant when it influences the economic decisions of users, i.e. it is able to confirm or alter expectations of economic decision-makers because this information reduces the uncertainty associated with any decision.

The credit portfolio includes financial instruments held on the balance sheet until their maturity and which generate yields over time as a result of the difference between the cost of financing and the amounts charged to customers. In such cases the factor determining the return is whether or not payments are made and the historical cost method provides reliable information about whether these payments are being made as agreed or not. Against this, the fair value method gets away from the process of generation of returns and cash flows, offering a result that has more to do with the opportunity cost than the essence of banking business. Obviously, the fair value of assets fluctuates over their lifetime, but if they are not going to be sold or redeemed early, registering these variations in the profit and loss account distorts the profits and introduces a fictitious volatility.

As regards financial instruments intended for trading, it is generally accepted that their fair value is the most significant value with which to record them on the balance sheet and that their variations in value must be reflected on the profit and loss statement. The discrepancies arise when trying to delimit the content of the trading portfolio. Some issuers of accounting standards maintain that they should only include derivatives other than those for hedging purposes, and financial assets listed on actively managed, deep and liquid markets. Other regulators go further and defend the inclusion of all instruments, listed or not, at no more than the discretion of the directors. Another proposal has been to treat the portfolio of "available for sale" instruments differently. This portfolio groups together all those instruments for which there is no short term management but where there is nevertheless no intention to hold them on the balance sheet indefinitely. It would seem reasonable that these securities appear on the financial statements at fair value, although while some regulators are of the opinion that variations in value must be reflected on the profit and loss account, whereas others only agree to this when the profit has been realised or the loss is irretrievable. Meanwhile, variations would be included as changes in equity.

3.3.2 Reliability of fair value

Accounting information is reliable when it shows faithfully the economic reality of the transaction, regardless of its legal form, as well as being prudent, complete and free from distortions. For this reason fair value should not be applied to all financial instruments because it is not possible to obtain reliable values for some as important as loans granted and deposits acquired, as there are no active markets for most of them, nor are there adequate valuation techniques allowing them to be estimated reliably.

In the case of loans granted by the institution, it is necessary to distinguish between uniform and non-uniform loans. Non-uniform loans are instruments for which there is no active market. This means that fair value has to be estimated using cash flow discounting techniques. This may be relatively straightforward, however, in the case of large borrowers, companies with an external rating, and traded debt that can be taken as a reference. Nevertheless, for the majority of debtors there is very little public information allowing this type of discount to be determined.

Uniform loans are assets with very similar characteristics to one another (consumer loans, mortgages on homes, etc.) which are usually classified into portfolios with uniform behaviour, and risk managed at the level of a mass of assets. In this case, fair value should be calculated by using the bank's internal rating systems. An interest rate is assigned to each loan based on the expected loss, which is used when discounting cash flows. However, these systems are not yet sufficiently developed, or at least not for all products. They are frequently used for small and highly standard loans, but their large-scale application to the whole portfolio raises serious doubts.

Lastly, it should be noted that for the purposes of external audits, it would be particularly difficult to verify if the fair values obtained using these models are reliable.

As regards sight deposits, it should be mentioned that these are a fundamental source of finance for banks and their contractual maturity is very different from the real behaviour of savers. If observed maturity is used to calculate the fair value of these liabilities it might turn out that their value is less than the nominal value, as their yield is zero or a very low interest rate. Therefore, the most appropriate estimate of their fair value is the historical cost of the deposit, i.e. its nominal value.

In the case of bonds issued by credit institutions, if these are valued according to fair value, a deterioration in the credit risk of the institution would give rise to a reduction in the value of its bonds, thus reducing the fair value of its liabilities. If the value of its assets did not change, it would result in the paradox that the reduction would, at the same time, be translated into an increase in shareholders' equity. This improvement in solvency as a consequence of a deterioration in credit risk is illogical and is particularly controversial from the point of view of banking oversight.

3.3.3 Comparability of financial information

Users of financial information must be able to analyse a company's financial statements over time and compare them with those of their competitors in order to analyse the company's financial position, performance and changes in its financial position in relative terms. Similar events and situations must therefore be treated in a similar way.

Whereas the mixed model may lead to situations in which identical instruments are given different valuations because they were acquired at different times, the results offered by this method are

consistent and perfectly comparable with one another. By contrast, applying fair value would, in many cases, entail a degree of subjectivity in the preparation of these financial statements which would make comparison more difficult. Given that institutions may use different models with substantially different assumptions to determine the fair value of the various financial instruments, both the fair value and the implications for the profit and loss statements of the various credit institutions may not be comparable.

Moreover, users of accounting information are accustomed to the mixed model and understand it perfectly well, having developed techniques that use the historical cost information to assess the company's situation and estimate future cash flows.

3.3.4 Impact on the stability of the system

If the fair value method is applied, the increase in volatility resulting from the closer relationship that would be established between the financial statements of credit institutions, their risk exposures and the prevailing economic conditions, could have consequences for the way in which these institutions manage risk or the extent to which they wish to assume it. This, in turn, could have an impact on the role of intermediaries they play and on the way in which the risks traditionally taken on by these institutions are redistributed to other economic agents.

Moreover, the earlier recognition of risk, deriving from the application of fair value, could reinforce the pro-cyclic nature of the loans business, giving rise to sharper economic cycles. An inefficient allocation of resources and suboptimal investor behaviour could result, given that projects that are not viable could obtain funding during economic booms, whereas promising projects would be rejected during times of recession.

4. APPLICATION OF THE FAIR VALUE MODEL

4.1 GENERAL POINTS

Having outlined the concept of *fair value*, in the sections that follow we will include some of the detailed points to consider when putting this concept into practice in the preparation of financial statements⁴.

As already mentioned, fair value is the amount for which an asset could be exchanged or a liability settle between knowledgeable, willing parties in an arm's length transaction . The following considerations should be highlighted when applying this criterion to value an asset or liability:

⁴ These considerations are mainly established in IAS 39 (on recognition and valuation of financial instruments) and IAS 32 (on disclosure and presentation regarding financial instruments) and in *Banco de España Circular 4/2004*, 22 December 2004.

a) Although it does not say so expressly, underlying the definition of fair value is the assumption that the company is a going concern. The fair value is a price set under normal market conditions, there is no need or intention to liquidate the asset, sell it urgently, or in general enter into transactions under duress or under terms that are unfavourable for the institution. Therefore, overestimates or underestimates due to special circumstances are excluded.

b) Fair value is determined for a specific date. At this moment certain information is available and particular market conditions and expectations exist which may change over time. Thus, the fair value on one date may not be appropriate for another. That is to say, the fair value at a given moment may not be a good estimator of the fair value in the future.

c) Fair value will be an amount agreed between " knowledgeable willing parties." This means that both the seller and the buyer are basically informed about the nature and characteristics of the asset, its state, market, etc. i.e. there are no information asymmetries.

d) "Arm's length" means that there is no special or particular relationship between the buyer and seller that may mean that the price is not that of a transaction taking place under normal market conditions.

4.2 APPLICATION OF FAIR VALUE TO FINANCIAL INSTRUMENTS

To give an idea of the importance of the concept of fair value, it should be noted that the IAS treat it as the default valuation criterion for any asset or liability (for example, when businesses are combined, all the assets and liabilities of the acquired entity are valued at fair value). In this section, given the specific make-up of a credit institution's balance sheet, we will focus on the application of fair value to financial instruments.

With the aim of showing the change that introducing the concept of fair value has brought about, it is necessary to consider for a moment the classification made in the regulations on financial instruments as this will determine the accounting criteria to be followed.

It is necessary to distinguish two moments: the time of the initial valuation and that of any subsequent valuation.

As regards the former, a financial asset or liability is initially valued at its fair value. This does not mean, in general⁵, any change from the previous regulations, as this fair value is the same, unless there is evidence otherwise, as the price of the transaction that forms the basis of its cost. Nevertheless, it is in subsequent valuations that the real impact of the new standards emerges. Thus, the following portfolios of financial assets and liabilities can be distinguished:

⁵ There are exceptions, such as swaps or non-monetary contributions to the purpose of shares whose valuation has not been modified with the introduction of the IASs.

- Financial instruments valued at fair value with changes in the profit and loss account (this basically includes the trading portfolio);
- Available-for-sale financial assets: these are valued at fair value with changes in equity until they are realised (excluding certain exceptions such as loss through deterioration and foreign currency gains);
- Held-to-maturity investments: these are valued at the amortised cost;
- Other financial instruments valued at amortised cost: these include primarily credit investments⁶ and most liabilities (also equity instruments that do not have a listed price on an active market and so for which no reliable value can be given).

Introducing the concept of fair value implies extending the valuation to market prices compared with what was established in the previous accounting standards. This is reflected in the creation of a new "available for sale" portfolio bringing together financial instruments that used to be valued at historical cost.

Once it has been determined what financial instruments should be valued at fair value, the institution has to effectively determine what this value is. To do so it is necessary to distinguish between financial instruments that have an active market and financial instruments with no market or for which the market is not very active.

4.2.1 Instruments with an active market.

The existence of published price quotations in an active market is the best evidence of fair value, i.e. prices that are regularly available and frequently updated, and which arise from real market transactions between independent parties. In these cases the fair value will be the same as the market value. This equivalence reflects the idea that through these figures participants in the market have achieved a consensus about the instrument's future cash flows and its risks and uncertainties.

The information available will vary depending on the type of market in which the asset is traded. In some markets, such as the Spanish stock exchange, there is just one price (the closing price). However, there are other markets, such as the Spanish public debt market, where buy and sell prices are published. In other cases, there may be more than one price for a given asset, as it is traded on different markets. In these cases it is necessary to consider the following points:

- When determining the fair value of a financial instrument that is traded on several active markets at once, the fair value will be the most advantageous price on the markets to which there is access and where transactions can be entered into with sufficient frequency and liquidity.

⁶ "Loans and receivables" in the terminology of IAS 39.

- When prices are presented in the form of bid and ask prices, the fair value of an asset that has been bought or a liability to be issued will be the bid price (i.e. the price at which the same asset is being offered on the market and that which the buyer is willing to pay) and that of an asset to be bought or a liability that has been issued will be the ask price (i.e. the price offered by sellers in the market).
- When an institution has assets and liabilities that between them offset market risks (e.g. when it has a debtor and creditor position in the same security), average market prices will be used to establish the fair value of the risk positions offset in this way, and the bid or offer price used for the net open position, as appropriate.
- When the market price does not include any factors that other market participants would take into account when valuing the asset, an adjustment will be made in order to consider these factors.
- In the case where there is no published price quotation for the financial instrument in its entirety on an active market, but there is an active market for its components parts, the fair value will be determined based on the market price of those components parts.
- When, rather than a price, what is listed is an interest rate, this will be used as a factor to include in the corresponding valuation model or technique.

Having highlighted these points, it should be noted that in general the application of the concept of fair value to financial instruments in an active market does not pose any practical difficulties and it seems clear that the market price is the most appropriate valuation. The problems arise when there is insufficient information from the market or this information is infrequent, irregular⁷ or not available, and it is necessary to substitute for it with estimates that include directors' valuations. In this case, the regulations are concerned with trying to obtain a measure that is as objective and reliable as possible, and to do so, the following requirements are established, which must comply with the various different valuation techniques and models.

4.2.2 Financial instruments without a market or with a somewhat inactive market.

4.2.2 a) Valuation techniques and models:

Estimating fair value using valuation techniques and models aims to determine the price of a transaction for the measurement date that, in an arm's length exchange motivated by normal business between knowledgeable and willing parties, would be given to it if it were sold, or the amount that would be necessary to acquire the assets.

The application of valuation techniques and models necessarily implies the use of the directors' judgment, which means it entails a certain degree of subjectivity. For this reason, the regulations

⁷ For example, many financial instruments (preference shares, securitisation bonds, etc.) that are listed on the AIAF (*Mercado de Renta Fija de la Asociación de Intermediarios de Activos Financieros*) fixed-income

establish a series of criteria in order to maximise the information from the market (to make maximum use of market inputs):

1. First of all, if the prices of the most recent market transactions between willing and duly informed parties acting independently are available, they should be used, provided there has not been a significant change in the economic conditions since the time of the transaction. If the economic conditions have changed (for example, a change in the risk-free interest rate), this price should be adjusted so that the fair view reflects this change. Similarly, the price of the most recent transaction should be adjusted if the institution can demonstrate that it is not the fair value (for example, because it is the result of a forced transaction, involuntary liquidation or urgent sale).
2. If the foregoing information is not available, references to the fair value of another, substantially similar, financial instrument should be used.
3. Valuation techniques and models (discounted cash flows, option pricing models such as Black-Scholes, etc.) will be used when the information enumerated above is not available. It is considered that a valuation technique offers a realistic estimate if the variables used are a reasonable representation of the expectations of market agents about this financial instrument and the risk/return factors inherent in it have been taken into account.

The inherent subjectivity of any valuation used when estimating fair value when there is no market price jeopardises its reliability. This is greatest when pure valuation techniques are used. For this reason, the standards dictate a series of guidelines with which valuation techniques and models must comply:

4.2.2.b) Characteristics of valuation techniques:

- (I) The techniques used to estimate fair value must be appropriate and consistent with economic methodologies and financial theory. They must incorporate observable market data and any other factors that participants in the market would take into account when estimating the fair value of the financial instrument concerned.
- (II) If a valuation technique is in common use by market participants, and it has been demonstrated to give reliable and more realistic estimates of the prices obtained in recent market transactions, this technique should be used.
- (III) The valuation technique must maximise the use of market inputs and limit as far as possible the use of own estimates and non-observable data.
- (IV) The choice of a valuation method or technique implies an exercise of judgement by the directors when deciding the fundamental principles and underlying theoretical assumptions.

securities market are not regularly traded, so the price should not be used as the only reference when deciding

For this reason, the regulations require that there be a wide range of documentation available on the chosen valuation method and that the reasons for choosing one alternative rather than the others be reported where appropriate.

- (V) Once a particular valuation technique or model has been chosen, this should be used over time, unless there are changes to the assumptions that led to its being chosen. It needs to be borne in mind that the valuation technique may be modified if this would result in a more reliable estimate of fair value, such as, for example, if a new technique or an improvement an existing technique has been developed. In such cases, these variations will be treated as changes in the estimates and applied prospectively.
- (VI) The valuation technique must be reviewed periodically to confirm its validity.
- (VII) The use of any valuation technique or model implies a risk known as "model risk". This risk covers the possibility that the chosen technique or model is incorrect, that it is based on erroneous assumptions or does not adequately reflect normal market behaviour. This risk always exists as there is no model or technique that is a perfect substitute for a market transaction.

As mentioned above, the fair value of a financial instrument is estimated for a specific day, using the available information and according to specific market conditions and expectations. It is normal for these factors to vary over time, therefore a value estimated for one date may be inappropriate for another, different date. Nevertheless, these changes in fair value do not indicate that the expectations were incorrect when the estimate was made, but that they have changed. In other words, the fair value of a financial instrument at a particular moment is not a good estimator of the fair value that same instrument will have in the future.

- (VIII) The valuation techniques and models use available market information as far as possible. Thus, the estimated fair value of a financial instrument will be based on one or more of the following factors:

1. The time value of money. On analysing the discounted expected cash flows the observable risk-free interest rate will be used for the period in which it is expected that each flow be produced. It is usually possible to deduce this interest rate from observable public debt prices. However, in most emerging countries, public debt is not free of credit risk. Therefore in these cases it may be more appropriate to use rates of interest on private fixed income securities, provided they are issued in the same currency and are traded on highly liquid markets between counterparties with good credit quality.

fair value.

2. Credit risk. The effect of credit risk on fair value is shown in the premium on the risk-free interest rate. This may be inferred from the observable market prices of negotiable instruments with different credit qualities, or from observable interest rates applied by lenders to borrowers with different credit ratings.

If there is insufficient information to determine the level of credit risk the market participants would consider when setting the price of the financial instrument, it may be assumed that, in the absence of evidence to the contrary, there have been no variations in the credit risk differential compared to that existing on the date of registration. Notwithstanding the foregoing, it is to be expected that the institution will make reasonable efforts to determine if there is any evidence of a change in these factors. When such evidence exists, the institution will consider the effects of the change when calculating the fair value of the financial instrument.

3. Foreign currency exchange prices. for transactions in different currencies.
4. Commodity prices (for example, in the case of derivatives on commodities).
5. Equity prices. For unlisted instruments, the fair value may be estimated from valuation techniques (ratio-based models, updating of free cash flows, multiple price approach, etc.)
6. Volatility. This may be estimated from historical market data, or using volatilities implicit in current market prices.
7. Liquidity, understood as the ease with which transactions involving particular financial instrument may be undertaken. For instruments listed on relatively inactive markets, liquidity is estimated depending on the time necessary to perform the transaction without a significant variation in prices occurring; for unlisted instruments, liquidity may be estimated in relation to the unique characteristics of the instrument (necessary size of the transaction, etc.)
8. Risk of early cancellation (prepayment risk and surrender risk and risk of redemption). The estimate of the coincidence or not between the real maturity and contractual maturity may be estimated using historical data.

On this point it should be noted that in any case, the fair value of the financial liabilities that may be cancelled on sight may not be less than the present value of amount that may be demanded calculated from the date on which its repayment may be demanded.⁸

⁸ If we apply the concept of fair value to a sight deposit which accrues a very low rate of interest, but which despite the possibility of immediate withdrawal the historical experience of the institution shows it to enjoy a degree of stability, when its flows are discounted a present value lower than its nominal value would be obtained, which means a profit or loss would automatically be registered. The regulations establish this limitation in order to avoid this.

9. Servicing costs. These costs may be estimated from the commissions required by other market participants.

The aim of introducing the concept of fair value was to give the market more reliable information. However, as we have just seen, its practical application necessarily involves a degree of subjective judgement by the directors. To limit this, the regulations are very strict when it comes to establishing requirements governing the use of the valuation techniques employed, although when institutions have to apply them in practice, it is possible that certain doubts may often arise as the reliability of the valuations. To enhance reliability and mitigate the subjectivity inherent in these valuations, the regulatory framework is bolstered by an extremely broad disclosure requirement.

4.2.3 Information disclosure requirements

One of the changes brought about by the application of the International Accounting Standards is the more central role given to management in defining the company's accounting policies. This greater flexibility has a cost, however, which is the placing of greater responsibility on the company's managers.

Another important aspect is transparency. Once again, this greater transparency has the consequence that the managers of the company have increased responsibility to disclose to the market the accounting policies adopted and any additional information necessary.

As regards fair value, the management's responsibility mainly takes the form of informing users of financial statements of the hypotheses adopted and assumptions made when they value financial instruments and the fair value of those financial instruments valued at cost in financial statements. To do so, the institution must group together all its assets and liabilities into classes and it may only offset them when their book values can be offset on the balance sheet. Additionally, information will be given on:

1. The fair value of each portfolio of financial assets and liabilities compared with its corresponding book values shown on the balance sheet. Also, the fair value of the financial assets on the various portfolios must be disclosed.
2. If the fair values of the financial instruments have been determined in whole or in part by direct reference to quoted prices published by an active market, or if on the other hand, they have been obtained using some or other valuation technique, and the percentage each of these groups represents.
3. The main methods and hypotheses adopted by the company's managers to determine the fair values of the most significant classes of financial assets and

liabilities for which there are no observable prices on an active market (proportions of early payments, estimated rate of losses on loans, interest rates, discount rates, etc.)

4. The fair value of the financial instruments that have not been valued in the financial statements using this criterion (portfolio of investments to maturity, credit investment, etc.)
5. If a different fair value could be derived if the hypotheses used in the estimate of the fair value of the financial instruments included in the financial statements were changed, in whole or in part. In such cases the institution must disclose the effect that the range of possible alternatives to this fair value would have.
6. Investments in unlisted equity instruments or the derivatives linked to them which are valued on a historical cost basis as their fair value cannot be measure reliably. Similarly, a description of the financial instruments should be given, with their main characteristics, book value, reasons why the fair value could not be determined reliably, and if possible, the range of values between which it is highly likely this value is located; whether the institution intends to sell or dispose of them, and the procedure for this. In the case of the sale of these instruments the book value will be indicated at the time of the sale and the amount of the profit or loss recognised, along with any information about the market for them.
7. In the case of assets that are available for sale, the amount of the profit or loss recognised in the equity during the financial year and the amount that has been withdrawn from the equity and recognised in the profit and loss account of the year must be reported.
8. The effect on the profit and loss account caused by the changes in fair value.

However, for certain financial instruments such as short-term receivables or payables no information is required about their fair value provided that their book value is a good approximation to it.

5. CONCLUSIONS

The introduction of the concept of fair value has meant a change from the classic principles of the accounting system based on prudence and reliability. This implies both advantages and disadvantages.

One of the advantages is that the book earnings are brought closer to financial earnings, which is considered a positive outcome for the efficient functioning of the market and for the use of accounting

information in the valuation of companies. Moreover, it should be noted that the information on fair value is valued by institutions in order to determine their global financial position, and to take decisions about individual financial instruments. Furthermore, in many cases fair value represents the market's expectations about expected future cash flows for a financial instrument, which makes it of considerable significance for users of financial statements when making decisions about them.

Additionally, fair value makes it possible to compare financial instruments of the same economic characteristics, regardless of their purpose, or when or for whom they were issued or purchased, and to evaluate the management's conduct on observing the effects of their decisions to buy, hold or sell financial instruments.

Despite all these advantages, generalised use of the criterion of fair value for all financial instruments entails a series of limitations. Basically, there are certain doubts as to the reliability of estimates of the fair value of those instruments that are not traded on active, liquid markets. Also, it is inadvisable, for the reasons given, to apply fair value to institutions' financial liabilities. For these reasons the regulations, and in particular *Banco de España Circular 472004* on Financial Reporting Standards for credit institutions, encourage the use of fair value when it facilitates solid risk management, limiting its application in the case of balance sheet items for which there is no deep market and when the estimate of fair value is not sufficiently reliable. The aim is to allow institutions to manage risks correctly and avoid artificial accounting volatility in the balance sheet and profit and loss statement, with the consequent negative impact this would have for shareholders and depositors.