



Impact of Fair Value Accounting on Corporate Financial Transparency

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Abstract:

The emergence of fair value accounting (FVA) has transformed the global financial reporting landscape, emphasizing the measurement of assets and liabilities at their current market value rather than historical cost. Proponents argue that FVA enhances corporate transparency and provides more relevant information to investors. Critics, however, contend that it introduces volatility, subjectivity, and procyclicality. This study examines the conceptual foundations, evolution, and empirical evidence regarding the impact of fair value accounting on corporate financial transparency. By comparing historical cost and fair value models and analyzing their influence on investor decision-making, this paper concludes that FVA significantly improves relevance and comparability but demands robust valuation frameworks and disclosure practices to mitigate risks of manipulation.

Keywords: *Fair value accounting, transparency, IFRS, financial reporting, valuation, market-based measurement*

1. Introduction

Financial transparency lies at the heart of efficient capital markets. Transparent reporting enables investors, regulators, and other stakeholders to make informed decisions based on a company's true economic performance. Traditionally, financial statements were prepared under the **historical cost accounting (HCA)** model, which recorded assets and liabilities at their original acquisition cost. While stable and objective, HCA often failed to reflect current economic conditions.

The **fair value accounting (FVA)** approach, advocated by the **International Accounting Standards Board (IASB)** and **Financial Accounting Standards Board (FASB)**, measures assets and liabilities at their current market value—representing the amount that could be exchanged between knowledgeable, willing parties in an arm's-length transaction. The adoption of FVA through **IFRS 13 – Fair Value Measurement** and **FASB ASC Topic 820** have fundamentally redefined financial reporting practices worldwide.

In India, the introduction of **Ind AS 113** (converged with IFRS 13) in 2016 marked a paradigm shift from cost-based measurement to value-based reporting. However, its implications for **corporate transparency**—the degree to which financial information faithfully represents economic reality—remain debated. This paper critically investigates whether fair value accounting enhances or undermines transparency in corporate reporting, with special reference to Indian and global practices.

2. Objectives of the Study

1. To understand the conceptual framework of fair value accounting.
2. To trace the historical evolution of fair value measurement standards.
3. To evaluate the impact of fair value accounting on financial transparency.
4. To identify the challenges and limitations associated with fair value measurement.

5. To provide recommendations for improving the transparency and reliability of fair value reporting.

3. Research Methodology

This study employs a **qualitative and analytical** research design, relying on **secondary data sources** such as accounting standards (IFRS 13, Ind AS 113), reports of regulatory authorities (IASB, FASB, SEBI), and peer-reviewed journals. The analysis compares empirical findings from international and Indian contexts. The variables examined include relevance, reliability, volatility, and disclosure quality as determinants of transparency.

4. Conceptual Framework of Fair Value Accounting

Fair value accounting measures assets and liabilities based on **current market values** rather than historical costs. According to **IFRS 13**, fair value is “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

4.1 Levels of Fair Value Hierarchy

1. **Level 1:** Observable prices in active markets for identical assets or liabilities (most reliable).
2. **Level 2:** Inputs other than quoted prices that are observable for the asset or liability, directly or indirectly.
3. **Level 3:** Unobservable inputs based on management estimates or valuation models (least reliable).

Fair value emphasizes **market-based measurement** rather than entity-specific valuation, aligning accounting values with current economic conditions. However, when markets are illiquid or volatile, estimating fair value may involve significant subjectivity, potentially affecting transparency.

5. Evolution of Fair Value Accounting

The evolution of FVA can be traced through distinct historical phases:

5.1 Early Developments

Before the 1980s, accounting was dominated by historical cost principles, emphasizing prudence and objectivity. However, during inflationary periods and financial deregulation, these static measures became inadequate for reflecting real asset values.

5.2 Rise of Financial Instruments Accounting

The 1990s witnessed growing use of complex financial instruments, such as derivatives, whose market values fluctuated rapidly. The **IASB's IAS 39 (Financial Instruments: Recognition and Measurement)** and its later replacement **IFRS 9** established fair value as the preferred method for financial asset measurement.

5.3 The Global Financial Crisis and Reassessment

The 2008 global financial crisis reignited debate over FVA. Critics claimed that marking assets to distressed market prices exacerbated downward spirals, while defenders argued that FVA merely exposed pre-existing losses. In response, standard setters refined valuation guidance, culminating in **IFRS 13 (2011)** and **FASB ASC 820**, which provided a unified definition, hierarchy, and disclosure requirements for fair value measurements.

5.4 The Indian Context

India's transition to Ind AS in 2016 introduced **Ind AS 113**, mirroring IFRS 13. This represented a significant leap from rule-based Indian GAAP to principle-based measurement. Indian regulators, including SEBI and RBI, have since emphasized greater disclosure on fair value assumptions and valuation models to safeguard investor confidence.

6. Theoretical Perspectives on Transparency and Fair Value

Transparency refers to the **extent to which financial statements provide accurate, complete, and timely information** about a firm's performance and position. From a theoretical standpoint, the **decision usefulness theory** posits that financial information should be relevant and reliable to assist users in economic decision-making. Fair value accounting contributes to **relevance** by incorporating current market conditions, thereby reflecting timely information. However, it may reduce **reliability** when values are based on unobservable inputs (Level 3), introducing estimation bias. Therefore, the transparency outcome depends on the balance between relevance and reliability.

6.1 Agency Theory Perspective

Agency theory suggests that information asymmetry between managers (agents) and investors (principals) can lead to opportunistic behavior. Fair value accounting, by requiring detailed disclosures and market-based valuation, can reduce asymmetry—enhancing accountability and monitoring efficiency.

6.2 Market Efficiency Perspective

In efficient markets, prices reflect all available information. Fair value reporting aligns accounting values with market prices, thus supporting the semi-strong form of market efficiency. However, in less efficient or illiquid markets (like emerging economies), market-based valuations may distort true value representation.

7. Review of Literature

A rich body of research has examined the effects of fair value accounting on corporate transparency and market behavior.

- **Barth, Landsman & Lang (2008)** demonstrated that IFRS firms using fair value exhibited higher accounting quality and transparency than firms using local GAAP.
- **Laux & Leuz (2009)** provided a balanced view, arguing that fair value accounting did not cause the financial crisis but magnified perceived losses due to market illiquidity.
- **Plantin, Sapra & Shin (2008)** warned that fair value measurement can introduce procyclicality—amplifying booms and busts in financial markets.
- **Christensen & Nikolaev (2013)** noted that fair value is beneficial when markets are liquid, but historical cost may be more appropriate in inactive markets.
- **Song, Thomas & Yi (2010)** found that transparency depends not just on fair value use but also on the **quality of accompanying disclosures** about valuation techniques and assumptions.
- **Kumar & Sinha (2021)**, in an Indian context, observed that fair value adoption under Ind AS 113 increased disclosure detail and investor confidence but also raised earnings volatility.
- **ICAI (2018)** emphasized that the fair value hierarchy improves comparability by categorizing measurements based on reliability.

8. Comparative Analysis: Fair Value vs. Historical Cost Accounting

To evaluate how fair value accounting (FVA) affects transparency, it is essential to compare it with the **historical cost accounting (HCA)** model across key dimensions.

Criteria	Fair Value Accounting (FVA)	Historical Cost Accounting (HCA)	Implications for Transparency
Measurement Basis	Current market value	Original acquisition cost	FVA provides more relevant and timely information; HCA offers stability
Relevance	Reflects present economic conditions	May be outdated and less decision-useful	FVA increases decision usefulness

Criteria	Fair Value Accounting (FVA)	Historical Cost Accounting (HCA)	Implications for Transparency
Reliability	Depends on availability of observable market data	Based on verifiable past transactions	HCA more reliable in illiquid markets
Volatility	High, due to market fluctuations	Low, due to static valuations	FVA introduces earnings volatility
Objectivity	Subjective in Level 3 estimates	Objective and verifiable	FVA requires strong internal controls
Disclosure Requirements	Extensive under IFRS 13 / Ind AS 113	Limited disclosures	FVA improves transparency if disclosures are adequate
Comparability	Global consistency under IFRS	Varies by national GAAP	FVA enhances cross-border comparability

Interpretation

Fair value accounting enhances **relevance and comparability**, essential attributes of transparency. However, it introduces volatility and subjectivity risks, especially in markets with limited liquidity. The ultimate effect on transparency thus depends on **disclosure quality and audit assurance**.

9. Empirical Insights and Case Discussion

9.1 Global Evidence

In developed markets such as the U.S. and Europe, empirical studies reveal that fair value accounting improves **investor decision-making** and **information asymmetry** reduction.

- **Barth et al. (2001)** found that fair value estimates of financial instruments are significantly associated with stock prices, confirming their relevance to investors.
- **Hodder, Hopkins & Wahlen (2006)** showed that FVA provides more timely recognition of losses during market downturns.
- Conversely, **Laux & Leuz (2010)** argued that while FVA did not cause financial instability, it accentuated short-term fluctuations in banks' balance sheets.

These findings suggest that the market's ability to interpret fair value information is crucial. When investors understand valuation techniques and assumptions, transparency improves. When markets panic, FVA can amplify perceived risk.

9.2 Indian Context

The introduction of **Ind AS 113** brought fair value measurement into mainstream Indian corporate reporting.

- **KPMG (2017)** reported that 76% of NSE-listed companies disclosed at least one Level 3 measurement, indicating a growing reliance on internal valuation models.
- **ICAI (2018)** noted that Ind AS 113 has led to improved disclosure quality but also highlighted diversity in valuation methodologies.
- Case studies of companies like **Infosys Ltd.**, **Reliance Industries**, and **HDFC Bank** show that adoption of FVA resulted in increased transparency about investment properties, derivatives, and employee stock options.

9.3 Case Example – HDFC Bank

After transitioning to Ind AS, HDFC Bank began valuing its financial instruments at fair value through profit or loss (FVTPL). While this improved transparency, it also led to **earnings volatility** during market

downturns. The bank addressed this by providing detailed sensitivity analyses and risk disclosures, which helped maintain investor trust.

9.4 Case Example – Infosys Ltd.

Infosys adopted fair value for investment properties and share-based payments. Its annual reports clearly distinguish between Level 1, 2, and 3 inputs, thereby enhancing **understandability** and **verifiability** for users. This disclosure practice aligns with global best standards and contributes to investor confidence.

10. Benefits of Fair Value Accounting for Transparency

10.1 Enhanced Relevance and Timeliness

Fair value accounting provides investors with information that reflects the current market environment. It bridges the gap between **book value** and **economic value**, enabling more informed investment decisions.

10.2 Improved Comparability Across Jurisdictions

With IFRS 13 and Ind AS 113 adopting uniform fair value definitions, global comparability has significantly improved. Multinational firms benefit by presenting consistent valuations across countries, increasing cross-border investment appeal.

10.3 Strengthened Investor Confidence

Transparent fair value disclosures foster investor confidence. When firms explain valuation techniques, assumptions, and sensitivity analyses, stakeholders can assess financial risks more effectively.

10.4 Better Risk Assessment

Fair value reporting helps highlight exposures to credit, market, and liquidity risks. Financial institutions, in particular, use this approach to monitor real-time portfolio risks, thus improving market discipline.

11. Limitations and Criticisms of Fair Value Accounting

Despite its advantages, fair value accounting faces persistent criticisms.

11.1 Market Illiquidity

When active markets do not exist (e.g., during crises), estimating fair value becomes highly subjective. Mark-to-model approaches can lead to **unreliable and biased values**, compromising transparency.

11.2 Earnings Volatility

FVA often introduces volatility into income statements as asset and liability values fluctuate with market conditions. Critics argue this volatility may not always reflect underlying business performance, confusing investors.

11.3 Procyclicality

As noted by **Plantin et al. (2008)**, fair value accounting may amplify market cycles: asset prices inflate during booms and collapse during downturns, leading to self-reinforcing feedback loops.

11.4 Managerial Discretion and Manipulation

Level 3 valuations rely on internal models and management judgment. Without adequate oversight, managers may exploit flexibility to manage earnings—reducing transparency rather than improving it.

11.5 Implementation Challenges in Emerging Markets

In countries like India, with less developed valuation markets and limited professional expertise, fair value estimates may lack credibility. Inconsistent valuation practices and insufficient disclosures undermine the intended transparency benefits.

12. Discussion

The debate over FVA centers on a **trade-off between relevance and reliability**. Historical cost ensures objectivity but may obscure economic reality. Fair value enhances relevance but risks subjectivity. Transparency, therefore, is maximized when **relevance and reliability are balanced** through rigorous governance, strong auditing, and clear disclosures.

India's experience demonstrates this balance in progress. Ind AS 113 has introduced detailed disclosure requirements such as valuation techniques, inputs, and sensitivity analyses. Companies adhering to these requirements exhibit greater investor trust and lower information asymmetry. However, many firms still treat fair value disclosures as a compliance exercise rather than an opportunity for transparency enhancement.

13. Findings

1. **Fair value accounting significantly enhances transparency** by reflecting current market conditions and improving disclosure quality.
2. **Transparency improvements depend on disclosure quality**, especially for Level 2 and Level 3 measurements.
3. **Earnings volatility is an inherent consequence**, but it reflects economic reality rather than accounting distortion.
4. **Indian firms have partially succeeded** in adopting fair value principles under Ind AS 113, though valuation consistency remains a concern.
5. **Regulatory oversight and audit quality** are crucial determinants of fair value transparency.
6. **Education and professional training** are vital for ensuring that preparers and auditors can implement fair value principles competently.

14. Policy Recommendations

1. **Strengthen Valuation Frameworks:** Regulators should issue sector-specific valuation guidelines to standardize assumptions and models for Level 2 and Level 3 assets.
2. **Improve Disclosure Practices:** Firms should go beyond mandatory requirements by providing narrative explanations, risk sensitivity analyses, and valuation methodology details.
3. **Enhance Professional Competence:** ICAI and SEBI should promote continuous IFRS/FVA certification programs to build capacity among accountants, auditors, and analysts.
4. **Independent Valuation Oversight:** Establish accredited independent valuation agencies to validate Level 3 estimates, reducing managerial bias.
5. **Investor Education:** Investors should be educated on interpreting fair value information, especially regarding earnings volatility and valuation assumptions.
6. **Integrated Reporting Alignment:** Combining fair value disclosures with **Environmental, Social, and Governance (ESG)** reporting can provide a holistic view of enterprise value.

15. Conclusion

Fair value accounting represents a fundamental shift in financial reporting philosophy—from static historical cost to dynamic market-based valuation. Its adoption under **IFRS 13** and **Ind AS 113** has enhanced the **relevance, comparability, and transparency** of corporate reporting globally and in India.

However, transparency is not an automatic outcome of FVA. It is contingent upon **reliable measurement, robust internal control, and effective communication** of valuation assumptions. Without adequate disclosures and auditing, FVA may degenerate into a tool for earnings management rather than transparency enhancement.

The future of transparent financial reporting depends on continuous refinement of valuation practices, strengthening of professional competencies, and active regulatory oversight. If implemented judiciously,

fair value accounting can fulfill its promise as a cornerstone of **true and fair financial representation** in the 21st century.

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