

ACCOUNTANT AND USER PERCEPTIONS OF FAIR VALUE ACCOUNTING: EVIDENCE FROM FIJI

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ABSTRACT

This paper through use of proxies for users and preparers of financial reports, finds the definition and understanding of 'fair value accounting', and identifies how it is measured (for shares and property investments) in Fiji. The paper also studies benefits and limitations of the concept, examines its impact on financial reporting roles, determines appropriate alternatives of this method and forecasts its prominence and endurance in Fiji. The paper concludes that users and preparers of financial reports have similar understanding of fair value accounting. Some measurement techniques identified were the use of active markets, independent valuers and referrals to cost. Some benefits identified were better disclosure and information that is more relevant. Proxies also identified limitations of the method in terms of costs of valuation, training and hiring of professionals, and the application of subjective judgment. The proxies predict prominence of fair value accounting in the long run.

JEL: M41

KEYWORDS: Fair value accounting, measurement techniques, valuation method

INTRODUCTION

The concept of fair value accounting (FVA) has emerged due to existing limitations of historical cost accounting, major corporate collapses and tremendous pressure from users of financial reports. As a result, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) are moving away from historical cost accounting towards FVA. The world at large is affected by this move, in one way or another. Despite Fiji being such a small economy (in comparison to USA and Australia), FVA has found its way here as well. Therefore, it is essential to consider 'FVA' in Fiji's context.

Firstly, this study (using proxies for users and preparers of financial reports) explores the definition and understanding of 'FVA'. Secondly, it identifies how fair value is measured in an economy with a very small active market (for shares and property investments only). Thirdly, it ascertains the benefits and limitations associated with this accounting phenomenon. Next, it touches on the perceived roles of financial reports and the impact that FVA will have on these roles. Finally, the study considers alternatives of this method and forecasts the prominence and endurance of FVA.

LITERATURE REVIEW

The Australian Accounting Standards Board (AASB) Statement of Financial Accounting Standards (SFAS) 157 *Fair Value Measurements* defines fair value as the price that would be received to sell an asset or paid to transfer a liability, in an orderly transaction between market participants at the measurement date. According to Herz (in Young, 2008), fair value is the price that one would get in a reasonable exchange between knowledgeable parties. The focus is on exit price and not the entry price.

However, Zacharski, Rosenblat, Wagner and Teufel (2007) specify that fair value includes market value but is not restricted to situations where current market quotations are available. Accounting standards discuss various ways of measuring fair value. The International Accounting Standard (IAS) 39 *Financial Instruments: Recognition and Measurement* requires an entity to use the most advantageous active market in measuring the fair value of a financial asset or liability when multiple markets exist, whereas IAS 41 *Agriculture* requires an entity to use the most relevant market.

Both IASB SFAS 157 and FASB SFAS 157, have been developed regarding FVA. These require an entity to use the principal market for the asset or liability. In absence of such, the entity uses the most advantageous market. A principal market is one in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity. The most advantageous market is one in which the reporting entity maximizes amount received for the asset or minimizes amount paid to transfer the liability, considering transaction costs.

Zacharski *et al.* (2007) note the FASB Statement identifies three valuation techniques: the market approach, income approach, and cost approach, requiring use of a given technique when sufficient data is available and where appropriate. Market approach uses observable prices and other relevant information generated by transactions involving identical or comparable assets. Income approach converts future amounts to a single present value amount. Cost approach is based on the amount that would be currently required to replace the service capacity of an asset. In some instances, there is use of a single technique, whereas in others, multiple valuation techniques may be appropriate.

They further explain the FASB Statement hierarchy, based on whether inputs are observable or unobservable. Observable inputs reflect assumptions used by market participants in pricing the asset or liability based on data obtained from sources independent of the reporting entity. Unobservable inputs reflect the reporting entity's own assumptions (developed based on best information available in the circumstances). The Statement instructs reporting entities to use fair value techniques that maximize observable inputs and minimize unobservable ones. The hierarchy determines the level of disclosure required in financial statements. The three levels, from highest to lowest priority, are as follows:

Level 1 inputs are quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at measurement date. Level 2 inputs are observable quoted prices in active markets for similar assets or liabilities; prices for identical or similar assets or liabilities in markets that are not active; directly observable market inputs for substantially the full term of the asset or liability such as interest rates and yield curves at commonly quoted intervals, volatilities, pre-payment speeds, default rates, and credit spreads; and market inputs that are not directly observable but are derived from or corroborated by observable market data. Level 3 inputs are unobservable inputs based on the reporting entity's own assumptions about the assumptions that a market participant would use. These assumptions are those that are reasonably available, without undue cost or effort on the part of the reporting entity.

According to White (2008), it is Level 3, which almost exclusively applies to Fiji. Literature identifies various benefits of FVA over historical cost. Edwards (1975) asserts that it is little comfort to know that the historic cost of every asset held by business firms has not changed since its acquisition. Yanez (in Young 2008) expresses that FVA is an evolution in financial reporting, which seeks to give users more timely and useful information. Barth (1994) notes that advocates of FVA believe it provides measures of assets, liabilities and earnings, which are more relevant.

Chisnall (2001) indicates that fair value is regarded as conceptually superior to historical cost values. It reflects open and competitive markets assessment of current economic conditions, showing all available information, up to the measurement date. Accounting on this basis will reduce anomalies in the existing mixed accounting approach. Ratcliffe (2007) explains the objective of new principles-based guidance is

to improve balance sheet management, clarity and consistency of financial reporting. This is achieved by eliminating incidents in which related assets and liabilities are measured differently.

Conversely, literature also identifies limitations of FVA. A byproduct of FVA, as discussed by Yanez (in Young 2008) is increased volatility. Due to subjective judgment, results derived will be questionable, and may lead to litigation. Rayman (2007) believes that FVA may be misleading or flawed. Botosan, Koonce, Ryan, Stone and Wahlen (2005) also considered research, which demonstrated that due to differences in interpretation of terms, if valuation information is seen as misleading, and taken to court, it would result in litigation costs.

Godfrey J, *et al.* (in White 2008) state the stewardship function is discharged through provision of a historical record, stressing the contractual relationship between the reporting entity and those who provide resources to it. A user seeking insights of this sort will have little use for FVA. In addition, FASB 159 *Fair Value Option for Financial Assets and Financial Liabilities* does not consider certain items. For example, assets and obligations associated with pension and other post-retirement benefit plans, financial assets and liabilities recognized under lease agreements, etc. This indicates FASB 159 may be incomplete. Such lack of guidance leads to inconsistencies in reporting practice.

According to White (2008), FVA applies to jurisdictions with active secondary markets for financial instruments. Therefore, it does not apply in Fiji. He also asserts the use of Level 3 inputs will not provide reliable financial reporting. Fiji simply does not have qualified valuers, thus there are cost issues (such as hiring expatriates). Furthermore, use of fair values will make financial reporting more complex and less readily understood.

Possibly, the analytical worth of FVA is not considered high enough to warrant the cost of producing it. Moreover, other advantages can only be realized if the method is widely practiced. According to Herz (in Young 2008), financial institutions now require more rigorous disclosures and thus, a greater number of assets are being carried at fair value. In Fiji, lead is taken from the IASB. Thus, regulations already permit (and often direct) reporting entities to employ fair values.

METHODOLOGY

Face to face and telephone interviews were conducted in 2008 to gather data for this study. Due to time constraints and difficulties in selecting specific users and preparers of financial reports, proxies were employed. Eight observations were made, four on the users and four on the preparers.

Table 1: Sample Used in the Study

Proxies for Users	Designation of Interviewee
1). Unit Trust of Fiji (UToF)	Fund Accountant
2). Kontiki Capital Limited	Manager Finance and Administration
3). South Pacific Stock Exchange (SPSE)	Management Accountant
4). Capital Markets Development Authority (CMDA)	Analyst Corporate Finance
Proxies for Preparers	
1). Ernst & Young	Audit Partner
2). G Lal & Co (PKF)	Audit Manager
3). Pricewaterhouse Coopers (PwC)	Audit Manager
4). KPMG	Audit Manager

This table shows proxies for the users and the preparers interviewed in the study.

FINDINGS AND DISCUSSION

Definition and Understanding of the term 'FVA'

When it comes to defining 'fair value', preparers interpret it as the 'market price or value', or simply as the 'price for which an item would be exchanged between a willing buyer and a willing seller'. This indicates the need for consensus between willing buyers and willing sellers, in order for fair value to be established. One of the preparers emphasized FVA to be the recording of assets and liabilities at values in an open market. In such a market, there would be willing buyers and willing sellers who have no restrictions (such as, cash, price or legal constraints). In other words, fair value is the value that one would get in an active market. This is a difficulty in Fiji, as only seventeen companies are listed on the stock exchange, and these companies engage in minimal trading.

The preparers view FVA to be a broad topic, where focus is not only on the definition of the term but also on measurement, presentation and disclosure of assets, liabilities and equity in financial statements. Preparers referred to the definition of fair value in the International Financial Reporting Standards (IFRS) and opted to adopt this.

Two of the users define fair value as the value at which an item could be bought or sold in a current transaction between willing parties. Another user viewed it to be an estimate of the price an entity would realize if it were to sell an asset, or a price it would pay to relieve a liability. Fair values are seen as rational and unbiased estimates of potential market prices of commodities, based on factors such as scarcity, utility, and risk.

Another user considered FVA to be about obtaining an estimate of market value of an asset (or liability) for which there is no established market. In other words, it is about how an economy like Fiji would determine the market prices of its assets and liabilities where there is no active market, except for shares and investment properties.

Fair Value Measurement

In Fiji, preparers decide what assets and liabilities are to be reported at fair values. They first refer to active markets to determine market values of financial assets. Reference is limited as SPSE is very small and caters for only seventeen listed companies. Moreover, there is no active market for assets and liabilities apart from property development and shares. Therefore, the amount of trading is very minimal and values obtained may not be representing the actual market values.

In absence of an active market, reference is made to market prices of identical assets and liabilities of its competitors or similar industries. Since this requires judgment, preparers have to be cautious deciding on what constitutes an appropriate identical asset or liability and which entity's price should be adopted for reporting. Since companies in Fiji do not face rigorous competition and they differ in terms of size and operations, it is quite difficult to make comparisons. To allow for use of fair values, the reporting entity would have to make the companies comparable by discounting selected values using some percentages. As a result, fair value derived would be subjective and unreliable.

An independent valuation would be the third option. Since Fiji does not have skilled people to provide valuations, expatriates would be needed. Multinational firms in Fiji may also prefer to use their own valuers who are located in other countries. However, this approach would be very costly.

The common approach is the use of valuation methods stated in IAS 39 and IFRS 7 *Financial Instruments: Disclosures*. Entities could use the future maintainable earnings method, which projects

future earnings by using discount rates to calculate value of the investment. This is used by companies that have been operating profitably for some time. A business which has just started or a business that has been making losses will use the net asset backing method, where entities will use their net assets to calculate fair values. The entities could also use other methods, such as discounted cash flows or dividend earnings method.

In absence of effective markets, one could also look at future cash flows. It is difficult to obtain reliable cash flow projections due to difficulty in predicting the economic and political stability in Fiji. The Reserve Bank of Fiji (RBF) takes quite some time in releasing interest and inflation rates. Due to this delay, entities are then required to predict and use their own discount rates. Thus, fair values are based on judgments or projections and therefore, are quite subjective in nature. It then becomes difficult to rely on assumptions that have been used to determine fair values based on future cash flows or discounted cash flow methods.

In the absence of an active market or in the case where minimal trading takes place, an entity has the last resort to record its assets at cost, which is presumed to be the fair value. Statutory and private entities assume that costs are market values for investments that do not have any listed or exchange values. According to preparers, many entities have adopted this approach in Fiji.

When asked for their preference of FVA, historical cost or 'hybrid' method, preparers responded by referring to the reporting distinction between small and medium entities (SME's) and large entities in Fiji. Fiji has a hybrid system of reporting, which includes a combination of historical cost and FVA. Each entity has its own variation of the hybrid system. Hence, they account for assets and liabilities differently.

Currently, a SME is not required to report under IFRS. Therefore, in most cases, their assets are recorded at historical cost. If SME's do opt to adopt IFRS, then they could use the 'deemed cost option' in which entities could record their assets at deemed values at the beginning of the year and depreciate these assets at its deemed cost. SME is which have investments in other entities, such as shares, can classify these in different categories (specified in IAS 39) and use fair values where applicable.

Preparers are holding consultations with their clients and advising them on the merits of adopting FVA. This indicates that accounting firms want their clients to use FVA for financial reporting purposes. It benefits accounting firms in terms of higher fees (consultation, advisory and audit) and concurrently benefits users by providing more relevant information.

However, it was noted that preparers are hesitant to report financial liabilities using FVA. They prefer to record these at contractual amounts due to lack of guidance and support from financiers. Furthermore, it is believed that users will not be able to comprehend values being reported or understand how it was derived. Additionally, if entities adopt the concept of recording financial liabilities at fair values and paying these liabilities at its contractual amounts on maturity dates, the financial reports would be perceived to be misleading.

Some preparers suggest that FVA should be industry based. That is, FVA should only be used by financial services, property and plant, manufacturing companies, real estate and insurance companies. It can also be used according to nature of business, type of ownership and type of users. However, a preparer added that if a rule applies, it has to apply generally. Comparisons will not be possible if entities start to pick and choose. If assets are disclosed at two different measurement bases within one industry, the purpose of IFRS, to achieve comparability is defeated.

Users preferred to employ the hybrid system of reporting, in order to ensure a balance between reliability and relevance of information in financial reports. According to them, all items that must be reported at

fair value should be done so, while other items can be reported at historical cost. Users also stated that full adoption of FVA will not be appropriate for small businesses, due to cost factors. Therefore, they believe that small businesses should be given the option of using either fair value or historical cost, and use fair value only in instances where users would benefit. Large entities, on the other hand, should use FVA and not be given any exceptions.

Given a list of assets and liabilities, users selected those they would like to see being reported at fair values (Table 1). It can be observed that items such property, plant and equipment, investment properties, intangible assets, financial assets, biological assets, inventories, cash and cash equivalents, provisions, financial liabilities, DTA and DTL and minority interests are some elements that users want to see being reported at fair values. One user stated that all items in the balance sheet should in fact be reported at fair values. It will let users know what the elements are worth today rather than being misled through historical figures.

Table 2: List of Assets and Liabilities

Item:	User 1	User 2	User 3	User 4
Property, plant and equipment	√	√	√	√
Investment property	√	√	√	√
Intangible assets	√	√	√	√
Financial assets		√	√	√
Investments accounted for using the equity method		√	√	√
Biological assets		√		√
Inventories		√		√
Trade and other receivables				√
Cash and cash equivalents		√		√
Trade and other payables			√	√
Provisions		√		√
Financial liabilities			√	√
Deferred tax liabilities (DTL) and deferred tax assets (DTA)	√			√
Minority interest		√		√
Issued capital and reserves attributable to equity holders of the parent				√

This table shows the responses provided by users. The ticked items are elements the users would like to see being reported at fair values.

Benefits of Using FVA

Preparers stated that users are consulted in the standard setting process, that is, before exposure drafts are issued. Therefore, since users of the financial reports are driving the changes in standards, it should benefit them the most. In particular, reference was made to shareholders and potential investors.

Fair value enables shareholders to know the value of their assets (shares) based on the current market prices and enables calculation of future estimates in an entity's current financial report (as opposed to historical cost). It also enables them to make an assessment of what the proceeds from disposal would be, if their assets were disposed of in an orderly fashion. Using fair value also ensures industry-wide and cross-country comparison of financial statements and enables timely feedback. In regards to prospective investors, they will have better understanding of what the value of an entity is, and this will help them assess their potential returns.

IFRS 7 requires entities to disclose fair value of some assets that are recorded at historical cost in the balance sheet. This benefits all users in their search for more useful information to make better decisions, that is, having financial gains rather than losses. This is especially so if the entities operate in shares and property investment markets.

One of the users explained that benefits will depend on the type of entity, what the user wants and their level of understanding. The interviewee stated that if users do not understand the concept of FVA,

financial reports produced will not be of any benefit to them. According to users, the shareholders, financiers and regulatory bodies will benefit.

Under FVA, financiers will be given an opportunity to monitor the level of profit growth, as well as capital growth. FVA requires revaluation of assets, leading to changes in capital values and hence affecting growth. All financial institutions in Fiji come under the scrutiny of RBF. Fair value reporting will help them in determining the level of investments and growth in the economy. RBF places prudential requirements on financial institutions. As such, if these entities maintain their investments at cost, RBF will not know the worth of their investments and also will not be able to assess whether the entities are adequately covered.

The major benefit of FVA is that it provides useful and relevant information for decision-making. Financial statements will show the market value of the business, and as such, despite a decrease in reliability, it will rank high in terms of relevance. It is felt that regardless of this tradeoff, the qualitative factor of relevance will surely assist users.

Limitations of FVA

According to the preparers, the major limitation associated with FVA in Fiji is the issue of costs. This is in terms of getting expatriates and specialists to perform valuations and prepare reports. For example, insurance companies (which require actuaries) will have to hire expatriates since Fiji does not have such specialists. Also, the need for training or hiring knowledgeable and qualified professionals will increase costs. The accounting firms will have to provide consultation services to help their clients understand FVA. In contrast, a preparer argues that cost does not seem to be a major limitation as IAS 36 *Impairment of Assets* already required the entities to do an impairment test. Therefore, in some way or the other, entities are exposed to these costs.

Entities which have greater levels of assets and liabilities tend to incur higher costs. The additional costs hinder full compliance with FVA. For example, it is approximated that The University of the South Pacific (USP) will have to spend around \$6 million in valuing its assets. This is a huge sum to expend on valuations alone. Thus USP is not in favor of this, and may fail to comply in totality. A preparer suggests that FVA should be mandatory for some organizations in particular, by looking at factors such as size, nature of business, users of the entities financial reports, and so forth. In this way, many small organizations will be saved from the cost burden.

In addition, there are practical difficulties, particularly in a small country like Fiji, where only seventeen companies (with minimal trading activities) are listed on the SPSE. Entities may not be able to comply fully with fair value reporting due to the absence of an active market. Furthermore, Fiji has a very vulnerable and changing economy. Due to the economic and political situation, specialists are quite reluctant to provide valuations.

FVA has also been criticized for being subject to managerial discretion and for not having properly defined valuation methods. This allows preparers to use their judgments in determining the factors or elements being used in the valuation models, and therefore, making it subjective. Valuers will have differing opinions on factors involved in these models. For example, deciding on appropriate discount rates. This could lead to under-or over-valuation of assets, leading to preparation of misleading reports. This could potentially result in litigation costs, if taken to court. Thus, financial reports will have to be thoroughly verified, before being made accessible to users. This will affect timeliness in reporting.

The choice between historical cost and FVA results in a tradeoff between reliability and relevance of financial information. Since these qualities are mutually exclusive, increasing relevance of information

compromises its reliability and vice versa. This creates a problem if reported information does not “provide useful information to financial statement users in making economic decisions” (IASB, 2008).

Users also expressed their concerns in regards to increased costs involved in adopting FVA. Also, most businesses in Fiji are family owned or private companies. In such cases, fair value reporting may not be relevant, as it does not bring in incremental revenues. Since many organizations in Fiji are small, it may be impractical and a cost burden for them to comply with FVA.

In addition, users also believe that valuation techniques adopted by entities in Fiji may not provide them with reliable information, even though it may provide relevant information to some extent. Reliability of fair values are questionable, as this information is subjective. Intentional or unintentional management biasness may result in inappropriate measurement and misstatements in earnings and equity capital. Even when valuations are done and reports are disseminated to users, there will be volatility in earnings.

There will also be problems in terms of understandability. If users are not familiar with FVA, how it is measured and the reasons for applying this concept, then eventually such reporting will be of little or of no value to them. Users will have to educate and familiarize themselves with FVA, to gain better understanding of financial reports.

Perceived Role of Financial Reports

Users uphold that financial reporting has a decision-making role. Relevant information will guide users in making informed and transparent decisions. Some users added that financial reporting also fulfills stewardship, accountability, transparency and comparability roles. Financial reporting provides a record of how funds and resources, contributed by the users, have been utilized by the entity. Comparability is achieved when users evaluate details within financial reports, and compare these across businesses of similar nature.

According to users, generally, FVA fulfills stewardship, decision making and valuation roles. It fulfills the stewardship role by making directors answerable to shareholders. It also fulfills the decision making role as shareholders will be able to make decisions, such as, whether they should continue their shareholding, realize or sell the shares based upon the realization or disposal proceeds.

However, one user believes that reporting under FVA will fulfill roles depending on the nature of business and users of its financial reports. He states that for private companies, FVA will not be useful since directors, shareholders and preparers are basically family members who have access to all information. As such, FVA will not produce any new information, but only contributes to increasing costs. However, for a public company, FVA will fulfill the role of decision-making and stewardship.

In addition, firms through use valuation models will be able to take into account relevant data, such as current economic forecasts and general market conditions to measure fair value. Hence, FVA fulfills the valuation role as well.

Prominence and Endurance of FVA

Both preparers and users agree that FVA will gain prominence and in future, will remain as part of the accounting standards. One preparer stated that although historical cost has served well, it has many limitations, particularly regarding valuation of assets. Recording of liabilities are fine under both historical cost and fair value methods, since they are stated at their contractual amounts. Assets, however, are held for longer periods of time and their values are quite volatile. Thus, there is hope that fair value will hold ground and replace historical cost.

Even though reliability is compromised when it comes to projecting risks, the use of chartered accountants and other professionals will be able to deal with the limitations of FVA. Eventually, the boards of companies may develop competencies in reviewing methods used to arrive at fair values. Valuation techniques could be revisited and reviewed. In this manner, confidence in FVA will increase and so will the demand for reporting under this method.

FVA has been present in the accounting standards for quite some time now. For example, impairment testing is not a new concept. There are possibilities that FVA guidelines may change slightly but it will definitely remain in future. IFRS's require FVA. Therefore, as more entities start adopting IFRS's, the market for FVA will expand and in this manner, it will gain prominence and survive in future.

Alternatives for FVA

From the interviews, it was noted that currently there are no alternatives for FVA. Since Fiji does not have resources to produce its own standards, there is not much choice but to rely on international standards.

However, the Fiji Institute of Accountants (FIA) has tried to seek provisions. That is, if there are practical difficulties associated in determining accurate fair values, entities are allowed resort to historical cost measures. For example, if entities do not have skilled staff or insufficient funds to hire experts, they could report assets and liabilities at historical cost.

CONCLUSION

Thus, this paper sought to find the definition and understanding of FVA and identify how it is measured (for shares and property investments) in Fiji. It also studied various benefits and limitations of the concept, examined its impact on financial reporting roles, determined appropriate alternatives of this method and forecasted its prominence and endurance in Fiji. Such information was gathered via interviews with four proxies for users and with four proxies for preparers of financial reports.

It was evident that preparers and users have similar understanding of FVA. Both agree that financial reports should be in line with either historical cost or FVA, depending on size, nature and users of financial reports. However, where one sees the need for relevant information, there is preference of FVA over historical cost accounting. Users perceive the roles of financial reports as being mostly for decision-making and stewardship purposes. They want entities in Fiji to report as many of their assets and liabilities at fair values, in order to prevent being misled like Enron's users'.

Due to time and resource constraints, this paper is based on views of eight interviewees (four each of users and preparers). This may not be a true representation of views of preparers and users Fiji-wide. To be fully conclusive, further research is needed using a greater sample size.

However, it may be agreed that FVA has its pros and cons. It will tend to provide more disclosures than what is generally provided under historical cost accounting. There will be limitations in terms of understandability, cost, reliability of information, volatility in earnings and timeliness. There are many valuation techniques being used, indicating that FVA has technical and practical difficulties in a small economy like Fiji. It has yet to develop the most appropriate and suitable way of determining fair values.

It is recommended that accounting bodies (such as FIA) create awareness, provide training and guidance to preparers. Entities should be given opportunity to resort to historical cost where they foresee practical difficulties in obtaining fair values. At this stage, differential reporting is preferred, with full compliance of FVA further in the future. Currently, no one sees any alternatives for FVA and many believe that with

daily modifications being done, FVA will survive. Therefore, it seems that even a country like Fiji is willing to adapt FVA, regardless of its limitations. This is for the benefit of users and to fall in line with other countries, in order to achieve harmonization in reporting.

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ACKNOWLEDGEMENT

The authors wish to thank the staff of SPSE, UTof, CMDA, Kontiki Capital Limited, KPMG, PwC, E&Y and G Lal &Co (PKF). They are also grateful to Professor Michael White for his comments and guidance.

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