# FAIR VALUE ACCOUNTING – A CRITICAL ANALYSIS OF INDIANSCENARIO

**Pawan Jain, Institute of Management Technology, Nagpur, India**

## ABSTRACT

*The purpose of this paper is to analyse concept of fair value accounting along with its merits & demerits as observed and concluded by researchers world over. With Indian standard setting body coming out with reporting standard on fair value accounting, the concept is being adopted by Indian corporate world. The paper also tries to present usage of concept of fair value accounting in Indian scenario. The paper is a qualitative study on the objectives mentioned and does not use any data to support the conclusion. The paper, however uses literature review extensively. Due to chosen research approach, the paper may lack generalizability hence further study can be carried out to test the work. The research has concluded that fair value accounting has merits and demerits when used for corporate financial reporting. Standard setters should laydown more comprehensive guidelines dealing with drawbacks like absence of active market, manipulation by firm's management, element of time affecting relevance & reliability of values captured under fair value. Academicians need to work on various training programs on adoption process of fair value accounting method in corporate financial reporting.*

**Keywords:** Fair Value Accounting, Indian Corporate Financial Reporting Scenario.

## INTRODUCTION

India declared independence from British rule of 200 years in August 1947. In January 1950, it became a republic. The lawmakers prepared India's own Constitution which came in forceon January 26, 1950. On business and trade regulations, Institutional ownership and business environment, India started with socialist outlook. Next 3 decades post-independence, business environment was highly regulated and License-Quota-Permit system was in place. Banks were nationalized, Insurance sector had complete monopoly of government owned companies having no representation from private sector and core & other industries were highly regulated. Private sector presence was miniscule and international corporate players were negligible.

In 1991, India faced payment crisis on Import front and under huge pressure from World Bank and IMF, it had to open up its economy for International community and private players. Next 3 decades saw India emerging as major economic, strategic and political force on world map. With second largest populated country in the world, India became a favourite market for companies across the globe. The population which was so far considered a curse for the economy,turned out to be boon and gave huge opportunity to multinational companies to come to India fromsaturated markets of Europe and America and sell their product. With one of the highest saving rate of 25% in the world, a highly controlled tax system, negligible government investment on infrastructure like roads, ports, airports, canals etc, very low consumption expenditure percentage as against world standards were some of the reasons which gave companies and government to believe that there is lot of work to be done for improvement of economy and made India attractive destination for global FMCG sector, heavy machinery and capital good sector, banking insurance& financial service sector along with many other global industrial giants. This was further fueled by two more reasons – a highly developed and very cheap Indian software development industry which provided cost



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effective advanced software to the world and English speaking population.

With global companies coming to India, domestic corporate sector smelled opportunity and initiated investment in technology upgradation, acquisition of new markets, development of new products & services, recruitment of workforce, establishing regional offices etc. For raising funds for all such activities, Indian capital market was a very costly choice as cost of raising funds was very high in India. The global capital markets were offering cheap funds but demanded high level of transparency and disclosures in financial reporting system of companies. Though India had its own financial reporting system in place yet it was not as per global standards. In 2005 when European Union adopted International Accounting Standards (later referred as International Financial Reporting Standards, IFRS), Institute of Chartered Accountants of India, Indian body for drafting and responsible for proper execution of accounting rules & regulations, started working on harmonization of Indian accounting practices with that of global accounting practices. Next decade saw great work on harmonization of Indian Accounting Standards with that of International Financial Reporting Standards. India now has its own accounting standards named as Ind Accounting Standards (Ind AS) which are very much in line with IFRS.

While converging its accounting practices with that of globally accepted accounting practices, India had to adopt few accounting practices which were very much acceptable on global level but not equally used in India. Fair Value Accounting is one such accounting practice. Due toreasons like more acceptance to historical cost concept, not a very developed market for instruments where Fair Value Accounting is to be used, more conservative approach towards accounting, lack of conceptual understanding of Fair Value Concept amongst practitioners and policy makers, Fair Value Accounting initially was not accepted as a reliable accounting system in India. However, with International accounting community using fair value accounting in Insurance sector, derivative & hedge instruments, employee stock options, valuation of financial assets & liabilities, Investment valuation etc, Indian accounting policy makers had to bring Fair Value Accounting system in main stream. The system is now being used widely in all the areas mentioned above (Bewley et al., 2021).

A plethora of qualitative and quantitative research had been carried out on application andusage of Fair Value Accounting for global business environment. Cardao-Pito & Barros (2016) observed in their study on taxation & public revenue that non adoption of FV accounting would have resulted in higher revenue for Portuguese government. Laux & Christian (2010) concluded thatadoption of fair value accounting did not result in enhancing problems for American banks duringfinancial crisis. They opined that loosening of existing fair value accounting rules would not be right approach. Taplin et al. (2014) carried out a study on adoption of fair value accounting for investment properties by Chinese companies. Study presented a comparison of adoption of fair value accounting and historical cost accounting by these companies. Another study carried out byPandya et al. (2021) on South African capital market explored the challenges being faced when applying and implementing fair value accounting requirements. Hadiyanto et al. (2018) examined whether using fair value method or the historical cost method on biological asset provides different financial reporting quality. Anicic et al. (2016) carried out a study on applying fair value accounting in Serbian corporate financial reporting. They concluded that in an active market where stable prices conditions exist, fair value application assists proper price discovery for assets & liabilities.

However, a gap still exists in research exploring scope and usage of Fair Value Accounting in Indian business environment. The paper tries to fill the gap by presenting a qualitative nature ofresearch.

The paper has been divided in following sections, - Section 1 is introduction; Section 2 presents a comprehensive literature review on usage and acceptance of Fair Value



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Accounting onglobal level and for Indian environment. It will also present a critical analysis of level of acceptance of fair value accounting as one of the valuation methods; Section 3 provides theoretical concepts for Fair Value Accounting; Section 4 explores areas where Fair Value Accounting is usedin India, comparative study of Indian accounting standard (Ind A S) and IFRS on fair value accounting, extent of usage of fair value accounting in Indian corporate financial reporting scenario, arguments in favor of and against usage of fair value accounting; Section 5 concludes the study.

## LITERATURE REVIEW

Globally, last two decades have seen increasing support for application of fair value accounting, a preferable choice over historical cost concept. Multiple studies have presented arguments both in favor and against usage of fair value accounting. The studies have been carried out considering stable economic conditions, during financial crisis, economic policy uncertainty, active market & stable price conditions etc. The studies had been carried out for Chinese, American, Serbian, Vietnamese, Japanese companies and economies. These studies had presented good arguments for and against usage of fair value concept in financial reporting under multiple economic situations (Clarke et al., 2003).

Initially, usage of fair value reporting was advocated for financial assets. Over a period oftime, there came plethora of studies which supported usage of fair value accounting for other corporate financial reporting issues also (Nguyen, 2019).

This section discusses broadly the literature that examine usage of fair value accounting invarious economic conditions, usage of fair value accounting in various countries and arguments infavour of and against usage of fair value accounting.

Ozili (2021) discussed utility of fair value accounting in providing financial information useful for users during economic uncertainty. He concluded that fair values during high economicuncertainty should reflect both the fair value and other valuable private information that is relevantto the transaction. He further concluded that fair value accounting numbers may be less relevant during unstable and uncertain times. Enahoro & Jayeoba (2013) discussed framework for measuring fair value as per IFRS 13. Palea (2014) argued that fair value accounting alone cannot provide useful financial information and that historical cost model is also required. Critics also argued against considering fair value accounting as a method for valuing financial assets & liabilities. They were of the opinion that one of the reason of worsening 2008 financial crisis wasusage of fair value accounting.

Barth & Landsman (2010) supported this viewpoint in their study which argued that if there are no observable market prices on which to determine the fair value estimates, the managers may utilize this as an opportunity to manipulate the estimates. Menicucci & Paolucci (2016) in their literature based analysis on fair value accounting and financial crisis concluded that fair value accounting information is highly volatile and sensitive to market prices and it can mislead investorson financial values during market bubbles. Wallison (2008) concluded that fair value accounting has been the major reason of an unprecedented financial institutions instability and bad economiccrisis in the USA. He was also of the view that fair value accounting is highly pro-cyclical.

Magnan (2009) observed similar finding that fair value accounting amplified financial crisis and created disconnect between financial reporting and business reality. Dixon & Frolova (2012) in their study on accounting standards reforms concluded that it has become a daunting task for Board of Directors (BoD) to fairly present the financial condition of a reporting business entity. BoD in current scenario need to inform themselves about the estimation models and management assumptions underpinning fair value accounting estimates; and satisfy themselves that the fair value accounting estimates incorporated into



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financial statements have been appropriately calculated in accordance with best industry practice and are in the best interest of the business entity (Badertscher et al., 2012).

Another study carried out by Alqatamin & Ezeani (2021) investigated the association between the estimates of fair value and external auditor's fee. The study found that external auditors are likely to spend more efforts for complex estimates, thereby increasing audit fee. The study tried to examine the validity of complex fair value estimates. Muller in their study of European Real Estate Industry observed that firms adopting IAS -40 mandatorily exhibited a larger decline in the information asymmetry which was reflected in lower bid-ask spread. They also found in their research that mandatory adoption firms continue to have higher information asymmetry than voluntary adoption firms which is partially due to the lower reliability of fair values reported by the mandatory adoption firms. They concluded that common adoption of fair value even for long lived tangible assets, under a mandatory reporting regime can reduce, but not necessarily eliminate, information asymmetry differences across firms. In another study carried out by Palea (2022) on appropriateness of Fair value accounting for long term equity investments which are considered key to retool economies according to sustainability criteria, it was concluded that fair value accounting has played a role in discouraging equity investments over time, thus leaving economies with poorer risk sharing and weaker long term investments.

Downing (2018) examined the interaction between fair value accounting, asset sales and banks' lending in boom & busts period and comparison with historical cost accounting. The studyconcluded that in a bust period, fair value accounting strengthens banks' incentive to sell assets while in boom period, it is done by historical cost. Further, in bust period, fair value adoption increases bank lending capacity while in boom period, increase in asset sales results in increased lending capacity for banks. Parbonetti et al. (2011) focussed on relationship between fair value accounting and the quality of the information used by financial analysts, a key group of financial markets participants. They concluded with mix findings. The results showed that larger the extentof a bank's assets and liabilities reported at fair value, more dispersed are analysts' earnings forecasts. Moreover as fair value increases, properties of analysts' forecasts deteriorate, showing a decrease in precision of public or private information. Further, shift from level 2 to level 3 decreases the informational properties of fair value disclosures. However, paper suggests that thedisclosure of levels has been beneficial to investors as it enhanced private information precision resulting in more accurate and less dispersed analysts' forecasts.

Blankespoor et al. (2013) carried out a study on whether adopting fair value accounting improve association between bank leverage and credit risk in which it was concluded that leverage ratios based on fair values of all financial instruments describe a bank's credit risk better than GAAP or tier 1 capital leverage ratios. The evidences further suggested that banks' financial statements with financial instruments measured at fair value, including loans, deposits, debt and held to maturity securities, are more descriptive of the credit risk inherent in the business model of banks than the current GAAP financial statements. Barth et al. (2008) carried out another studyon impact of fair value accounting on equity & debt value of a firm. The study concluded that if fair values were recognized, then firms experiencing increases in credit risk would recognize gainsbecause increases in credit risk results decreases in debt value; the opposite would be the case for firms experiencing decrease in credit risk. Peng & Bewley (2010) in their study on assessing feasibility and desirability of a major emerging economy adopting and implementing fair value accounting, as codified in IFRS by studying china's recent experience found a high degree of adoption of IFRS fair value accounting standards in china's 2007 GAAP for financial instruments, but many differences for non-financial long term asset investments. The Research found standard setters justifying this divergence by fundamental characteristics of Chinese environment. The



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resulting differences from IFRS in the 2007 GAAP fair value accounting standards, and in their implementation challenge official claims of "*substantial convergence*" between 2007 GAAP & IFRS.

Bewley et al. (2018) concluded another study on Chinese data. The research examined china's stop-start adoption of fair value accounting into its national accounting standards. While analyzing how fair value accounting standards were eventually adopted in China despite its conservative accounting tradition, the study concluded that shared interest of elite national and international groups, creation of social infrastructure, marshaling of key resources and specific actions to frame fair value accounting standards are found to be major factors supporting fair valueaccounting reforms in china.

Majercakova & Skoda (2015) observed that concept of fair value accounting is far from being perfect. The study found it difficult to determine the contribution of fair value accounting in improving financial reporting. Lilien et al. (2020) concluded that investors, analysts or auditors should pay attention to firms performed bargain purchase transaction, as those firms are likely to intentionally bias fair value assessment and engage in earning management practices. The study found that bargain purchase gains, and in particular the level 3 fair value estimates of intangible assets acquired, have consistently been used to smooth earnings but that such smoothening activities are not associated with long term market returns. This was another study which, throughits conclusion questioned complete validity of fair value accounting method of valuation.

Clark et al. (2003) discussed in detail implications of fair value accounting for general insurance companies. Ngoc (2020) in an empirical study of Vietnamese financial reporting scenario evaluated adoption of fair value accounting in Vietnam and impact of factors on adoptionof fair value. Study showed that human resource have the strongest and positive impact on adoption of fair value. Casta in his research looked at the usefulness of measuring a company's wealth and net income using fair value method. The research analyzed traditional accounting model based on historical cost and determining factors in the emergence of the fair value methodto address whether fair value accounting numbers provide a better estimate of the value of a company and the risk relating to its activity. Slavko concluded that higher share of mark to model assets (level 2 and level 3 fair value inputs) will increase earnings volatility as these inputsare more subjective and could contain more measurement errors.

Literature review has provided various inputs on issues such as advantages of using fair value accounting, misuse of fair value, areas where fair value is being used, and issue faced during adoption of fair value in various countries. Next session lay down conceptual framework for fair value accounting methods.

## CONCEPTUAL FRAMEWORK

As defined in Ind A S 113 (Indian accounting standard, corporate financial reporting standards, developed by Indian regulatory body), fair value is a market based measurement and not an entity specific measurement. The objective of fair value is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions. Ind AS 113 have been prepared very much on lines with IFRS 13 which deals with fair value.

As fair value is a market based measurement, it is measured using the assumptions that market participants would use when pricing the assets or liability, including assumptions about risk. As a result, an entity's intention to hold an asset or settle/fulfill a liability is not relevant whenmeasuring fair value. Therefore while measuring fair value, an entity shall take into account the characteristics of assets & liabilities if market participants would take those characteristics into account when pricing assets or liability at the measurement date. A fair



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value measurement assumes that the transaction to sell the asset or transfer the liability takes place either in the principal market or the most advantageous market for asset or liability.

Ind A S 113 deals with principal market (PM) and most advantageous market (MAM) in detail. It suggests that a company need not to do an extensive research for PM & MAM. The company will take into account all information that is reasonably available. In case of non- availability of information, if the company enters into a market and perform sale/settlement of an asset/liability, that market will be considered as PM & MAM. Further, any price in PM will be fair value for asset/liability even if price in a different market is potentially more advantageous at the measurement date. Also, PM/MAM will be considered from the perspective of the entity and it is not mandatory for the entity to sell or settle asset/liability even if it has access to market. Finally, in case of non-availability of market, transaction shall take place on measurement date and price reached shall be considered as fair value.

Ind A S 113 provide details on market participants also. An entity measures fair value of an asset or liability using assumptions that market participants will use while pricing asset or liability. It is assumed that market participants act in their economic best interest. Characteristics that distinguishes market participants are assets or liability, PM or MAM for assets or liabilities and market participants with whom the entity would enter into a transaction in that market. Further,the standard explain fair value as a price that would be received to sell an asset or paid to transfera liability in an orderly transaction in the PM at the measurement date under current market conditions regardless of whether that price is directly observable or estimated using another valuation technique. Also, the standard clarifies that price of PM would not be adjusted for transaction cost as this cost is not a characteristics of an asset/liability. It is specific to transaction.However, where location is a characteristics of asset, there fair value will be adjusted for transportcost.

Researchers all over the world have carried out extensive studies on usage of fair value concept. The studies have found that fair value can be applied to find out value of both financial and non-financial assets. Studies were also carried out to examine fairness of concept of fair valuein valuing assets & liabilities. Here, researchers have conflicting views and there is no common consensus. Ind AS 113 lays down application aspect of fair value accounting also. For non- financial assets, a fair value measurement of a non-financial asset takes into account a market participant ability to generate economic benefits by using the assets in its highest and best use or by selling it to another market participants that would use the asset in its highest and best use.

Highest and best use of a non-financial assets takes into account use of asset that is physically possible, legally permissible and financially feasible. Highest and best is also determined from market participants' perspective and not from entity's even if entity intends a different use. However use of asset is considered to be highest and best unless market or other factors suggest that a different use by market participants would maximize value of asset. For liabilities and entity's own equity instruments, according to the standard, a fair value measurement assumes that liability or entity's own equity instrument is transferred to market participants at the measurement date. In this case, the liability would remain outstanding and the market participant transferee would be required to fulfill the obligation. Further, entity's own equity instrument would remain outstanding and the market participant transferee would take on the rights and responsibilities associated with the instrument.

For financial assets & liabilities, Ind A S 113 suggests that an entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs. As per the standard, these inputs are categorized in 3 levels, level 1, 2 & 3 wherein level 1 inputs are quoted prices (unadjusted) in active



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markets for identical assets or liabilities that the entity can assess at the measurement date. Level 2 inputs are inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly while level 3 inputs are unobservable inputs for the asset or liability.

## FAIR VALUE – INDIAN SCENARIO AND CRITICAL ANALYSIS

Globally, firms have been using concept of fair value extensively for measuring and presenting value of assets & liabilities. In Indian corporate world, acceptance is gradual after Ind A S 113 have been brought in force. Firms are adopting concept of fair value with caution. However, there are multiple areas where concept of fair value is being used extensively. Jain listed real estate sector, future & options instruments, employee benefits, leasing etc as some of the sectors where concept of fair value is being used. However, with Ind A S 113, firms can use concept of fair value for financial assets and liabilities. An analysis of Indian corporate financial reporting practices and Ind A S, following can be summarized:

1. In case of a non-monetary asset is given free of cost, it is recognized at fair value.
2. Loan or assistance provided by government to the firm is initially recognized and measuredat fair value.
3. Financial assets other than trade receivables are initially recognized at fair value plus transaction cost for all financial assets not carried at fair value through P&L.Financial assets carried at fair value through P&L are initially recognized at fair value and transactioncosts are expensed in statement of P&L.
4. In subsequent measurement for financial assets, if financial asset is held with an objective to collect contractual cash flows and selling such financial assets, it is measured at fair value through other comprehensive income. However investment in financial assets other than equity instruments not measured at either amortized cost or fair value through other comprehensive income is measured at fair value through P&L.
5. All investments in equity instruments classified under financial assets are subsequently measured at fair value. Equity instruments which are held for trading are measured at fair value through P&L.
6. All financial liabilities not carried at fair value through P&L are initially recognized at fairvalue net of transaction cost.
7. Financial guarantee contracts are recognized initially as a liability at fair value.
8. Firms use derivatives financial instruments, such as forward foreign exchange contracts to hedge its foreign currency risks. Such derivatives financial instruments are initially recognized at fair value on the date on which a derivative contract is entered into and are subsequently measured at fair value.

For the purpose of true & fair view of firm's financial performance & Position, the financial data should be relevant & reliable. The biggest challenge concept of fair value is facing is to proveits reliability & relevance. We present an analysis of fair value concept on these challenges. Globally, researchers have put forth arguments in favour of and against using fair value concept. The analysis will summarize these arguments from firm's and external users' point of view.

1. Fair value accounting relies on data which is taken on the basis of current market conditions. The information collected is updated on the basis of changing market conditions. This information provides most relevant, updated and timely estimates.
2. Financial statements contain more information on methodology used in collecting data based on fair value compared to historical cost method. Firms using fair value have to provide information on assumptions made, risk associated, related information regarding observable market price etc. This increase the transparency in providing enough information to users like potential investors, contractors and lenders for their decision making process. Since there is availability of observable market price that cannot be influenced or manipulated easily, qualitatively better information can be made available tostakeholders.
3. Fair value is obtained from the market price of a given asset. In case of any doubt regardingthe validity of values such obtained, these can be obtained from available information aboutcurrent & past market price. The entire process is backed by methodology and informationcan be verified, the values provided are



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extremely reliable.

4. Another disadvantage which is due to inefficiency of market is that observed value of assetin the market may not be indicative of the asset's fundamental value. The other reasons causing this anomaly can be behavioral bias, investors' irrationality etc. Market liquidity can be another cause for this deviation.
5. In case of non-availability of market price of an asset in an active market, it is difficult to compute fair value estimate. In such situation, mark to model accounting is used which due to its complexity may create a deviation of market price of an asset from its fair value estimate. Managers may further take advantage of this situation by finalizing what kind of model or a parameter would be used and thus manipulating the fair value estimate.
6. Another factor which put question mark on reliability and relevance of fair value estimate is Time. As the information is time specific, with time passing and changing market conditions may lose its relevance & reliability. Creating new sets of values based on changed market conditions is a costly affair and may not be carried out at short intervals. A less experienced reader may find it difficult to connect values obtained and changed market conditions.
7. In a market which is illiquid, firms can easily manipulate the price due to non-availability of information on current and past market price.
8. Researchers have quite often suggested vagueness in the measurement procedure of assetsfor financial statements which creates loopholes for pricing deviations. This vagueness could produce different values resulting in deviations from desired fair value.

With all its benefits and disadvantages, fair value accounting is a method which can capturetrue market value with ease. Markets now a days are more volatile and investors seek more information on their financial decision. This has given enough scope for concept of fair value to evolve and provide live valuation of firms/assets. With ever-changing business scenario with moremergers & acquisitions, takeovers, buy-outs taking place, managers prefer to have an estimate which is reliable, relevant and present true & fair view.

Concept of fair value accounting has taken a center stage for present financial reporting system. Stakeholders world over are adopting fair value accounting as an alternative valuation system for historical cost accounting in expectation that this will make valuation process based on current values rather than historical values. Regulators have also come out with detailed guidelineson adoption of fair value accounting as a valuation method. However, various studies have provedthat both the methods – fair value & historical cost may not be able to resolve all valuation relatedissues. Each one has more than one drawback and hence cannot be considered as a full proof valuation method. Fair value estimation fails to deliver when estimation of the evaluation is be made at market value in the event of a market in growth or decline, or in the absence of an active market. Each situation involves professional judgment and possibility of manipulation by the person making the necessary estimates cannot be ignored completely.

Another challenge which was concluded by Pandya et al. (2021) in their study on South African data is that developing economies are not very inclined to replace historical cost method with fair value accounting method. This is majorly due to time & resources involved in understanding and implementing IFRS 13 dealing with fair value. Ravenscroft & Williams (2009) questioned appropriateness of shifting the emphasis from holding management accountable for their stewardship of company resources to using financial statements as a tool primarily to assess the amount, timing and uncertainty of future cash flows. These views result in the initial implementation of IFRS 13 being difficult and challenged frequently by those required to implement required changes. In another study, Christensen & Nikolaev (2009) found that Level 1 fair values are not readily available for core operating assets and that, generally, companies in non-financial businesses avoid using fair value models for non-financial elements.



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## CONCLUSION

The paper has tried to analyze fair value accounting as a valuation method. The method is not free from faults and responsibility to make necessary corrections lies on standard setters and academicians. Standard setters should lay down more comprehensive guidelines dealing with drawbacks like absence of active market, manipulation by firm's management, element of time affecting relevance & reliability of values captured under fair value. Academicians need to work on various training programs on adoption process of fair value accounting method in corporate financial reporting. This would help in reducing time and resources involved in adoption of fair value method with more companies adopting the method and thus drawbacks getting reduced.

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