International Journal of English Literature and Social Sciences
Vol-6, Issue-6; Nov-Dec, 2021

Journal Home Page Available: https://ijels.com/
Journal DOI: 10.22161/ijels

Peer-Reviewed Journal

New Evaluation Approach of Fair Value in Financial Industry

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Received: 15 Nov 2021; Received in revised form: 18 Dec 2021; Accepted: 22 Dec 2021; Available online: 31 Dec 2021

Abstract*— As a new measurement attribute, fair value has attracted significant attention since its inception and remains a challenging hotspot and difficulty in international accounting. The introduction of fair value into China's new accounting standards in 2006 marked a major breakthrough. This paper analyzes the impact of fair value on corporate profits under the new accounting standards and explores the relationship between fair value and accounting fraud.

***Keywords*— Fair value; Corporate profit; Financial fraud**

I. DEFINITION OF FAIR VALUE

China's new Accounting Standards for Business Enterprises defines fair value as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's-length transaction." The definition emphasizes three aspects: Fair value is based on fair transactions;Transactions must be voluntary, not forced or liquidation sales[1]; fair value is a measurement attribute inherently linked to market-based transactions.

Internationally, fair value encompasses both financial and non-financial items, with key components including transaction conditions (fair, orderly, non-coercive), market context, market participants (informed, independent, willing), and asset/liability transfer prices[2]. Theoretically, fair value more accurately reflects the true value of measured objects compared to historical cost, providing insights into future cash flows and aiding stakeholders in decision-making.

China's definition aligns with international standards, though its application of fair value remains more conservative.

II. APPLICATION OF FAIR VALUE IN NEW ACCOUNTING STANDARDS AND ITS IMPACT ON CORPORATE PROFITS

(1) Fair Value in Investment Property

Accounting Standard for Business Enterprises No. 3 – Investment Property permits fair value measurement if:

The property's location has an active market; Reliable market data is accessible.

Differences between fair value and book value are recorded in current profits. In China's booming real estate market, fair value often exceeds historical cost, reducing depreciation expenses and boosting profits.

(2) Fair Value in Debt Restructuring

Accounting Standard for Business Enterprises No. 12 – Debt Restructuring requires debtors to recognize gains from debt exemptions or non-cassetransactions in current profits[3]. This can significantly inflate short-term earnings.

(3) Fair Value in Financial Instruments

Accounting Standard for Business Enterprises No. 22 – Recognition and Measurement of Financial Instruments mandates initial and subsequent fair value measurement for trading securities. Fluctuations directly affect profit or loss[]4. For example, rising stock prices increase reported profits, while declines reduce them. Gains from selling equity investments (e.g., held as "available-for-sale" assets) also enhance profits.

Tax implications arise due to differences between fair value and tax bases, creating deferred tax assets/liabilities.

(4) Fair Value in Non-Monetary Asset Exchanges

Accounting Standard for Business Enterprises No. 7 – Non-Monetary Asset Exchanges requires fair value measurement if the exchange has commercial substance. This contrasts with the previous use of book value, which rarely generated profits [5].

(5) Fair Value in Business Combinations

Accounting Standard for Business Enterprises No. 20 – Business Combinations applies fair value to assets/liabilities transferred in non-controlling mergers. This improves financial transparency but may lower consolidated profits compared to historical cost methods.

III. CASE STUDIES ON FAIR VALUE'S IMPACT ON PROFITS

Analysis of 75 listed companies' 2007 annual reports revealed:

Net profit surged by 83.70%, driven by operating margins (71.49% contribution), investment income (48.83% from asset sales), and extraordinary gains (237.34% from debt restructuring[6]).

Notable Cases:

Fangda Group Co., Ltd. (Fangda A): Fair value adjustments on investment properties contributed ¥42.43 million (74.23% of non-recurring profits), boosting net profit by 205.33%.

ST Langsha Holding Co., Ltd.: Debt restructuring gains of ¥285.37 million accounted for 99.92% of extraordinary income, turning losses into profits.

China Ping An Insurance (Group) Co., Ltd.: Fair value gains of ¥6.885 billion from trading securities.

Youngor Group Co., Ltd.: Sold CITIC Securities shares for ¥3.691 billion profit, a 220% year-on-year increase.

IV. FAIR VALUE AND FINANCIAL STATEMENT FRAUD

Fair value's reliance on market inputs and subjective estimates creates opportunities for manipulation:

(1) Challenges in Measurement and Valuation Techniques

Inactive markets and complex valuation methods (e.g., discounted cash flows) introduce subjectivity. China's underdeveloped markets exacerbate risks of earnings management.

(2) Related-Party Transactions

Transactions between affiliates often lack fairness. While standards restrict non-arm's-length exchanges, hidden relationships enable profit inflation.

V. CONCLUSION

Fair value enhances financial relevance but risks misuse without robust markets, governance, and oversight. China's cautious adoption balances progress with stability. As markets mature, fair value will play an expanding role, supported by regulatory and institutional improvements.

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