

Statement of Financial Position: A Hybrid Recognition Model

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This discussion explores the hybrid combination of fair value and historical accounting measures used to present an entity's statement of financial position, including assets, liabilities, and owners' equity. Generally accepted accounting principles establish and guide valuation determinations that explain the valuation differences. The history of fair value guidance and recognition provides a foundation for presenting the advantages and disadvantages of financial measurement methods. Financial reporting valuation has evolved over time and is a copulation of both fair and historical value methodologies to determine the reported value. Future research is suggested to evaluate and resolve the outstanding reporting differences, concerns and issues.

Keywords: fair value, historical cost, financial statement measurements, codifications

INTRODUCTION

Different measurement models for valuing financial statement assets and liabilities remain a contentious topic in accounting (Yoo et al., 2017). Ensuring the accuracy of financial information for investors, stakeholders, and financial statement users across time and industries, with relevance and comparability, creates a challenging task for accounting regulators and providers (Blecher, 2018). Throughout the twentieth century, proponents of fair value accounting have advocated for its use over historical cost for financial statement reporting. They maintain fair value, which is more relevant than historical cost, as it presents the current value of the entity's assets and liabilities. (Munteanu & Zuca, 2017). However, opponents claim that fair value has significant drawbacks, and its measurement creates inconsistent values, volatility, and financial situations, such as stock market downturns (Bischof et al., 2014; Majercakova & Skoda, 2015).

Some have suggested that historical costs represent the present value of expected future cashflow. Opponents of the historical costs recognition claim that its value changes over time and therefore the historical cost basis loses its relevance (Zeff, 2007). Early accounting guidance relied on the historical cost measurement basis because it is objective and verifiable (FASB, 2009c); however, recent pronouncements utilize more current value information (Schroeder et al., 2023).

This descriptive review contributes to the ongoing discussion of fair value and historical cost measurement guidance, as well as the values recognized for most assets and liability items presented in the statement of financial position. The current reporting model comprises a mix of both historical cost and fair value. Historical costs are the more prevalent financial statement measurement due to their early advocacy by accounting standard setters (Leuz & Wysocki, 2016; Tojek, 2021). Major accounting measurement methods used to recognize historical and fair value are identified and discussed. Given the identification of

measurement methods, major balance sheet items and their current measurement methods that comply with US GAAP are presented. Lastly, a comparison of historical cost and fair value, along with some of the setbacks associated with using specific value, is discussed. An analysis of these findings together with suggestions for future research concludes the discussion.

FAIR VALUE ACCOUNTING HISTORY

Some scholars blame fair value i.e., mark-to-market accounting practices for causing or exacerbation financial crises in the US (Laux & Leuz, 2010; Menicucci, 2014; McDonogh et al., 2020). Following the 1929 stock market crash, the New York Stock Exchange (NYSE) asked the American Institute of Accountants (AIA) to devise rules for public companies to use that would ensure consistent investment reporting, allowing investors and other stakeholders to rely on it (Emerson et al., 2010). In 1938 President Roosevelt blamed fair value accounting for the 1929 market crash and the prolonged Depression. He abolished the use of mark-to-market accounting as an acceptable accounting recognition technique due to its volatility and lack of authority in regulating the financial reporting of public companies, which resulted in investor misinformation (Cascini & DeFavero, 2011). Rather than repealing the investment measurement method alone, the AIA compiled a set of accounting principles that would become known as Generally Accepted Accounting Principles (GAAP) (Emerson et al., 2010).

The 1929 market crash also served as a catalyst for the creation of the Securities and Exchange Commission (SEC) in 1934 (Levitt, 1998). The SEC is responsible for protecting investors, maintaining fair and orderly markets, and facilitating capital formation. Although the SEC has the authority to create accounting guidance for companies listed on the exchange, it chose to assign the power of financial reporting regulation to the AICPA (Emerson et al., 2010). The AIA accountants responded by creating the Committee of Accounting Procedure (CAP) in 1939 to promulgate accounting theory and reporting standards. After two decades of ineffective accounting standardization, the AIA reorganized into the American Institute of Certified Public Accountants (AICPA) and shortly thereafter dissolving the CAP assigning its responsibility including a charge to modify GAAP to a newly created Accounting Principles Board (APB) (Young & Mouck, 1996; Emerson et al., 2010).

In 1971, the AICPA established an accounting group to study the objectives of financial statements chaired by F. M. Trueblood (Goetz & Birnberg, 1976). The primary recommendation of the Trueblood Commission was that financial statements should provide investors and creditors with useful information for economic decisions, focusing on the cash-generating ability of the business. The report also addressed accountability and stewardship by recommending that the financial statements provide information about the entity's economic resources, obligations, and owner's equity, including the disclosure of both historical cost and current cost when the values were significantly different (Zeff, 2016).

The Trueblood Commission Report substantially influenced the future Financial Accounting Standards Board's (FASB) concept framework projects, and the decision usefulness concept became an integral part of standard-setter objectives and accounting guidance (Coetsee, 2010). The decision usefulness concept was a significant departure from the earlier accounting measurement based on historical costs, entry value, and exit value used for measuring assets and liabilities (Zeff, 2013).

In 1973, the Financial Accounting Standards Board (FASB) was created and the Accounting Principles Board dissolved (Beresford, 1998). Fair value took a significant step forward with FASB Standard No. 12, Accounting for Certain Marketable Securities (FASB, 1975). This new accounting guidance allowed entities to move away from historical recognition and recognize unrealized losses or gains on security transactions as a component of reported income (Janell & Imhoff, 1978). FASB Statement of Financial Accounting Concepts No. 5, issued in 1985 and amended in 2021, identifies five measurement attributes to determine the valuation of assets or liabilities, including historical cost, current cost, current market value, net realizable value, and the present value of future cash flows (pp. 3-4). FASB provided no guidance regarding valuation because the specific situation should determine the correct method to use, and it was not the responsibility of FASB to micromanage the decision (Cascini & DeFavero, 2011).

Concept No. 5 (2021) became the basis of assets and liability fair value valuation decisions as well as the principles included in future accounting guidance. FASB Statements of Financial Accounting Standards (SFAS) guidance addressing assets and liability fair value determination include the following:

- SFAS 107: Disclosures about Fair Value of Financial Instruments (1991)
- SFAS 119: Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments (1994)
- SFAS 157: Fair Value Measurements (2006)
- SFAS 159: The Fair Value Option for Financial Assets and Financial Liabilities (2007)

FASB Standards With Fair Value Guidance

SFAS No. 107, *Disclosures about Fair Value of Financial Instruments* issued in 1991 expanded the existing historical cost guidance to require all companies to display the fair value of all financial instruments in their financial statements. The guidance was effective for companies with total assets of \$150 million or more. The guidance was expanded to all companies in late 1995 (Nelsen, 1996).

SFAS No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, issued in 1994 amended SFAS No. 107 by requiring companies to disclose derivative activities. Derivatives were defined to include currency swaps, forward contracts, and futures contracts. SFAS No. 119 objective was to report the gains and losses from derivatives transactions in the income statement (Wong, 2000).

SFAS standards No. 107 and 119 helped transition from historical cost to fair value recognition, increasing relevance to the financial statement user (Cristea, 2018). However, the reaction to the standards was mixed. Financial statement users who believed that historical cost was the appropriate way to value transactions were upset that fair-value transactions appeared to be volatile, while proponents of fair value thought the new standards did not go far enough in promoting and requiring fair-value valuations for comparability (Răscolean & Rakos, 2016).

The standards define fair value as the amount of money the asset can be sold for in the current marketplace between willing parties that are not in a forced liquidation situation, using the following fair value metrics (Kaya, 2013).

- Entry value – the purchase price (if price changes then the replacement cost)
- Exit value – the selling price it could be sold
- Value in use – value the asset provides the company that owns it

The three fair value metric definitions are argued to be too narrow. Instead, many argue that the exit value would be the most relevant metric in establishing the valuation of an asset, as it takes the value from the seller's perspective. Therefore, the financial statement reflects the asset's value at what the company could receive for the asset sale. Instead, a separate metric, 'value in use' can be calculated as entry value minus exit value (Pinto & Pais, 2015; Tang 2019).

FASB issued two new standards, SFAS No. 157, *Fair Value Measurements* (FASB, 2006), and SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FASB, 2007) to increase comparability and consistency while helping to promote the usage of fair value accounting. These new standards decreased historical recognition by expanding the number of items that could be valued at fair value including the following assets and liabilities (Ratcliffe, 2007).

- Loans receivable and payable
- Investments in equity securities
- Rights and obligations under insurance contracts
- Rights and obligations related to warranty agreements
- Host financial instruments that are separated from embedded derivative instruments
- Firm commitments involving financial instruments
- Written loan commitments

SFAS No. 157 (FASB, 2006) established a framework to measure fair value and create guidance for fair value measurement disclosures. The Standard emphasizes that fair value is a market-based

measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants can use the market price for an asset or liability. As a basis for considering fair value measurements, the guidance distinguishes between (1) those based on market data obtained from sources independent of the reporting entity (observable inputs) and (2) the reporting entity's own assumptions based on the best information available (unobservable inputs). The concept of unobservable input is designed to accommodate situations where little to no market activity is available for the asset or liability at the measurement date (Emerson et al., 2010; Kaya, 2013).

Disclosure guidance regarding the use of fair value to measure assets and liabilities in interim and annual periods was initiated to focus on the inputs used to measure fair value and for recurring fair value measurements using significant unobservable inputs together with the effect of the measurements on earnings for the period (Cascini & DelFavero, 2011; Jajairam, 2013).

SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FASB, 2007), introduced disclosure guidance to facilitate comparison between companies that have similar or the same assets and liabilities but use different measurement methods (Ristea et al., 2016). Companies can elect to use fair value for certain assets or liabilities on an item-by-item basis, allowing the company to value an item at fair value while using the historical cost method for a similar item. However, once a company uses fair value accounting to value an item it cannot switch back to historical cost later (Schneider & McCarthy, 2007; Chung et al., 2023).

FASB's main goal in issuing SFAS No. 157 (FASB 2006) and SFAS No. 159 (FASB, 2007) was to create consistent rules and therefore comparable reporting of assets and liabilities values. Before the guidance, GAAP only required selected assets and liabilities to be valued using fair value resulting in inconsistencies of how items were reported that caused a lack of comparability. This inconsistency also caused a fluctuation in earnings. Thus, the main goal of the new guidance was to reduce huge earnings' variations. For example, a company using historical cost valuation with investments consisting of stocks or trading securities would recognize any gain or loss on the sale as income only at the time of the sale or liquidation. Under the new fair value accounting standards, if the fair value option is used, gains or losses on the investments would be recognized as income or loss each period, resulting in consistent market value recognition over the period the investment is held (Cascini & DelFavero, 2011).

Fair Value Accounting Guidance Conversion to Codifications

In 2009, the FASB moved all existing GAAP pronouncements for nongovernmental entities into the Accounting Standards Codification (ASC) online at WWW.FASB.org to simplify access and improve usability. The ASC consolidated all current standards into a new, numbered, structured, online, searchable database organized by topic, which can be updated in real-time as new standards are adopted or existing standards are amended. This structure enables users to easily locate specific guidance and have access to the latest information. Thus, the Codification became the single source of authoritative nongovernment GAAP guidance (Binz et al., 2023).

SFAS No. 107 and SFAS No. 159 were combined with amendments to become *ASC 825, Financial Instruments* (FASB, 2009f), which provides reporting guidance for financial instruments. Although the Codification includes a fair value option that can be elected for certain financial assets and liabilities, its primary guidance mandates disclosure regarding fair value, concentration of credit risk, and market risk associated with the financial instruments.

The Codification's fair value option allows companies to elect to measure financial assets and liabilities at fair value, thereby reducing earnings volatility. Entities have flexibility in selecting the reporting option including an instrument-by-instrument basis. Companies that elect the fair value option must disclose the reasons for the election, how fair value changes affect earnings, and any information that would have been disclosed if the option had not been elected. Once the option is elected, it is typically irrevocable unless a new election date occurs. Any costs or fees associated with the fair value option election must be recognized immediately.

Additional required disclosures include differences between fair values and contractual cash flows, amounts of gains/losses from fair value changes in earnings, and how interest/dividends are measured. For

loans, receivables, and liabilities, entities must disclose estimated or attributable gains/losses resulting from changes in instrument-specific credit risk, along with the methods used to determine these amounts. Annual financial reports require the disclosure of methods and significant assumptions used to estimate fair value.

SFAS No. 119 was combined with various derivative accounting standards to become *ASC 815 Derivatives and Hedging* (FASB, 2009d). The Codification provides transparent and consistent format in about its derivatives and hedging activities while aligning financial reporting with risk management strategies. The standard is complex due to its extensive requirements, including documentation and fair value measurement. Guidance compliance can lead to improved transparency, enhanced risk management, and reduced financial volatility. Overall, ASC 815 establishes the accounting framework for derivative and hedging instruments and activities to promote financial reporting transparency and consistency.

SFAS No. 157 was combined with amendments and updates to become *ASC 820 Fair Value Measurements* (FASB, 2009e). Since there was no prior guidance to define fair value, ASC 820 defines fair value as the amount an asset/liability can be traded as of the balance sheet date – also known as the exit price. In addition, ASC 820 allows assets or liabilities to be either grouped or stand alone in a transaction. Grouped items may include business units, an entire business, standalone items, marketable security, or fixed assets. ASC 820 also defines three approaches to valuing the fair value of asset or liability (Emerson et al., 2010):

- Market approach: Compare value to similar assets or liabilities
- Income approach: Converted to present value by using discount rate from cash flows
- Cost approach: Creates value from a theoretical replacement perspective.

With the means to determine the fair value, ASC 820 identified the three levels of value recognition hierarchy. Level 1 is the most reliable value because the items have an available value derived from an active market or exchange, such as the NYSE. Level 2 values are derived for items that do not have analogous items exchanged in the marketplace thus a value cannot be easily or consistently determined with an accurate value. Therefore, Level 2 values are assigned values obtained from appraisals or comparable item sales. Level 3 values are more difficult to determine fair value due to their not having a marketplace or comparable basis for value determination. The entity with these assets or liabilities must use their judgement to estimate the item's value or consult an outside valuation expert to determine an appropriate fair value. The three levels within the value hierarchy can be categorized into two groups: observable and unobservable. Observable items are those with a fair value that can be obtained from an outside source or marketplace. Unobservable items are those the entity owns that due to lack of a market must employ a comparable value, the present value of future cash flows, or a reasonable estimate to value the asset or liability (Ketz, 2003; Collins, 2020).

STATEMENT OF FINANCIAL POSITION VALUES

Several valuation methods are prescribed as part of GAAP guidance to report the assets and liabilities displayed on an entity's statement of financial position. Fair value is one of the valuation methods used in financial accounting, defined by GAAP in ASC 820 (FASB, 2009e) 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. However, GAAP guidance using fair value is somewhat limited to accounting for selected assets as the use of historical cost is more frequently advocated by the FASB (Tojek, 2021; Leuz & Wysocki, 2016).

Balance Sheet

The balance sheet comprises three main elements: assets, liabilities, and equity. Assets are items that the entity has the right to its economic benefit. Liabilities are the entity's economic obligations. Equity is the residual value of the assets after deducting the liability obligations and is accounted for by the activities that contributed to the asset less liabilities difference. Each of the balance sheet elements has multiple sub-classifications that provide information for decision-making. Since the three classifications represent a myriad of transactions, they are measured using a hybrid mix of recognition methods depending on their

circumstance and available information. Some assets and liabilities are valued at historical cost, while others are valued at fair value. Additionally, some assets or liabilities are valued on another basis, such as the lower-of-cost-or-market method, e.g., inventory. The commonalities and differences in the balance sheet account measurements exist because they have different sources, value formats, life spans, and recognition or measurement procedures.

ASC 820 defines fair value as the price received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (FASB, 2009e). A fair value price shows the current and intrinsic worth of an asset or a liability and requires ongoing adjustments to reflect changes in market conditions, potentially leading to more dynamic financial reporting (Rascolean & Rakos, 2016). There are three valuation techniques used to measure fair value, including the market approach, cost approach, and income approach. The fair value for the market approach is measured at the market prices for identical or similar assets or liabilities. Fair value using the cost approach is measured at the current replacement cost of a transaction determined from a hypothetical market participant's perspective. When an income approach is used, fair value is measured by converting the net future income or expense cash flow amounts into a single current amount. These techniques can be used individually or in combination to measure the fair value of an asset or liability (Collins, 2020).

ASSETS

Current Assets

Current assets are items that represent what the entity owns and are listed on the balance sheet in order of their nearness to liquidity or cash. They typically have a lifespan of one year or less. Current assets include cash, cash equivalents, receivables, inventory, and prepaid expenses.

Cash and Receivables

Cash, cash equivalents and prepaid expenses tend to be recognized at historical value. Receivables are initially recorded at their historical value however they are adjusted annually to their net realizable value using an aging process to identify the amount that is not expected to be received. The amount of anticipated nonpayment is recognized as a contra receivable, such as allowance for nonpayment if payment is judged to be possible or as an expense if payment is not anticipated.

Inventories

According to ASC 330 (2009b), inventories are tangible property held for resale or materials to be consumed in the production of goods or services available for sale. By reporting inventory at the lower-of-cost-or-net-realizable-value, a conservative approach is ensured that does not *overvalue* inventory. Following its acquisition, management tests the inventory to ensure an up-to-date valuation. Inventory value may be reduced for several reasons, such as obsolescence, damage, or missing items. These periodic remeasurements reduce the inventory to its current market value. In the event of a reduction in value, the inventory is written down to the lower of cost or net realizable value, using either an income approach or a balance sheet approach. When reducing the inventory value through the income approach, a loss is recorded in the period it occurs as another expense. When the balance sheet approach is used, a contra account records an allowance to reduce the inventory its net value. Through the balance sheet approach, management is conservatively valuing inventory in a manner that does not exaggerate its estimated worth. In either case, according to GAAP, the inventory value cannot subsequently be increased or written up if a higher value comes into being, such as an acquisition price increase.

ASC 330 requires an entity to report inventory at the lower of cost or market (LCM). According to the Codification, when the cost of an asset exceeds its expected benefit, reducing the asset to its market value is a better measure of its expected future benefit. Thus, the term market used in the phrase lower of cost or market implies current replacement cost provided it meets two conditions: a) market does not exceed the net realizable value and b) market is not less than the net realizable value reduced by an allowance for a normal profit margin (FASB, 2009b).

The criticism of the LCM rule is that it is applied only for downward adjustments, recognizing holding losses, while holding gains are ignored. Thus, when the asset is sold, the costs are understated in the period of the sale, which can result in a misinterpretation of operating costs by external users of the financial data (Schroeder et al., 2023).

Accounting Standards Codification ASC 330 (FASB, 2009b) defines net realizable value as the estimated selling price of inventory in the course of business, less reasonably predictable costs of completion, disposal, and transportation.

Early accounting guidance required entities to measure inventory at the lower of cost or market with market defined using ceiling and a floor value less a normal profit margin. ASC 330 was amended to simplify inventory measurement by requiring entities to report inventory within its scope at the lower of cost or net realizable value. This change eliminated the need to determine the market price and its related ceiling and floor (FASB, 2015).

According to GAAP, inventory consumption changes its balance sheet value depending on the cost method employed by the entity. If inventory consumption is measured using any method other than last-in, first-out (LIFO), or the retail inventory method, the lower of cost and net realizable value is used for any subsequent measurement. However, if the inventory consumption is initially measured using the first-in, first-out (FIFO) method, the lower of cost or market is used for the subsequent measurement. The inventory on hand at the end of the fiscal period is counted to reconcile the actual value on hand with the accounting value recorded. Any difference is recognized as consumption and recognized as an expense.

Noncurrent Assets

Noncurrent assets are those with lives greater than one year and are expected to help generate entity income. Noncurrent assets commonly include trading security, investments, leases and tangible capital assets such as property, plant and equipment.

Leases

Present value is part of ASC 820 guidance that defines future accounts such leases to a present value amount using a discount rate. Present value can be used as an income approach for fair value measurement. The primary reason for using present value as a measurement method is specifically required by GAAP such as ASC 840 (FASB, 2009g) to measure lease assets or liabilities.

Investments

Observability is a key factor when measuring investments at fair value. When valuing marketable equity security, an observable input is a quoted trade price. Conversely when valuing a private company investment, an unobservable input is the company's projection. Observable inputs are those that are developed using market data and reflect the assumptions of market participants. Unobservable inputs are inputs for which market data are not available, and their value represents the entity's best understanding of the assumptions that market participants would use when pricing the asset or liability (Collins, 2020; Ishinagi & Oh, 2024).

ASC 820 requires valuation techniques to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs (FASB, 2009e). Codification 820 also established a fair value hierarchy to distinguish the levels of observability achieved by Level 1 measurements within the fair value hierarchy. Level 1 fair values are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date. Level 2 fair values are other than quoted prices that are observable for the asset or liability, either directly or indirectly while Level 3 fair values are unobservable inputs for the asset or liability (FASB, 2009e).

According to ASC 320 (FASB 2009a), trading security investments are investments that represent a creditor relationship with another entity and are typically bought and sold on exchanges such as the NYSE. GAAP requires investments in debt securities classified as trading securities to be measured at fair value and unrealized gains and losses from trading securities to be included in earnings. Investments in debt securities classified as available-for-sale securities should also be measured at fair value; however,

unrealized gains and losses from these securities must be included in equity account 'other comprehensive income' until realized. Held-to-maturity (HTM) securities are securities that the entity intends to and has the ability to hold until their maturity date. These securities are recognized at their amortized cost, which is the original acquisition price adjusted for the amortization of any premium or discount paid when acquired. Income earned from HTM securities such as bond coupons is recognized as income as it accrues over time. Unearned gains or losses that arise from holding the HTM, such as changes in market interest rates, are not recognized because the securities are intended to be held until maturity. However, if there is a permanent decline in the fair value of HTM investment or an unexpected credit loss, an impairment loss is recognized (FASB, 2009a). These recognition treatments provide stability in the entity's financial statement presentation.

Property, Plant & Equipment

Historical cost is the value resulting from a buyer and seller agreeing on an arm's-length transaction and is used to recognize property, plant, and equipment (PP&E) acquisitions. PP&E are long-lived assets that create, house and distribute products and services. These capital assets include land, land improvements, buildings, machinery, equipment, and furniture and fixtures. According to ASC 360 (FASB, 2009c) capital assets are initially measured at historical cost. In subsequent periods, depreciation is calculated based on the asset's useful life for those PP&E assets other than land. In addition, accounting GAAP guidance states that when an impairment loss is recognized, the adjusted carrying amount of a long-lived asset is recognized as its new cost basis.

LIABILITIES

Current Liabilities

Current liabilities are listed on the balance sheet in order of their nearness to consuming cash to settle the economic obligation, which typically has a life span of one year or less. Current liabilities require the consumption of current funds to satisfy their obligation that can significantly impact the working capital of the organizations. Generally, current liabilities include payables, deferrals and the current portion of long-term debt

Accounts Payable

Accounts payable tend not to create a recognition issue as the obligation value is determined by a transaction that involves a promise to pay an amount at a subsequent date. Deferrals are near-term obligations that require recognition to satisfy rather than a cash disbursement. A deferral example is the distribution of prepaid cash for services before the due date, or an advance payment received for a service obligation. Unless the deferral is substantial, recording it as a liability will not significantly impact the financial statement presentation.

When a long-term debt payment in the current period requires the use of current funds, GAAP requires the transaction to be recognized as a current liability. However, not all current maturities are classified as current liabilities. An example is the retirement of a long-term liability using special or restricted funds, which will not need to be reclassified as a current liability because the retirement will not consume current entity resources. Another situation that does not require a reclass to current liabilities is the issuance of new or additional long-term debt. Neither of these examples should be reported as a current liability as they would distort the working capital presentation.

Noncurrent Liabilities

Long-Term Debt

Typically, the largest value listed in the liabilities noncurrent section of an entity's balance sheet is long-term debt. Although many entities use historical cost to report their long-term debt obligations, SFAS 115 (FASB, 1993) established the option for business entities to elect the fair value option for long-term financial liabilities. The guidance stipulates that if an entity designates a financial liability under the fair

value option, the entity must measure the financial liability at fair value, with any qualifying changes in fair value to be recognized in net income. When SFAS 115 was converted to ASC 825 (FASB, 2009f), the guidance was amended to allow fair value changes in assets to be matched with corresponding fair value changes of liabilities due to changes in interest rates (Chung et al., 2023). Thus, if an entity anticipates holding a debt liability until maturity, the intermittent changes in fair value are not only irrelevant but also misleading to shareholders and investors. These changes create gains and losses that do not reflect the economic reality of the debt. Therefore, if a company has no intention or lacks the opportunity to extinguish a debt liability before maturity, recording the debt at the present value of its cash flows discounted at the market rate of interest more accurately describes the amount of money the entity will pay over the life of the debt.

Other Long-Term Liabilities

Other long-term payable obligations include deferred liabilities, pensions, and leases that the entity does not expect to pay in full within the normal operating cycle. Unlike debt liabilities, no portion of long-term liabilities are reported as current liabilities. Since these liabilities are not financial instruments they are not eligible to be accounted for using fair value. Therefore, these liabilities are recognized and evaluated using their historical values.

Equity

Equity is the risk capital of the enterprise. It has no guaranteed return and no repayment term for the owners. From a perspective of stability and solvency exposure, equity is permanent with an indefinite life (Schroeder et al., 2023). The equity section of the balance sheet represents the net difference between the value of what the entity owns, i.e., assets, and what the entity owes, i.e., liabilities, and is often referred to as the entity's residual interest. The balance sheet equity section is broken into multiple categories, including the display of various ownership and legal claims against the entity's assets, such as stock classes, retained earnings, dividend requirements, and noncontrolling owner interest. This is also the section of the balance sheet that holds the unrealized gains and losses on investments in debt and equity securities classified as available for sale.

HISTORICAL COST VS FAIR VALUE

Advocates of historical cost reporting prefer assets to be recognized at their acquisition price and liabilities to be recognized at the amount of their original obligation value. The negative aspect of this balance sheet valuation selection is its focus on the past and over time the amounts can change or become obsolete.

The Securities and Exchange Commission (SEC) from its inception required historical cost accounting to be used for balance sheet reporting and disapproved revaluations (Zeff, 2007, p. 49). In 1973, the Trueblood Committee issued a report stating that the objectives of financial reporting should be to provide information useful for making economic decisions, especially by external users, which shifted accounting standards to decision usefulness, enabling users to predict future cash flows (Zeff, 2016). The financial crisis in the early part of the 1990s led the push for the use of fair value measurements for certain assets and liabilities (Seay & Ford, 2010; Bowen & Khan, 2014).

According to Barlev and Haddad (2003), financial statements based on historical cost do not accurately reflect the real financial position and results of an entity's operations. Rather, historical cost provides management opportunities to manipulate reported earnings and performances reported in the financial statements. On the other hand, fair value-based financial statements display the real financial position and the results of operations of an entity, as they measure the current value of assets, liabilities, and equity, which are more relevant for financial statement users. Fair value is highly associated with stock returns compared to historical cost values. It is easier for shareholders to distinguish between two management tasks: maintaining equity and generating a return on equity that facilitates shareholders' ability to judge management activities more effectively (Barlev & Haddad, 2003).

In contrast to fair value-based financial statements, management has significant influence over the process when preparing historical cost-based financial statements. Management can manipulate income to make the financial position look better using techniques such as “window-dressing.” Barlev and Haddad (2003) explain that historical cost based financial statements reflect the “manager’s voice” while fair value based financial statements reflect the ‘market’s voice’ (p. 384.). Fair value based financial statements are more transparent as they provide complete full disclosure. Accounting transparency means that the financial statements provide true, accurate, and complete information about a firm's business activities and financial position. Fair value-based financial statements achieve this accounting transparency by reflecting the real economic value of business activities in income statements, as well as in assets, liabilities, and equity in the balance sheet (Barlev & Haddad, 2003; Shortridge et al., 2006).

Blankespoor et al., (2013) examines fair value and historical value from an income statement perspective. They investigate whether historical cost is more reliable than fair value based on the nature and amount of judgments and estimates required to implement each measure (p. 778). Using the historical cost method, they find that there are limited judgments and estimates at the initial measurement of an asset because the initial price is observable, but varies subsequently depending on the type of asset. Financial assets have little difficulty measuring judgments and estimates; however, it is challenging to measure judgments and estimates for nonfinancial assets. The most difficult measurement under the historical cost is subsequent measurement regarding asset impairment. Based on their findings, Blankespoor et al. (2013) conclude that historical cost cannot always be considered more reliable than fair value.

After identifying historical cost deficiencies, they examine the relevance of fair value from an income statement perspective. They find fair value can be useful when there is a recognition of unrealized gain or loss in income. It is particularly useful to assess the future cash flow if management sells the asset before maturity or the end of its useful life. In such cases, unrealized gains or losses provide information about the potential change in a corporation’s equity. This information is useful for assessing both cash flow prospects from the entity and the value realized by the entity if management chooses to sell rather than hold the asset. Blankespoor et al., (2013) conclude fair value should not always be considered more relevant than historical cost because the usefulness of information about unrealized gains or losses depends on whether management may or may not sell the asset before maturity or at the end of its useful life.

Determining Value

Financial value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date under current market conditions (FASB 2009e). Often fair value is determined by the transaction price. However, it should be determined whether the exchange occurred between related parties or under duress. Transactions occurring between related parties are not considered to have occurred at arm’s length. Likewise, transactions occurring under duress, such as bankruptcy, sales, or other financial difficulties, may not approximate fair value. In these situations, management must determine whether fair value at initial recognition is accurately reflected by the transaction price (Liang & Riedl, 2014).

To facilitate disclosures that are both consistent and comparable, GAAP requires the use of the fair value hierarchy to determine fair value measurements (McDonough et al., 2020). The hierarchy was created because the FASB recognized that active markets do not always exist for specific assets and liabilities (Landsman, 2007). The fair value hierarchy consists of three levels, labeled as level inputs, ranging from 1) transaction price, to 2) comparable value, to 3) management’s judgment. A reporting entity should use valuation techniques that are appropriate in the circumstances and for which sufficient data is available to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs (FASB, 2009e). As the reported imputed fair value moves down the fair value hierarchy from level 1 to level 3 reliability and verifiability decrease while estimations and judgements increase.

Mark-to-market accounting is used for many financial instruments traded on open markets. This creates greater transparency for the valuation of these select assets. Fair value is effective at reporting gains and losses on trading securities as well as available-for-sale securities. As both instrument types can be

measured using the level 1 input requirement, reliable and verifiable reporting is achieved. Gains and losses on trading securities are reported directly in income whereas gains and losses in available-for-sale securities flow through accumulated other comprehensive income reported in the statement of financial position equity section.

The issue regularly debated is whether fair value accounting is equally effective at measuring illiquid assets that can remain on an entity's balance sheet for many years. Seay and Ford (2010) find identical long-lived asset transactions are often measured at different values on different balance sheets based on the same purchase date which results in financial reporting inconsistency within, among and between financial reporting entities (Seay & Ford, 2010, p.56). This is credible support for fair value accounting to be used so that more consistent reporting of the economic reality of balance sheet accounts is available.

Relevance and Reliability of Value Determination

When examining the justifications for and against the use of fair value accounting for valuation beyond financial instruments and derivatives, relevance and reliability are frequently a debate. The discussion specifically addresses whether the information is relevant to shareholders and investors, and whether it is more reliable than other valuation methods. Ideally, fair value accounting should provide information that is more reflective of an entity's economic reality. Carrying values based on any measurement other than fair value does not report the current economic value of assets and liabilities. Conversely, fair value accounting could better reflect economic reality by revaluing assets and liabilities at every financial statement reporting date. However, the revaluations will increase reporting costs (Baker & Burlaud, 2015; Pinnuck & Stevenson, 2021).

When fair value reflects current market conditions, it is relevant because it offers the same conditions for investors to rely on the information for decision-making (Emerson et al., 2010). This removes the disparity created by entities valuing identical items at different amounts. Therefore, reporting all assets and liabilities on the balance sheet at fair value will offer a more accurate representation of an entities current economic value.

ADVANTAGE AND DISADVANTAGES

Marketable securities are an asset for which fair value measurement is the most appropriate method of valuation due to the ease of obtaining a market value (Răscolean & Rakos, 2016). However, items such as derivatives that do not trade on a public market would be a more difficult choice for valuation as there is no means of obtaining a market value. Thus, derivatives must be valued by company estimates or comparisons (Kothari et.al., 2010).

Fair value reflects the current market value of assets, which is the same as that used by financial statement users (Răscolean & Rakos, 2016). A fixed asset purchased decades ago, valued using historical cost, does not accurately reflect the true value of the asset and may have significant hidden value if the market value has increased (Fontes et al., 2025).

Due to the value of the assets following the market, the value of a company's assets can plummet overnight if the market fluctuates wildly (Hsu et al., 2018). Problems can occur with the ability to properly set the market value of an asset due to various reasons. An asset might be specific to a certain industry or use, and that can make it difficult to get a market price (Fontes *et al.*, 2025). In situations like this, an alternative method, such as calculating the replacement cost after depreciation, could be used instead of fair value. (Abbott & Tan-Kantor, 2018).

Suppose there is no market for a particular asset. In that case, managers must use their own judgement to value the asset which can be an opportunity for fraud if managers seek to make the financials appear as they would like in order to avoid paying taxes on income or to show an increase in the value of a company's assets in order to impress investors (Hsu et al., 2018). Some statement users are against using fair value if a reliable market does not exist, which results in a true market value rather than allowing a company to value its assets as they see fit (Hsu et al., 2018).

Managers of companies with assets that cannot be truly verified for value in a market might be inclined to overvalue the assets rather than undervalue in an attempt to overstate income for the company due to the manager having a financial incentive to achieve a particular income (Blecher, 2018; Hsu et al., 2018). Beginning with the financial downturn in 2009, the focus has been on banks using fair value to write off or dramatically lower the asset value (Kothari et al., 2010; Bowen & Khan, 2014). Some argue against fair value by claiming fair value does not properly explain asset valuation in a predictable manner (Cascini & DelFavero, 2011). The departure from historical accounting removes objectivity of accounting in situations where a real market value cannot be obtained. For example, Enron employed fair value accounting measurement for some of its assets, which it subjectively overvalued (Haswell & Evans, 2018).

Even if a market is available to derive an accurate price, price variability can make it difficult to rely on that price as the best representation of the asset's value (Whittington, 2015). If a particular asset decreases or increases in value drastically over a short amount of time at the end of the entity's fiscal year, the value of the asset can be misinterpreted on the balance sheet. Lack of consistency also occurs due to the lag between the fiscal year-end, when the financial statements are prepared, and the publication date. This delay could cause the fair value amount of the assets to become stale and inaccurate by the time the statements are made public (Whittington, 2015).

Lack of comparability from company to company is also a major drawback of fair value accounting for assets and liabilities. If firm A chooses to use fair value to estimate value of an asset, but firm B uses historical cost, the two items are not comparable (Fontes et al., 2025).

Valuation fluctuation can unnecessarily wreak havoc on investor and stakeholder confidence in a company. In Blackstone Group's 2008 annual report, they included a statement that stated: during the 2008 financial crisis, the fair value of investments might be much lower than it was a few years ago, but the current value is not the actual long-term value (Cascini & DelFavero, 2011, p 6). Even though the value of the investments were reduced, the company pleaded with investors that it would be temporary, and the investment's value was greater than the amount the firm reported to comply with ASC 820 (FASB, 2009e). Often Level 3 investments are overvalued due to reliance on internal estimates and outdated transaction data. In reality, the actual realizable value of these assets may be far below their stated values due to interest rates or market value changes (Well, 2025).

Chief financial officers (CFO) tend to not like fair value accounting because it causes the company's income to fluctuate, and they have no control over the timing or magnitude of the fluctuations (Reason, 2008). As a result, CFOs must spend a lot of time explaining to investors that the investment value is not increasing or decreasing because of the company's performance, but rather the fluctuations of the company's assets or liabilities fair value. For CFOs, there can be the increased issue of valuing assets when working with accounting firms or auditors as there can be disagreement or lack of knowledge when valuing level 3 items with little or no information (Reason, 2008). An auditor who is not well-versed in determining an appropriate amount for a fair value asset or liability might not be able to provide due diligence to investigate and determine a proper value. Without the company's ability to provide accurate asset or liability values, investors' assessment of the company's financial performance would be prevented (Cascini & DelFavero, 2011; Kaya, 2013).

Proponents of fair-value accounting argue historical-cost financial statements are not relevant because they do not provide information about current values (Chung *et al.*, 2023). The balance sheet contains numerous accounts reported at historical cost that may be considered outdated and therefore irrelevant. If a significant period has passed since the land or property, plant, and equipment (PP&E) was purchased to open a production facility, the amount reported at historical cost may no longer reflect the asset's economic value, creating a hidden asset for the entity.

If land and property, plant, and equipment (PP&E) long-term assets were reported at fair value, the balance sheet accounts would need to be adjusted for appreciation or depreciation. The appreciation or depreciation value would be recorded in a long-term asset contra account to maintain the unrealized portion of land and property, plant, and equipment (PP&E) 's market or present value for financial statement users. The appreciation or depreciation offset amount to recognize the unrealized gain or loss would be recorded in the other comprehensive income account comparable to the recognition of a security investment's

unrealized gains or losses. This recognition of the land and PPE make fair value display of capital assets comparable to the fair value hierarch recognition set forth in ASC 820 (ASC, 2009e).

VALUATION METHOD SETBACKS

Fair value accounting provides transparency and relevance by reporting the current market value; however, it is subjective and requires estimates for complex or illiquid assets, which can create situations that can be exploited for fraudulent activities, such as recognizing gains or losses on a selective basis (Barr-Pulliam, 2019). Another argument against fair value is that management may hire an appraiser to provide an appraisal that increases asset values solely to increase the entity's income (Emerson et al., 2010).

A balance sheet approach, which potentially incorporates the extended use of fair value measurements not based on market observations, can result in information that is potentially unreliable and not easily verifiable. The complexity of fair value measurements can create an information gap between those preparing the financial statements and the statement users, resulting in an asymmetry that prevents investors and auditors from detecting manipulation (Krumwiede, 2008; Alharasis et al., 2022). Conversely, when analyzing information produced by financial analysts, a preference for the income statement approach over the balance sheet approach is evident for long-term assets (Krumwiede, 2008, p. 39).

Due to cost allocations, such as depreciation, the current market valuation of many assets is not reflective of the entity's economic reality. When a depreciable asset is acquired, management's use of estimates to determine its useful life and the appropriate cost allocation schedule does not alter the overall expense; only its timing is affected. There is no justification to revalue the asset's value in future periods. If the salvage value is later determined to have been inaccurately estimated, a gain or loss on disposal is reported in income as a part of normal operations. Furthermore, the valuation of the asset as considered by an open market is not always reflective of the value of an identical asset. The relative value of an asset used by an entity for manufacturing goods or providing services will be more valuable than the dollar amount it could be sold for at a specific point in time (Barr-Pulmann, 2019).

Fair value standards have been found to be associated with litigation risks due to the evaluation volatility that is also likely to result in financial restatements (Huang et al., 2020; Cho & Kang (2024); Ashrol et al., 2025). Even well-intentioned management estimates of fair value will be wrong to the extent that the various predictions and assumptions are wrong" (Krumwiede, 2008). When estimates and predictions fall short, which can never be entirely avoided, the management's intent must be considered. This creates an unnecessary burden for auditors who will be required to analyze the situation that existed when the inappropriate or fraudulent estimate was created, as well as any subsequent revaluations. Typically, fair value accounting systems do not have processes in place to identify or detect manipulation or fraudulent accounting transactions. Therefore, the increased reliance on estimates compounds the difficulty of detecting criminal intent. (Cardao-Pito, 2024).

CONCLUSION

As a measurement basis, the choice between fair value and historical cost measurement is determined by accounting standard setters and little evidence exists that entities choose between fair value and historical costs (Christensen & Nikolaev, 2013; Fontes et al., 2025). The use of fair value reporting incurs additional costs compared with historical cost accounting. Revaluation at each reporting period can create a cumbersome task that provides debatable benefit. This is coupled with the reality that many financial statement revaluations involve assets and liabilities that will not be transferred, resulting in unrealized gains and losses. In addition to the increase in compliance and auditing costs, additional costs can be imposed in the form of increased financial reporting errors and potential future abuses by opportunistic and dishonest management (Cardao-Pito, 2024)). Since gains and losses can be presented on the income statement due to quarterly revaluations, the door is open for manipulation in either direction, based on management's intent (Cho & Kang, 2024). Although it is beyond the scope of this discussion, the infamous Enron scandal has

proven the near limitless possibilities of an overreliance on and misuse of fair valuation (Haswell & Evans, 2018).

There are many nuances associated with each type of transaction that can be reported on the balance sheet. Therefore, this discussion of balance sheet valuations is limited to the account classifications that represent the larger number of transactions or highest value in publicly traded entities' financial statements. Currently, a change to fair value accounting for all assets and liabilities reported on the balance sheet appears to be a challenge due to the added costs associated with measurements as the benefits must be sufficient to justify the implementation.

There is ample evidence to the benefits of fair value accounting for debt and equity securities. Research suggests that disclosed and recognized fair values provide informative data to investors; however, the level of information is affected by the amount of measurement error and the source of the estimates, whether made available by management or external appraisers (Landsman, 2007). As these investments can be measured based on level 1 inputs, management has readily available verifiable information to recognize them at fair value. Thus, the change to fair value accounting has been a useful and reliable tool for investors interested in the entity's debt and equity securities.

Long-term assets are measured and reported in the balance sheet using a historical cost basis. Cost allocations, such as depreciation and amortization, ensure that these items can be systematically reported without adjustments to market value, although recognition and reporting using fair value is also possible. Any potential appreciation in the value of these assets flows into the income statement upon disposal and may not benefit from fair value accounting.

According to GAAP, long-term liabilities can be measured at fair value under the fair value option. The implementation of the fair value option has several advantages over other valuation methods, as it provides investors with an up-to-date valuation of an entity's debt obligations. However, companies are unlikely to take advantage of the fair value option as unrealized changes can mislead the investors regarding the economic reality of the entity. Ultimately, fair value changes act as a hedge offsetting the changes in asset valuations.

Although this discussion has presented a plethora of financial statement valuation and reporting information, there is a need for further research. For example, future research could determine whether the two measurement methods (i.e., fair value and historical cost) complement or substitute for one another, and whether the relationship might vary over time or by entity type. Exploring these issues may help determine if historical cost information is lost when the fair value method is employed and how this lost information can be restored. Since both measurement methods employ different assumptions, what data should be disclosed in the notes to clarify the reported valuations and provide decision-useful information for analysts and investors?

Future research can help to better understand why investors view fair value valuations for payables less decision useful than for receivables and does this perception influence entities' selection of valuation methods. Investing in this challenging issue might result in valuable insights for interested parties, including investors, stakeholders, and financial statement users.

Current GAAP for financial reporting employs a hybrid mix of fair value and historical cost measurement to prepare the entities' financial reports, which provide investors and other interested parties with ample information for decision-making. An overreliance on estimates and judgements when other methods are available creates an unnecessary addition of more unrealized gains and losses that may never materialize. Valuation methods, such as historical cost, provide financial statement users with relevant and reliable information for illiquid assets and liabilities. Reporting trading securities using fair value measurement provides financial statement users with timely market information. Changing GAAP to require the entities' financial statements to be presented only using fair value measurement would be a disruption because users of the financial statement data employ the information for different purposes. What remains is for the FASB to determine whether financial statements based on fair value provide more reliable information than historical cost-based statements (Landsman, 2007).

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