Fair Value Measurement in Saudi Arabia and its Expected Impact: A Special Focus on the Insurance Sector

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Abstract
There is an ongoing debate in the world regarding valuing the assets at their historical cost or at the fair value measurement. The fair value measurement has been explained under Standard 13 of International Financial Reporting Standards (IFRS), providing a single framework to measure fair value and associated disclosures. The adoption of fair value accounting in all the companies for equity as per IAS 16, IAS 38, IAS 40 and IFRS 13 in the Kingdom of Saudi Arabia (KSA) is under consideration by Saudi Organization for Certified Public Accountants (SOCPA), Saudi Arabian Monetary Authority (SAMA) and Capital Market Authority (CMA), but allowed in banking and insurance sectors. The Saudi Arabian companies might achieve several benefits in adopting the IFRS framework and also revaluing the equity and marketable securities according to fair value measurement. Hence, the current study assesses the expected effect of fair value measurement on the companies' financial statements in the insurance sector. Data Envelopment Analysis (DEA) was used to measure the efficiency of the two methods of accounting, i.e., the historical cost method and fair value method. Even though there are policy issues that might hinder the adoption of fair value accounting by the companies, since IFRS is more comprehensive compared to Saudi standards, it is found that the adoption is enhancing the reporting standards in KSA.

Keywords: IFRS, Fair value, Financial reporting, Insurance.

Introduction:
According to the Generally Accepted Accounting Principles, most of the companies in the world report their financial statements on the basis of historical cost. The historical cost of an asset comprises costs relating to purchasing, installation and any other incremental cost that help in increasing the utility of the asset. The marketable securities, such as shares are valued at their nominal cost even though they are highly influenced to changes brought in by various market factors. Therefore, the Fair Value Measurement (herein after FVM) has been considered for revaluation of equity and marketable securities. The equities under the FVM are recorded at their market value. This value is the price that an asset or instrument can fetch if it were sold in the open market. There is an ongoing debate regarding valuing the equities at their historical cost or at the FVM. There are studies that perceive historical cost as far better than fair value (Barth et al 1996; Dietrich et al. 2001). Despite the inferences drawn in favor of historical cost, there is a supporting evidence in favor of the assumption that the fair value is reliable than the historical cost, in association with stock market indicators (Rodriguez-perez et al. 2011).

The FVM has been explained under Standard 13 of International Financial Reporting Standards (IFRS) providing a single mechanism to measure fair value and its disclosures. The fair value has been defined on the basis of an “exit price” and uses a “fair value hierarchy” which is market-based rather than specified firm. The previous studies in the literature followed different approaches in exploring the characteristics of fair values. Some research works of (Barlev et al., 2007; Nichols and Buenger, 2002; Rodriguez and Navarro, 2007) observed motivations as the objective of revaluation. The managers revalue the assets as per fair value to enhance their financing capacity and access to capital markets. This shows that the perspective of revaluing assets on the basis of fair value is to attract the financial statements users.
Further, in order to lower the political costs, the firms revalue their assets according to FVM (Rodriguez-perez et al. 2011).

**Saudi Accounting Framework**
The Saudi Arabian economy have strong relations with the other world economies. The listed companies in Saudi Arabia have established their subsidiaries in other countries, and several multinational corporations have established their subsidiaries in Saudi Arabia (KSA). In KSA, all the listed and unlisted companies generally follow the standards issued and adopted by the Saudi Organization for Certified Public Accountants (SOCPA). SOCPA came into existence under the provisions of Royal Decree 1992 and operates under the direct supervision of the Ministry of Commerce. The other regulators in the Kingdom besides SOCPA are the Saudi Arabian Monetary Agency (SAMA) and the Capital Market Authority (CMA). Companies in the Kingdom follow relevant standards issued by the IASB in the absence of SOCPA standards. There are 21 standards issued by SOCPA, and in addition to these the General Presentation and Disclosure Standards covers six topics that are addressed by the IFRS individually. “The SOCPA has approved an IFRS transition plan that will require listed companies to report using the national standards that are closely merged with full IFRSs. Further, unlisted companies will be required to report under IFRS for Small and medium-sized Enterprises (SMEs) as adopted in KSA”.

**Motivations for Saudi Arabia to adopt FVM under SOCPA**
The FVM has been explained under Standard 13 of IFRS provides a framework for measuring fair value and its disclosures. This standard defines fair value on the basis of an “exit price” and has a “fair value hierarchy”, which is market-based rather than firm-specific. The companies in KSA have future prospects according to the Kingdom’s 2030 vision. Further, Saudi Arabia is a member of G-20 countries for three years. In addition, it is also a member of World Trade Organization (WTO) for four years. According to the IFRS application in KSA, the standards extends to all insurance companies, banks, and listed companies of the TADAWUL. Further, SAMA has also directed all the banks and insurers to maintain their financial statements according to IFRS. On the other side, the CMA on 16th October 2016 decided not to use FVM for property, plant, equipment and intangible assets. This is as per the provisions of IAS 16 and IAS 38. Accordingly, fair value for equity has to be as per IAS 40 for the first three years, for the period 2017 to 2019. The CMA after completion of this period, will study the requirement to continue the existing cost model or move to FVM. The rise of fair value accounting in the last two decades denotes the departure from the traditional method of maintaining books at historical cost. The main drawback of historical cost method is that it does not report the real value of the financial instruments in the market. Further, the conceptual framework of IASB says that the context of FVM provides useful information to the external users to predict the firms’ capacity in generating cash flows. The IFRS standard of FVM has been adopted by many countries in the world. The Saudi Arabian companies might achieve several benefits in adopting the IFRS framework and also revaluing the equity, according to fair value measurement.

**Research Problem**
The historical cost method of accounting is generally assumed as reliable method in evaluating the financial statements, but the research studies observed FVM as more reliable method than the historical cost method, since it provides more information to the accounting information users. Therefore, the following questions need to be answered:

1. Are the observations of the literature on FVM is enough to prove that the FVM is more reliable than the historical cost method, or some more strong evidence is needed to prove?
2. Is there any change effect to IFRS on reported equity?
3. What is the consequence of individual financial reporting standards on financial statements?

**Research Objectives**
The core objective of this study is to examine the expected impact of fair value accounting on the financial statements of the insurance companies. This core objective is divided into following sub-objectives.

1. To provide stand on accounting treatments for the transition from the historical value to fair value of equity.
2. To measure the efficiency in analyzing the financial statements based on historical cost and fair value.
3. To evaluate the impact of applying the FVM on the qualitative characteristics of accounting information, which disclosing in the financial statements.
4. To highlight the importance of rules and disclosure requirements and accounting measurement at fair value.

Literature Review

The objective behind financial reporting by the companies is to provide useful accounting information to the internal and external users, such as investors, creditors, lenders (IASB 10). Therefore, the users assess the quality of information provided to them. Further, there is difference in reporting the financial information as per the historical cost model and FVM. Hence, the empirical research has thrown some light by focusing on the relation between FVM and historical cost modeling.

The earnings based on FVM are more changeable than the historical cost earnings. The capital regulatory violations are more under the FVM compared to historical cost method. The usage of fair value accounting for banks’ concerns, such as earnings, capital and cash flows is not supported (Barth et al. 1995). Further, the revaluations of fixed assets are positively associated with the changes in firms’ operating performances. Moreover, the revaluation of securities is positively associated with net profit and book value of equity. The timely changes in the underlying asset values can be evidenced from the revaluations (Aboody et al. 1999). Moreover, the investment as per FVM and stock prices have significant relation as well as between FVM of security gains and losses and stock prices. Therefore, these securities need to be valued as per FVM, such as the private or non-G7 securities and requires the incremental value-relevance of the same of fair value. Further, the inconsistency in the previous research results on fair values may not be a primary explanation against use of fair values, but can be referenced to the non-availability of fair value measures in some aspects (Carrol et al. 2002). There are some issues in introducing the fair value system in sectors like insurance, such as unwillingness to shift from historical cost to fair value, difficult to have two different accounting systems in a company side by side due to cost and confusion, reduce competitiveness among companies due to significant changes in business strategies, systems and policies over time, increase in cost of capital due to volatile earnings, there might arise compliance problems under the Sarbanes-Oxley Act, and the explicitness of financial statements would be increased if fair value accounting is introduced (Dickinson and Liedtke, 2004). Similarly, the bank regulators need to consider some important issues while using the fair value accounting in a banking system, such as letting managers to disclose hidden information in their fair value estimates, and minimizing strategic model implementation, maximizing usefulness of fair value accounting to users and maximizing economic efficiency of banking system by minimizing fair value measurement error and ensuring bank managers to have incentives in selecting investments (Landsman, 2005). Further, revaluing financial instruments as per FVM increases the bank’s financial performance. The Earnings per Share (EPS) is strongly high and positive when FVM is considered compared to income calculated without considering holding gains and losses (Aldeen and Abdullatif, 2009).

Moreover, there was a popular belief that the key source to financial crisis are bank capital requirements and fair value accounting rules. There was a less impact of fair value accounting, rather the banks with large loan portfolios were challenged by loan losses (Shaffer, 2010). In contrast, there is a significant change in financial reports and also there is a variation between companies and class of assets in case of magnitude of this change. Therefore, a shift from historical cost accounting to FVM may change analysts’ forecasts, but may not have major impact on performance (Rodriguez-perez et al. 2011). Similarly, revaluing financial instruments according to fair value accounting reflects the expected future outcome as it is able to predict the firm’s ability to utilize the opportunities and respond to difficult situations (Ijeoma, 2013). The amazing aspect is that the FVM played a significant role in amplification of financial crisis during 2007 and 2009.
It was believed that FVM was just a messenger of spreading bad news during the crisis period causing huge losses to the banks (Masoud and Daas, 2014). In contrast, the role of the book value of balance sheet and equity in stock market valuation is significant, against the role of profit after tax and income statement, upon the adoption of FRS 139 (Gan et al. 2015). Similarly, the usage of fair value accounting throws a positive light, having a unique advantage of reflecting the current financial condition compared to the historical cost accounting, but both the systems are not free from shortcomings (Abdullahi and Ma’aji, 2016).

Therefore, in the light of above discussed literature, we found positive and negative aspects in evaluating the financial statements as per the FVM system. The earnings are more volatile when evaluating as per FVM and there were timely changes in the revaluations. Further, there was a change in the prices of securities and the EPS was strong when FVM method of accounting was followed. There is a change noticed in the perceptions of the stock market analysts (Aboody et al. 1999; Carrol et al. 2002; Aldeen and Abdullahatif, 2009; Rodriguez-perez et al. 2011). Further, it was believed that the FVM of accounting was the reason for the financial crisis as it acted as a messenger to spread the bad news, and there was a less impact of FVM while valuing the banks’ capital requirements (Shaffer, 2010; Ijeoma, 2013; Masoud and Daas, 2014).

**Research Methodology**

In the present study, the expected impact of FVM is evaluated on the face of financial statements. The research methodology consists of the following:

1. The data for our study is collected through secondary sources, such as the financial reports of 35 companies in the insurance sector that are listed in TADAWUL, which is our study population. We retrieve the components from the balance sheet and income statement, which are prepared as per the historical cost accounting method. We also retrieve the fair values of land and buildings, plant and equipment, and financial investments from the notes given in financial statements.

2. We consider each type of equity elements, and calculate their mean and standard deviations for the revaluation rates as per both the methods and examine the difference in the revaluation rates. The significance of these differences will be tested by using a non-parametric test.

3. We calculate various type of ratios, such as profitability ratios and turnover ratios from the given financial statements and calculate the DEA scores to measure the efficiency of changing from one method of accounting to another method of accounting.

**Analysis of Data**

This study takes into consideration all insurance companies listed in Saudi stock market. The analysis is based on the published financial statements and their notes of insurance companies of 2019. Footnotes provide information about the transition from national accounting standards to IFRS based financial statements. Data were collected through financial report of insurance companies published in TADAWUL website. Number of companies under the study were 33, which listed in Saudi stock market and licensed from Saudi Arabian Monetary Authority (SAMA). The researchers had compared the equity of the companies under two accounting conventions, which are pre and post IFRS, utilizing two-tailed t-test for paired samples. The result of t-test was -0.3745. This signifies that companies' equity reported as per the pre IFRS has no significant difference from post IFRS adoption. However, this could be true with respect to the overall effect of transmission. It could be worth considering a detailed analysis. Table 1 presents the results of the t-test of the two samples.

<table>
<thead>
<tr>
<th>Variables</th>
<th>N</th>
<th>Mean</th>
<th>Std. Error</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre IFRS</td>
<td>33</td>
<td>16.56046</td>
<td>21.67</td>
<td>1.414786</td>
</tr>
<tr>
<td>Post IFRS</td>
<td>33</td>
<td>16.67825</td>
<td>21.56</td>
<td>1.281652</td>
</tr>
<tr>
<td>Combined</td>
<td>66</td>
<td>16.80847</td>
<td>32.35</td>
<td>1.437249</td>
</tr>
</tbody>
</table>
The impact of the individual standard on insurance companies in KSA is presented in Table 2. This table presents all the standards stated by the companies in their settlements.

**Table 2. IFRS Amendments**

<table>
<thead>
<tr>
<th>Financial Reporting Standards</th>
<th>Number of Companies</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>IAS 16-38: Tangible Intangible Assets.</td>
<td>13</td>
<td>49</td>
</tr>
<tr>
<td>IAS 19: Employee Benefits.</td>
<td>25</td>
<td>93</td>
</tr>
<tr>
<td>IAS 28: Investments in Associates.</td>
<td>3</td>
<td>12</td>
</tr>
<tr>
<td>IAS 36: Impairment of Assets.</td>
<td>2</td>
<td>7</td>
</tr>
<tr>
<td>IAS 37: Provisions, Contingent Assets Liabilities.</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>IAS 39: Financial Instruments.</td>
<td>20</td>
<td>72</td>
</tr>
<tr>
<td>IAS 40: Investment Property.</td>
<td>2</td>
<td>7</td>
</tr>
</tbody>
</table>

The following is the content analysis of the financial statements, which presents the significant changes.

1. **Value of Assets**: Companies have initiated impairment test for their related items, when it appears that the value may have decreased.
2. **Tangible and intangible Assets**: Companies have re-estimated the useful life of their assets – both tangible and intangible.
3. **Provisions, liabilities and contingent assets**: Companies have started to calculate them according to their judgement.
4. **Employee benefits**: Companies have commenced to rely on actuarial estimations for calculating the employee benefits.
5. **Financial instruments**: Companies have initiated using effective interest rate method for applying amortized cost approach.
6. **Investment in associates**: If the investment in associates have significant influences on investee, certain companies initiated "equity method".
7. **Investment property**: A few companies reclassified their properties in the form of investments instead of property, plant, and equipment. A few companies prefer FVM to cost model.

**Conclusion**

This study investigated the effects of the transition of using IFRS on Saudi insurance companies. Insurance companies in Saudi Arabia shifted IFRS on January 1, 2017. This shift has been done based on new developments in international accounting standards. Since Saudi insurance companies compete internationally, they need to understand and adapt to the latest developments in reporting standards. The findings of the study identified no significant differences in the equity of insurance companies before and after adoption of IFRS. The style of IFRS is to evaluate both assets and liabilities based on FVM. In the absence of an active market, it would be ideal to make several assumptions for the estimation of fair value. Since assumptions increase the degree of subjectivity in valuing, companies need to disclose crucial assumptions of their valuation pertaining to liabilities. Assumptions regarding high-quality disclosure would help decision makers to appreciate the impact of changes or illiquidity of the reported amounts and the consistent application of IFRS. Peerless financial data from insurance industry will facilitate in bringing efficiency to the markets by allowing investors to make comparison between the companies. But this could hold good only on consistent implementation of IFRS.

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References


