

**THE RELIABLE RELEVANCE OF
BANK FINANCIAL STATEMENT IN KAZAKHSTAN:
THE FAIR VALUE CHALLENGE FOR AUDITORS**

John Dixon
Department of Public Administration
College of Social Sciences
KIMEP
Kazakhstan

Email: dixon@kimep.kz

Yuliya Frolova
Bang College of Business
KIMEP University,
Almaty, Kazakhstan

ABSTRACT

The reliable relevance of the financial statements filed by publicly listed banks in Kazakhstan in recent years is questionable. This is because of inadequate disclosure on the fair value valuation of their financial assets, particularly those for which there is little, if any, market activity upon which to base the expected market valuation. The Accompanying Notes to filed Financial Statements do not provide the basis for end-users to judge either their reliability (verifiability, neutrality, and representational faithfulness) or their relevance (predictive and feedback value). Conspicuously lacking is any robust assessment by auditors of any significant fair value estimation contingencies and risks. The crucial implication for end-users is their need to be ever alert to the ethicality of both management and auditors, as both grapple with the ethical dilemmas associated with estimating and auditing those financial estimates that are, and will always remain hypothetical and, thus, unknowable.

Key words: Fair value accounting, corporate governance, Fair Value accounting, accounting ethics

INTRODUCTION

The reliable relevance of the financial statements filed by publicly listed banks in Kazakhstan in recent years is questionable. This is because of inadequate disclosures on the fair market valuing of their financial assets, particularly those for which there is little, if any, market activity upon which to base the expected market valuation. The purpose of this paper is to present a qualitative assessment of the explanatory Notes accompanying financial statements (henceforth the Accompanying Notes) filed by every bank listed on the Kazakhstan Stock Exchange in 2011 against the *fair value* disclosure principles embedded in the global accounting standards. It highlights the challenges facing the auditing profession in addressing the issue of accounting disclosure in a way that enhances the trust- and utility-conduciveness of *fair value* valuations and, thus, the reliable relevance of the audited financial statements of those banks.

The accounting profession has long judged the dual governing principle of financial reporting to be *reliability*—assets and liabilities valuations must be attestable (*verifiable*), unbiased (*neutral*), and measure the phenomenon they purport to represent (*representational faithfulness*)—and *relevance*—assets and liabilities valuations must be useful to end-users in terms of whether they predict future actual values (predictive value), whether they provide feedback that corroborates or corrects prior assumptions or past decisions (feedback value), and frequency of financial reporting (timeliness)) (FASB 2010: Ch 1, OB2). Over recent decades, the pendulum has shifted from *reliability* towards *relevance*, with the incorporation of *fair value* conventions into the global accounting standards provided by the International Auditing and Accounting Standards Board (IAASB) the International Auditing Standards Board (IASB), and the US Financial Accounting Standards Board (FASB). The emphasis in financial reporting has, thus, shifted from presenting documentary-based accounting facts (*historical cost* accounting method (Spiceland *et al.* 2007), towards declaring accounting speculations (*fair value* accounting method) (Cunningham 2004, Emerson *et al.* 2010, Jones 1988, Magma and Cormier 2005, Power 2010). The integrity of *Fair Value valuations* that comes from their authenticity—the accuracy, legitimacy, and validity—as trustworthy measures of current fair market values. This necessitates the adoption of a disclosure approach that focuses the Explanatory Notes accompanying Financial Statements (henceforth the Accompanying Notes) on promoting the trust- and utility conduciveness of the *Fair Value* valuations, so enhancing the reliable relevance of Financial Statements.

FAIR VALUE ACCOUNTING

Accounting estimations under *fair value* principles are based on calculating the *hypothetical* sale price (exit-price) of designated assets or liabilities (FASB 2008a: Statement of Financial Accounting Standards (SFAS) 157). This requires “inputs”, which have been categorized by the FASB as either *observable* as market prices for the *same* or *similar* assets and liabilities (SFAS 157: para. 21) or *unobservable* as *management assumptions* “about the assumptions market participants would use in pricing the assets or liabilities, developed based on the best information available in the circumstances” (SFAS 157: para. 21 (a)), ensuring that “the reporting entity shall not ignore information about market participant assumptions that is *reasonably available without undue cost and effort*” (SFAS 157: para. 30, emphasis

added). This gives rise to a three-level *fair value* hierarchical input classification, which guides accountants on the selection of the appropriate *fair value* estimation approaches (SFAS 157: paras 22–25)

- Level 1, which denotes observable objective data inputs in the form of “quoted prices (unadjusted) in active markets for identical assets or liabilities” to those being valued, where an active market is defined as “a market in which transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis.”
- Level 2, which denotes observable objective data inputs in a form “...other than quoted prices included within Level 1, that are observable for the asset or liability, either directly or indirectly through corroboration with observable market data (market-corroborated inputs)”, including the price of similar assets or liabilities to those being valued.
- Level 3, which denotes “unobservable [subjective data] inputs”—the reporting entity’s own assumptions—“developed based on the best information available in the circumstances.”

The expected fair market value estimations of financial assets for which there is no active market—*fair value* level 3 assets (SFAS 157: para.25)—involve the inputting of the reporting entity’s own pricing assumptions as “unobservable [subjective data] inputs”. These expected market valuations are, notionally, their *hypothetical sale price*—Bromwich’s (2007) imaginary prices—that would be received in a *hypothetical* transaction (SFAS 157: para. 7 emphasis added)—in Bromwich’s (2007) mystical market—between *hypothetical* market participants at the valuation date (SFAS 157: para. 5). This is calculated by the application of the *income approach*, which “uses valuation techniques [such as closed-form models (such as the Black-Scholes-Merton model), open-form models (such as binomial or lattice models), and multi-period excess earnings models] to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted)” (SFAS 157: para. 18 (b)), and which imputes management’s assumptions about the assumptions that hypothetical buyers would make about the sale price of an asset (SFAS 157: para. 13), “developed based on the best information available in the circumstances” (FASB 2008a: SFAS 157, paragraph 25), on the assumption that the market exchange takes place “in the most advantageous market” (SFAS 157: para. 8), as “an orderly transaction,” (SFAS 157: para. 7), with none of market participants being “under duress” (SFAS 157: para. 16), and all of them being “independent of the reporting identity”, being “knowledgeable, having a reasonable understanding about the asset and liability and the transaction based on all available information”, and being “able” and “willing to transact for the asset or liability” (SFAS 157: para. 10). A *hypothetical* sale price is, then, an estimate of the price that would induce buyers to purchase an asset, provided that their *hypothetical* usage “would maximize the value of the asset” (SFAS 157: para. 13), that the *hypothetical* transaction is “physically possible, legally permissible, and financially feasible” (SFAS 157: para. 12), and that the *hypothetical* sale prices reflect any *hypothetical* non-performance risk—the risk that the sale “obligations will not be fulfilled” (such as the “obligation [of the buyer] to deliver cash” or the “obligation [of the seller] to deliver goods and services” (SFAS 157: para. 15)—and any *hypothetical* “terms of credit enhancements related to the liability, if any” (SFAS 157: para. 15).

Reliably relevant expected fair market value estimations of financial assets, particularly those for which there is no market activity upon which to base those valuation, requires accounting disclosures that focus on providing any information necessary for a proper understanding of their methods of calculation, and the associated estimation contingencies and risks. This places significant importance in the Accompanying Notes evidencing a robust assessment by auditors of management's framing of those *fair value* estimations.

DISCLOSURE PRINCIPLES

These principles endorse "providing with financial statements any financial or other facts that are necessary for proper interpretation of those statements" (Williams 2010:64). Under global accounting and auditing standards, accounting disclosure means presenting mandatory information about the basis of the preparation of Financial Statements and the specific accounting policies used (IAASB 2003: International Financial Reporting Standard (IFRS) 1, para.10 (as amended)), particularly with respect to financial assets valuations (IAASB 2005: IFRS 7, paras 25–30). While these global standards provide accountants and auditors with principles-based guidance on the extent and nature of mandatory accounting disclosures, much is left to their professional and commercial judgments, particularly, in the Fair Value context, whether the benefits of establishing the credible reliable-relevance of Fair Value estimations using subjective (level 3) inputs justifies the cost involved in preparing the necessary Accompanying Notes (Seay and Ford 2010).

Readability

Readability is the ease in which the text of the Accompanying Notes can be read and understood. Under global accounting standards, this is an implied rather than an explicit disclosure requirement. Disclosure readability would be maximized when accounting terms and issues are presented in a technically correct way, but in non-technical language that is understandable to the educated layman who is business literate.

Prudence

Prudence is related to a principle of conservatism. This holds that accountants should not overestimate revenues, gains and assets, or underestimate expenses, losses and liabilities (FASB 2008b, Statement of Financial Accounting Concept (SFAC)2, Glossary of Terms). Under global accounting standards, prudence requires disclosure on matters that threaten the principle of conservatism. The indicators that bring into doubt the prudence of the *fair value* valuations:

- The absence of the *fair value* hierarchical input classification of its fair-valued assets and liabilities.
- The classification of assets and liabilities designated for *fair value* valuation for which there is no active market as anything other than those requiring subjective (level 3) inputs for their valuation.
- The absence of a warning about realization of *fair value* valuations.
- The inclusion of historical cost valuations that are above *fair value* valuations.

- The absence or inadequacy of the details on the methods and assumptions used to calculate *fair value*.
- The absence or inadequacy of any statement on the presence or absence of any contingencies or risks that could materially impact on the *fair value estimations* using subjective (level 3) inputs.

Completeness

Completeness assumes “the inclusion in reported information of everything material that is necessary for faithful representation of the relevant phenomena”(FASB 2008b, SFAC2, Glossary of Terms, see also Accounting Concerns 2012). Under global accounting standards, disclosure is required on any confirmed or validated events or occurrences, information items, or state of affairs that could significantly influence how end-users interpret *fair value* valuations. The indicators that bring into doubt the adequacy of *fair value* valuation disclosures are:

- The absence or inadequacy of any statement on relevant corporate *fair value* accounting policies adopted for accounting item valuations requiring subjective (level 3) inputs.
- Any evidence of misclassification of assets and liabilities requiring subjective (level 3) inputs for their valuation.
- The absence of any transfer of any *fair value* category asset and liability to or from the *fair value* level-3 category.
- The absence of data on the proportion of assets the *fair value* of which are calculated using subjective (level 3) inputs.
- The absence or inadequacy of any statement on the choice of *fair value* valuation method(s) using subjective (level 3) inputs.
- The absence or inadequacy of any statement on any changes in the *fair value* valuation method(s) using subjective (level 3) inputs.
- The absence or inadequacy of any statement on the management’s own key subjective *fair value* valuation assumptions.
- The absence or inadequacy of any statement on the major changes to management’s own key subjective *fair value* valuing assumptions.
- The absence or inadequacy of any statement on any sensitivity analysis undertaken when calculating *fair value* estimations using subjective (level 3) inputs.
- The absence or inadequacy of any statement on any contingencies that could materially impact on the *fair value* estimations using subjective (level 3) inputs.
- The absence or inadequacy of any statement on any risks associated with the *fair value* estimations using subjective (level 3) inputs.

Consistency and Comparability

Consistency is “conformity from period to period with unchanging policies and procedures” (FASB 2008b, SFAC 2, Glossary of Terms) and *comparability* is “the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena” (SFAC 2, Glossary of Terms). Under global accounting standards,

disclosure is required on matters that threaten the consistency and comparability of financial information. The indicators that bring into doubt the consistency and comparability of *fair value* valuation are:

- The absence or inadequacy of any statement that there were no changes in fair value valuation methods.
- The absence or inadequacy of any statement on the changes made to the *fair value* valuation methods.
- The absence or inadequacy of any justification of any *fair value* hierarchical input classification change of *fair-valued* assets and liabilities.

KAZAKHSTAN BANK SECTOR: A QUALITATIVE ASSESSMENT OF FAIR VALUE ACCOUNTING DISCLOSURES

This study presents a qualitative assessment of the Accompanying Notes filed by every bank listed on the Kazakhstan Stock Exchange in 2011 (unless otherwise specified) against the articulated standards of adequate disclosure. In so doing it highlights the challenges facing the accounting profession in addressing the issue of accounting disclosure. It also permits judgments to be made about the reliable relevance of the *fair value* in the financial statements filed, particularly the valuation of fair value level 3 financial assets on the basis of subjective (level 3) inputs.

By way of context, Standard and Poor's (2012) review of the Kazakhstan banking sector ranked it in Group 8 of the Banking Industry Country Risk Assessment (BICRA) framework (together with Nigeria, Georgia, Lebanon, Latvia, Argentina, Bolivia, Egypt, Tunisia, Uruguay, and Uzbekistan). Amongst its identified weaknesses were weak governance and transparency and a high incidence of corruption and fraud; and narrow and shallow domestic debt capital markets.

Structure

The Kazakhstan banking system comprises 38 banks (as of July 2012), all of which, except for the Kazakhstan Development Bank¹, are commercial retail and/or investment banks. Of these 19 (50 percent) are listed on the Kazakhstani Stock Exchange, of which five are subsidiaries of international banks (26 percent). The remaining 19 banks are foreign-owned and their Financial Statements and Accompanying Notes to Financial Statements are not in the public domain.

This study examined the Financial Statements of all 19 banks listed on the Kazakhstan Stock Exchange² in each of three years between 2009 and 2011 (henceforth, the review period). It considered the Accompanying Notes related to the *fair value* valuations of

¹ The Kazakhstan Development Bank is "an investment institution of the Republic of Kazakhstan which funds the non-primary sector of the economy" (Kazakhstan Development Bank 2012)

² These are: Alliance Bank, ATF Bank, BTA Bank, Bank Centercredit, Delta Bank, Development Bank of Kazakhstan, Eurasian Bank, Eximbank Kazakhstan, Halyk Bank, Kaspi Bank, Kazinvestbank, Kazkommertsbank, Nurbank, Danabank, Subsidiary Bank Sberbank of Russia, Senimbank, Temirbank, Tsesnabank, and VTB (Kazakhstan).

financial assets in 2011 (or for the latest year for which a financial statement with Accompanying Notes is available). All these banks are required to report their financial assets at *fair value*, from 1 January 2007, in accordance with regulatory requirements (IAASB 2005, IFRS 7), despite this, two banks³ still chose to adopt the historical cost accounting method to value all their financial assets at their carrying-forward or amortized cost (entry-price).⁴ Four banks⁵ had not filed their Financial Statements for 2011 with KASE in a timely manner, and two banks⁶ failed to provide Accompanying Notes with their filed 2011 Financial Statements.

The Balance-Sheet Importance of Fair Valued Assets and Liabilities

Of the 15 banks that have filed their 2011 Financial Statements, 12 (92 percent) reported *fair value* assets (see Table 1) and five (33 percent) reported *fair value* liabilities (less than two percent of total liabilities in any reporting bank). The percentage of total assets that are fair valued ranges from 41 percent (Development Bank of Kazakhstan) to less than one percent (Eximbank Kazakhstan). Noteworthy is that two banks reported dramatically reduced relative importance of their fair-valued assets over the review period: VTB Kazakhstan (down from 28 percent to under two percent) and Eurasian Bank (down from 11 percent to under one percent), while two banks reported significant increases in the relative importance of their fair-valued assets over the same period: Nurbank (up from just under 5 percent to 12 percent) and Tsesnabank (up from just over 5 percent to 10 percent).

TABLE 1: PERCENTAGE OF TOTAL ASSETS REPORTED AT FAIR VALUE

Bank	2011	2010	2009
Alliance Bank	25.65	28.98	27.21
ATF Bank	2.90	1.78	1.92
BTA Bank	N/A	5.71	8.17
Bank Centercredit	9.49	9.28	N/A
Delta Bank	9.80	11.27	5.66
Development Bank of Kazakhstan	40.96	35.79	32.15
Eurasian Bank	0.71	10.22	10.95
Eximbank Kazakhstan	1.67	0.19	1.55
Halyk Bank	13.62	13.70	10.32
Kaspi Bank	N/A	2.72	4.63
Kazinvestbank	0.00	0.00	0.00
Kazkommertsbank	7.94	8.93	5.06
Nurbank	11.69	9.51	4.63
Danabank	N/A	N/A	N/A

³ These are Senimbank and Kazinvestbank.

⁴ Delta Bank and Tsesnabank adopted historical cost accounting method to value particular financial assets that are subject to fair value Level 3 input data requirements according to IFRS. It is noted that the amounts involved are not material.

⁵ These are BTA Bank, Subsidiary Bank Sberbank of Russia, and Senimbank, Temirbank. Therefore, their Financial Statements for 2010 were used for the analysis.

⁶ These are Danabank and Kaspi Bank. Therefore, their Financial Statements for 2010 were used for the analysis.

Sberbank of Russia	N/A	18.47	12.59
Senimbank	N/A	N/A	N/A
Temirbank	N/A	10.00	5.90
Tsesnabank	10.07	6.00	5.31
VTB (Kazakhstan)	1.65	22.42	27.91

Notes:

N/A Information not provided in the accompanying Notes to Financial Statements filed.

Across the sector, the percentage of total assets that were reported as fair value Level 3 assets over the review period was miniscule (see Table 2). Only two banks (11 percent of all banks or 17 percent of banks that reported Fair Valued assets over the review period) reported *fair value* level 3 assets in their Financial Statements on each of the three years between 2009 and 2011, and a further two banks reported only miniscule holdings of *fair value* level 3 assets in one or two years of the review period. Alliance Bank had by far the biggest proportion in each year, although falling from 24 percent in 2009 to 19 percent in 2011. The Development Bank of Kazakhstan reported a reduction in the balance-sheet importance of *fair value* level 3 assets over the review period. Both banks reported increases in the percentage of *fair value* level 2 assets to total assets. Thus, 15 banks (78 percent of all banks) did not declare holding any *fair value* level 3 assets over the review period.

TABLE 2: PERCENTAGE OF TOTAL ASSETS REPORTED AS FAIR VALUE LEVEL 2 AND LEVEL 3 ASSETS

Bank	2011		2010		2009	
	FVL2 Assets	FVL3 Assets	FVL2 Assets	FVL3 Assets	FVL2 Assets	FVL3 Assets
Alliance Bank	6.58	19.15	6.36	22.54	2.80	24.41
ATF Bank	2.89		1.72	0.01	1.79	N/A
BTA Bank	N/A	N/A	0.25		1.83	
Bank Centercredit	0.35	0.02	0.28	0.10	N/A	N/A
Delta Bank	9.80		11.27		5.66	
Development Bank of Kazakhstan	34.78	5.62	29.24	6.16	24.71	7.24
Eurasian Bank	0.18		8.15		10.95	
Eximbank Kazakhstan						
Halyk Bank	0.15		0.22		0.26	
Kaspi Bank	N/A	N/A	0.07			0.25
Kazinvestbank						

Kazkommerts- bank	N/A	N/A	N/A	N/A	N/A	N/A
Nurbank	0.19		0.80		0.56	
Danabank	N/A	N/A	N/A	N/A	N/A	N/A
Sberbank of Russia	N/A	N/A				
Senimbank	N/A	N/A	N/A	N/A	N/A	N/A
Temirbank	N/A	N/A	0.44		0.88	
Tsesnabank	9.23		5.76		4.42	
VTB (Kazakhstan)						

Note:N/A Information not provided in the accompanying Notes to Financial Statements filed.

The overall impression gained from the data included in Financial Statements filed over the 2009–11 review period by banks listed on KASE is that they—with Alliance Bank being the conspicuous exception—are not reporting significant amounts of *fair value* level 3 assets.

A Qualitative Assessment of Accompanying Notes

A qualitative assessment of the *fair value*-related content of the latest available (2011 unless otherwise specified) Accompanying Notes filed by all 19 bank listed on the KASE in 2011 against the above-mentioned disclosure principles has been undertaken, with a focus on the meaning received by end-users from those Accompanying Notes about the identification and valuation of *fair value* level 3 asset holdings. Each set of Accompanying Notes was systematically reviewed and their acceptability in terms of both the general adequacy of the *fair value* disclosures, and adequacy of the disclosures on the valuation of *fair value* level 3 assets.

The General Adequacy of Fair Value Disclosures

The general adequacy of the *fair value* disclosures is judged by their readability, prudence, completeness, and consistency and comparability, determined on the basis of the set of indicators described in the previous section and scored on a four-point Likert scale: unacceptable (0), limited acceptability (1), acceptable (2), and highly acceptable (3). The results are presented in that Table 3.

TABLE 3: THE GENERAL ADEQUACY OF THE FAIR VALUE DISCLOSURES BY KAZAKHSTAN'S PUBLICLY LISTED BANKS

Bank	Readability	Prudence	Completeness	Consistency and Comparability	Percentage of maximum possible score
Alliance Bank	3	2	3	0	67
ATF Bank	3	3	3	0	75
BTA Bank**	3	3	3	0	75
Bank Centercredit	2	1	3	0	50
Delta Bank	3	3	3	0	75
Development Bank of Kazakhstan	3	1	2	0	50
Eurasian Bank	3	3	2	0	67
Eximbank Kazakhstan	3	3	3	0	75
Halyk Bank	3	2	2	0	58
Kaspi Bank*	3	3	2	0	67
Kazinvestbank	2	2	1	0	42
Kazkommertsbank	3	3	3	0	75
Nurbank	3	3	2	0	67
Danabank*	2	2	1	0	42
Sberbank of Russia**	3	2	1	0	50
Senimbank**	3	0	1	0	33
Temirbank**	3	2	2	0	58
Tsesnabank	3	2	2	0	58
VTB (Kazakhstan)	3	1	2	0	50
Percentage of maximum possible score	95	72	72	0	

Notes

* No accompanying Notes filed with 2011 Financial statement. Latest available Notes accompanying filed with the 2010 Financial Statement.

** No Financial Statements for 2011 filed. Latest available accompanying Notes filed with the 2010 Financial statement.

Readability. Overall, the readability of the *fair value* disclosures in Accompanying Notes were judged to be significantly more than acceptable, with no bank being rated below “acceptable” and 16 banks (84 percent) being rated “highly acceptable”.

Prudence. Overall, the Accompanying Notes were judged to be marginally more than acceptably prudent, with only three banks (18 percent) being rated below “acceptable”, one of which was rated “unacceptable” because the Accompanying Notes filed contained no reference to *fair value*. Eight banks’ *fair value* disclosures (42 percent) were judged to evidence a “very acceptable” level of prudence.

Completeness. Overall, the Accompanying Notes were judged to be marginally more than acceptably complete, with only four banks (24 percent) being rated below “acceptable” but none were “unacceptable”. Seven banks’ *fair value* disclosures (37 percent) were judged to have achieved a “very acceptable” level of completeness. Noteworthy, however, is that no bank provided any details that would enable an end-user to understand the methods and assumptions used in the calculation *fair value*.

Consistency and Comparability. Overall, the Accompanying Notes were judged to be “unacceptable” as end-users received no information from any bank by which they could judge the consistency in their *fair value* methods and assumptions used on a year-on-year basis. Thus, they could not be confident in the *fair value* evaluations being calculated consistency, therefore, comparable over time.

Implications. The publicly listed banks in Kazakhstan, overall, provided in their latest available Accompanying Notes *fair value* disclosures that are readable, and are largely prudent and complete in their content. They failed dismally, however, to provide the IFRS-sanctioned disclosures that enable end-users to understand the methods and assumptions used in *fair value* calculations and to judge their consistency and comparability over time. This not only diminishes the trust- and utility-conduciveness of those disclosures, but also the reliable relevance of the Financial Statements filed.

The Adequacy of Fair Value Level 3 Asset Valuation Disclosures

The adequacy of the disclosures relating to the valuation of *fair value* level 3 assets is judged by the inclusion (scored as 1) or absence (scored as 0) of IFRS-required (IAASB 2005, IFRS7, IASB 2003, IAS 39) information items in Accompanying Notes to the latest available filed Financial Statements for the three banks (Alliance Bank, Bank Centercredit, and the Development Bank of Kazakhstan) that have reported *fair value* level 3 assets. The results are presented in Table 4. The *fair value* level 3 asset valuation disclosures by these three banks fall a long way short of the IFRS disclosure requirements. End-users of these Accompanying Notes would not have been able to understand the basis of the *fair value* level 3 assets valuations or to appreciate any estimation risks or contingencies that might prevail. Thus, the risks associated with drawing conclusions about, or from, those *fair value* estimations are indeterminable.

TABLE 4: THE ADEQUACY OF THE DISCLOSURES ON THE VALUATION OF FAIR VALUE LEVEL 3 ASSETS BY KAZAKHSTAN'S PUBLICLY LISTED BANKS

Disclosure Indicator	Alliance Bank	Bank Centercredit	Development Bank of Kazakhstan
The inclusion of appropriate corporate accounting policies.	0	0	0
The inclusion of a warning statement on the realizability of Fair Value valuation	0	1	0
The inclusion of statement justifying the presumption of the absence of active markets for Fair Valued Level 3 Assets.	1	0	0
The inclusion of a statement on whether or not Fair Value Level 3 assets have been reclassified.	0	1	0
The inclusion of a statement on the management assumptions and models used in Fair Valued Level 3 asset valuation.	1	0	1
The inclusion of a statement that there has or has not been any changes in valuation methods	0	0	0

for Fair Value Level 3 assets			
The inclusion of sensitivity analysis data for Fair Valued Level 3 Asset valuations.	1	0	1
The inclusion of a comparison the Fair Value Level 3 assets valuations and their historical cost valuations.	0	0	0
The inclusion of a statement on the presence of absence of any Fair Value Level 3 asset valuation contingencies	0	0	0
The inclusion of a statement on the presence of absence of any Fair Value Level 3 asset valuation risks	0	0	0
Percentage of Maximum Possible Score	30	20	20

Implications. The publicly listed banks in Kazakhstan reporting *fair value* level 3 assets provided very inadequate disclosures on the valuation of their declared *fair value* level 3 assets. The reliable relevance of the Financial Statement filed in 2011 by Alliance Bank is questionable because of its very restricted disclosures on the valuation of 19 percent of its assets, which significantly reduces its trust- and utility-conduciveness. In contrast, the implications of the restricted disclosure on the reporting of *fair value* level 3 assets for the reliable relevance of the 2011 Financial Statements filed by Bank Centercredit, and, to a lesser extent, the Development Bank of Kazakhstan, are rather more constrained because of their limited exposure to such assets (six and well less than one percent of total assets, respectively).

Fair Value Classification Ambiguities

Five banks⁷ included in their Accompanying Notes information on how they valued *fair value* level 3 assets (26 percent of all banks) (see Table 5), four of which explicitly declared that they held no *fair value* level 3 assets (31 percent of banks that did not report Fair Value level 3 assets).⁸

TABLE 5: EVIDENCE OF BANKS INCONSISTENCY ON FAIR VALUE LEVEL 3 ASSET CLASSIFICATION

Bank	Evidence
BTA	Note 32 (2010): “Trading securities and available-for-sale investment securities valued using a valuation technique or pricing models primarily consist of unquoted equity and debt securities. These securities are valued using models which sometimes only incorporate data observable in the market and at other times use both observable and non-observable data. The non-observable inputs to the models include assumptions regarding the future financial performance of the investee, its risk profile, and economic assumptions regarding the industry and geographical jurisdiction in which the investee operates.”
Kaspi Bank	Note 32 (2010): “Financial assets, available-for-sale, are valued using methods of valuation and models that mostly include unquoted equity and debt marketable securities. These assets are valued based on models that include explicit as well as implicit market data (assumptions regarding the future financial performance of the investee, its risk profile, and economic assumptions regarding the industry and geographical jurisdiction).”
Nurbank	Note 27 (2011): “Trading securities and investment securities available-for-sale valued using a valuation technique or pricing models primarily consist of unquoted equity and debt securities.”
Sberbank	Note 26, 2010: <i>Financial instruments recorded at fair value</i> The following is a description of the determination of fair value for financial instruments, which are recorded at fair value using valuation techniques. These incorporate the Bank’s estimate of assumptions that a market participant would make when valuing the instruments. <i>Available-for-sale investment securities</i> Investment securities available-for-sale valued using a valuation technique or pricing models primarily consist of unquoted equity

⁷ These are BTA Bank, Kaspi Bank, Nurbank, Subsidiary Bank Sberbank of Russia, and Temirbank.

⁸ These are BTA Bank, Kaspi Bank, Nurbank, and Subsidiary Bank Sberbank of Russia.

	and debt securities. These securities are valued using models which sometimes only incorporate data observable in the market and at other times use both observable and non-observable data. The non-observable inputs to the models include assumptions regarding the future financial performance of the investee, its risk profile, and economic assumptions regarding the industry and geographical jurisdiction in which the investee operates.
Temirbank	Note 5 (2010): “Where the fair values of financial assets and financial liabilities recorded on the statement of financial position cannot be derived from active markets, they are determined using a variety of valuation techniques that include the use of mathematical models. The input to these models is taken from observable markets where possible, but where this is not feasible, a degree of judgment is required in establishing fair values.”

Implications. One-third of the publicly listed banks in Kazakhstan not reporting *fair value* level 3 assets provided in their latest available Accompanying Notes very confusingly, perhaps even misleadingly, disclosures on the valuation of their (non-existent?) *fair value* level 3 assets. This hints at incompetence, or, more worrying, the possibility of the non-disclosure of *fair value* level 3 assets. In any event, the reliable relevance of the filed Financial Statements of those banks is diminished by the inclusion of such ambiguities in their Accompanying Notes. This has implications for the auditing profession.

FAIR VALUE DISCLOSURES: THE CHALLENGES FOR AUDITORS

The global auditing standards guide “the auditor’s responsibilities relating to accounting estimates, including fair values accounting estimates and *related disclosures* in an audit of financial statements” (IAASB 2008, ISA 540: para. 1, emphasis added). An auditor has an obligation to obtain sufficient appropriate audit evidence to enable him or her to include in the audit documentation “the basis for the auditor’s conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks; and indicators of possible management bias, if any” (ISA 540: para. 23). At issue is that estimation uncertainty — the degree of veracity of an accounting estimate — leads to “the risks of material misstatement of accounting estimates, including their susceptibility to unintentional or intentional management bias” (ISA 540: para. 2). An auditor has, moreover, a mandate to evaluate disclosures related to all accounting estimates (ISA 540: 465), so as to ensure a full and accurate disclosure of all relevant information related to the calculation of all *fair value* and other accounting estimates. Indeed, an auditor may conclude that the disclosures are inadequate, even if they are in accordance with applicable financial reporting standards, when they relate to a significant risk of material misstatement (ISA 540: A122).

Auditors are not expected to, cannot, and do not affirm the correctness (truthfulness) of the fair value accounting estimates (Georgiades 2005, Pannese and DelFavero 2010). The implications of the accounting profession adopting what Popper ([1935/1959] 2000) would

undoubtedly have regarded as self-referential systems of thought, one that generates unfalsifiable accounting estimates, is that Auditors should at least be expected “to obtain audit evidence about *reasonableness* of fair value accounting estimates and *adequacy* of related disclosures in the financial statements in the context of the applicable financial reporting standards or framework” (ISA 540: paragraph 6, emphasis added).

CONCLUSION

The publicly listed banks in Kazakhstan provided in their latest available Accompanying Notes *fair value* disclosures that are, overall, readable, and are largely prudent and complete in their content. Not disclosed in any Accompanying Notes, however, are the financial or other facts necessary for a proper understanding of the methods used to calculate the expected market values of financial assets, and their associated estimation contingencies and risks, particularly for *fair value* level 3 assets. The two banks that chose, contrary to regulatory requirements, to adopt the historical cost accounting method to value all their financial assets did not disclose their reasons for this decision, which solicited no disclosure reaction by the auditor. All banks reviewed failed dismally to provide the IFRS-sanctioned disclosures that enable end-users to establish consistency and comparability. Those reporting *fair value* level 3 assets provided very inadequate disclosures of their own subjective pricing assumptions. More worryingly, almost one-third of the banks *not* reporting *fair value* level 3 assets made disclosures on the valuation of (non-existent?) *fair value* level 3 assets. This hints at incompetence, or, more worryingly, the possibility of the non-disclosure of *fair value* level 3 assets. These non-disclosures and ambiguous disclosures diminish the trust- and utility-conduciveness of both the *fair value* valuations and the filed Financial Statements.

Overall, the Accompanying Notes reviewed do not provide the basis for end-users to judge the *reliability*—verifiability, neutrality, and representational faithfulness—of the reported fair market value of financial assets, particularly those for which there is little, if any, market activity upon which to base a valuation. Nor do they give end-users any basis for confidence in their *relevance* (predictive and feedback value). Conspicuously lacking was any robust assessment by auditors’ of any significant *fair value* estimation contingencies and risks. The crucial implication for end-users of these financial statements is their need to be ever alert to the ethicality of both management and auditors, as both grapple with the ethical dilemmas associated with estimating and auditing those financial estimates that are, and will always remain *hypothetical* and, thus, *unknowable*.

REFERENCES

- Accounting Concerns (2012). “Completeness”. Available at:
www.accountingconcern.com/accountingdictionary/completeness/ (retrieved 27 August 2012).
- Bromwich, M. (2007). “Fair Values: Imaginary Prices and Mystical Markets.” In Walton, P. (ed.), *The Routledge Campaign to Fair Value and Financial Reporting*. London: Routledge.

- Cunningham, C. (2004), "Fair Value Accounting: Fair for Whom?" *Financial Executive* March/April.
- Emerson, D. J., Karim, K. E. and Rutledge, R. W. (2010). "Fair Value Accounting: A Historical Review of the Most Controversial Accounting Issues in Decades". *Journal of Business & Economic Research* 8 (4): 77–85.
- Financial Accounting Standards Board (FASB) (2008a). *Fair Value Measurement* (Statement of Financial Accounting Standards, No. 157). Norwalk, CT:FASB.
- FASB (2008b). *Statement of Financial Accounting Concept* (SFAC)2, Glossary of Terms. Norwalk, CT:FASB.
- FASB (2010). *Statement of Financial Accounting Concept* (SFAC)8 (September). Norwalk, CT:FASB.
- Georgiades, G. (2005). "Audit Considerations in the Current Economic Environment (PCAB Staff Audit Practice Alert No. 3)". *GASS Update Service* 9 (03).
- Gibbins, M., Richardson, A., and Waterhouse, J. (1990). "The Management of Corporate Financial Disclosure: Opportunism, Ritualism, Policies, and Processes". *Journal of Accounting Research* 28 (1): 121–143.
- International Accounting Standards Board (IASB) (2003). *Financial Instruments: Recognition and Measurement* (International Accounting Standards (IAS) 39) (as amended). Available at: <http://www.ifac.org> (accessed 4 September 2012).
- International Auditing and Accounting Standards Board (IAASB) (2003). *First-time Adoption of International Financial Reporting Standards*(International Financial Reporting Standards (IFRS) 1) (as amended). Available at: <http://www.ifac.org> (accessed 4 September 2012).
- IAASB (2005). *Financial Instruments: Disclosures* (IFRS 7) (as amended). Available at: <http://www.ifac.org> (accessed 4 September 2012).
- IAASB (2008). *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (International Standard on Auditing (ISA) 540). Available at: <http://www.ifac.org> (accessed 4 September 2012).
- Jones, J . C. (1988). "Financial Instruments: Historical Cost v. Fair value". *The CPA Journal* 58 (8): 56–63.
- Kazakhstan Development Bank (2012). *About the Bank*. Available <http://www.kbd.kz/en/about/> (retrieved 21 August 2012).
- Magma, M. and Cormier, D. (2005). "From Accounting to 'Forecounting'". *Accounting Perspectives* 4 (2): 243– 257.

- Pannese, D. and DeFavero, A. (2010). "Fair Value Accounting: Affect on the Auditing Profession." *The Journal of Applied Business Research* 26 (3): 43–50.
- Popper, K. (2000 [1935/1959]). *The Logic of Scientific Discovery* (2nd ed.). London: Routledge.
- Power, M. (2010). "Fair Value Accounting, Financial Economics and the Transformation of Reliability". *Accounting and Business Review* 40 (3): 197–210.
- Seay, S. S. and Ford, W. W. (2010). "Fair Presentation—an Ethical Perspective on Fair Value Accounting Pursuant to the SEC Study on Mark-to-Market Accounting." *Journal of Legal, Ethical and Regulatory Issues* 13 (1): 53–66.
- Spiceland J. D., Sepe, J. F., Nelson, M. W., and Tomassaini, L. A. (2007). *International Accounting* (4th ed.). New York: McGraw-Hill.
- Standard & Poor (2012). *Banking Industry Country Risk Assessment: Kazakhstan*, available at:
<http://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245333605360> (Retrieved 26 June 2012).
- Williams, J.R. (2010) *Financial Accounting* (15th ed.) New York, McGraw-Hill.