Fair Value, an Alternative to Historical Cost in Accounting

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Abstract

In the last years, traditional management – based on the analysis and interpretation of accounting data – has turned out to be incapable to assess and express, in a clear and correct manner, real performance of the entities involved (Barneto P., 2008). Under these circumstances, it has been necessary a change in the managers' attitude. Currently, they tend to bend more focused not on the income maximization but on the maximization of the value provided to shareholders, and not on resorting mainly to accounting data, but to the dynamics of cash flows. This paper proposes an valuation of the fair value concept based on entities realities - legal, accounting practices in that area, and taking into account the existing fiscal limitations.

Keywords: *Historical cost, fair value, future treasury flows from use, active market, use value, market value.*

JEL Classification: M41

Introduction

Traditional indexes, such as economic profitability or other performance indexes, which nonetheless do not integrate comparison with the market and with the profitability of alternative investments, can no longer meet the needs for making decisions at the moment. Under these circumstances, it has been necessary a change in the managers' attitude (Robu I.B., Bălan C.B., Jaba E., 2012). Currently, they tend to bend more focused not on the income maximization but rather on the maximization of the value provided to shareholders, and not on resorting mainly to accounting data, but rather to the dynamics of cash flows. This is also a result of the fact that the traditional instruments for measuring managers' performance, by being based on accounting data, do not take into account neither risk or inflation influence, nor the opportunity cost.

Currently, national destinies are strongly influenced by the forces of the world global competition (Deaconu A., 2009), so that the decisions of management, investment and of financial nature have considerable international implications. Since most of these decisions are based on accounting information, it is necessary a good knowledge of national and international accounting norms, so that business can go well.

Thus, it can be witnessed a transformation of the accounting system, which has to insure to information users – investors/shareholders, creditors, a.s.o. – clear, credible and internationally comparable sources, so that their decisions be based on strong grounds. In the past, at a global level, there were two opposed accounting traditions: the Anglo-Saxon one, which is in the interest of investors and has the main objective of comparing financial performances, and the continental one, which is controlled by the state and oriented towards all the partners of an entity – fiscal administration, creditors, employees, owners, a.s.o. While the continental system agrees the measurement at a historical cost, the Anglo-Saxon one proposes the adoption of fair value, the evaluation being carried out at the market value (mark to market).

1. Why fair value?

Fair value has been the key-point of the debates within the international accounting comm unity and the business world for more than two decades. It is currently combining with the international process of accounting harmonization. The need for using fair value comes from the increasingly strong criticism brought to the traditional accounting system - confronted with an accounting perspective more and more based on shares. Thus, one may justifiably ask what fair value represents and how useful its use is, as accounting convention replacing the traditional accounting system. Presenting the results of an accounting entity is based on the knowledge and understanding of some concepts and conventions called *accounting principles*, whose observance and enforcement represent one of the elements related to accounts fairness. These accounting principles have evolved and have undergone changes throughout time. Thus, together with the development of fair vale notion, the principle of monetary nominalization (or of historical cost) is no longer universally acknowledged; moreover, the prudence principle has been put under question.

Historical cost is nowadays subject to a lot of criticism. Before this reality, one might reasonably want to know the reason for which this principle does no longer meet the expectations of accounts users. Just like the method of complete costs in the management accounting, this old principle has been based on the needs of the post-war industrial enterprises. Notions such as value creation, financial instruments and swaps did not represent at that time a preoccupation of enterprises managers (Ristea M., 2007).

The principle of historical cost presupposes the valorization of all balance-sheet fields concerning expenses and, respectively, immobilizations at the level of the expenses incurred at the entrance of the items in question. These costs represent the point of reference in relation with the eventual valorizations of such elements. Notions such as inflation, evolution of the purchasing power and other similar ones are ignored, even if they exist, without a doubt, in the sphere of economic reality. Accounting based on historical costs has been harshly criticized, particularly in the inflationist periods, by many authors who have noticed that the changes affecting the purchasing power have led to strong variations of the general level of the goods and services price, thus reducing the reliability of the currency as valuation unity.

And, although historical cost offers unquestionable advantages, such as reliability, prudence, continuity, verifiability and precision, its enforcement leads nonetheless to a number of deformations, in inflation conditions, such as:

- ✓ in balance-sheet: immobilizations undervaluation, stock undervaluation, distortion of the concrete economic statement (which is generally under valuated), a.s.o.;
- ✓ in the profit and loss account: materials cost undervaluation – due to stock undervaluation, undervaluation of amortization related expenses – due to immobilizations undervaluation, increase of income tax – due to overvaluation of results (which are in their

turn determined by unevaluated expenses: materials consumption, amortization related expenses, a.s.o.).

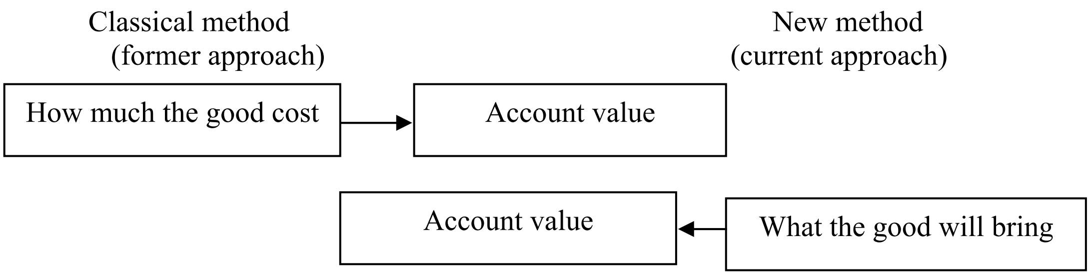
In what the *prudence principle* is concerned, IASB (IFRS, 2011) states at paragraph 20 of IAS 1 ("Presentation and elaboration of financial statements") the following: „Prudence is necessary to avoid overstating assets or profit, or to avoid understating liabilities or a loss, and to ensure that uncertainties are disclosed adequately." And, even if the prudence principle is acknowledged by the international regulator, it is still not exempted from criticism. Thus, as it happens with accounting at historical costs, the prudence principle collides with the investor's perspective, not allowing, for instance, obtaining an extinguishable value of the eventual investments. Accounts do not insure a fair value of assets and do not offer the possibility to assess the potential pluses of value.

The prudence principle does not permit to establish the performance of an investment immediately. This principle presupposes and advances the idea that the pluses of value must be acknowledged only at the moment when they are accomplished. Moreover, a prudence excess at the level of accounts is tantamount with a transfer of the result over future taxable years, therefore leading to a penalty of current shareholders in relation to the future ones.

2. Are historical cost and fair value in conflict?

Fair value has been generated by the increasingly important evolution of accounting objectives. Such evolution has emerged in its turn as a consequence of the recent changes within the economic background (Ristea M., 2009). As pointed before, accounting at historical costs allows for the measurement of items and balance-sheet categories at the level of the purchasing cost, which is a comeback price. A certain idea has become dominant in the last years, namely that of assessing certain expenses, but particularly the enduring elements of financial statements, such as the assets immobilized at the estimated value of future flows which they can provide to an enterprise (the recoverable sum or the recoverable value). As a consequence of this perspective, we can take into consideration the potential price for which a good is resold, particularly for insuring to that good a value within accounts.

The account value of a good



(Source: TOURNIER J.C., La révolution comptable: Du coût historique a la juste valeur, Editions d'Organisation, 2000)

This major change of perspective involves assessing future flows from incomes rather than past expenses, a fact which involves a significant turnover in accounting. According to such a perspective, the objective of accounting is that of fathoming and analyzing future, precisely in order to transpose it in financial statements; this approach has a strong incidence upon annual financial statements. IASB adopted this tendency in 1997: accounting norms must be established from the perspective of favouring the previsions of managers, of decisional factors.

Thus, the IAS accounting norm related to financial statements ("Purpose of financial statements") provides that the information presented in accounts "helps users in regard to their previsions about future flows, but particularly in regard to the reliability of obtaining cash or other equivalents". This accounting change, having a strong impact upon the economic background and favouring at the same time the emergence of fair value notion, was generated by the development of market operations but especially of complex financial instruments and swaps.

Generally, swaps are initially negotiated without involving cash flows. By not having an origin cost, these financial products are not, according to the traditional accounting model, assessed within the balance sheet. Currently, enterprises use these financial instruments at a massive scale, thus becoming exposed to superior risks, but without adapting their informational content of annual financial situations.

Moreover, the current economic background, which is strongly influenced by the internationalization process, contributes to the purchasing of enterprises at prices often high, a fact which leads to the apparition of new valuation methods. Finally, the purchasing price of an enterprise is based on the information regarding its future, that is on its future flows. Under these circumstances, the account value of the past, concerning the purchased assets, does not have much importance for the purchaser in reality.

In order to meet the users' needs of information and, respectively, to improve and insure the transparency of information, it is necessary to use *fair value*. The Romanian expression *"valoare justă"* is the imperfect, but currently consecrated translation, of the Anglo-Saxon expression *fair value,* which literally corresponds to the idea of *honest*, *loyal* value. The first definitions of fair value emerged quite late: FASB (Financial Accounting Standards Board) defined it around 1982, by adopting the norm FAS 87. IASB (International Accounting Standards Board) introduced fair value within its rules system only in 1995, with the norm IAS 32 ("Financial instruments"): *"fair value shows the amount for which an asset could be exchanged, or a liability settled, between two knowledgeable, willing parties in an arm's length transaction…"* There mustbe a convergence between the way that assets are assessed in accounts and, respectively, the use of accounts. Both IASB and FASB have chosen a valuation method based on the value of immediate accomplishment of assets, that is the value at a "t" moment on the market (Anglo-Saxon approach), in opposition with the European approach which takes into account the transaction itself. Fair value is the result of the need to satisfy the needs of financial statements users, allowing the latter to answer at the following question: do I have to purchase, to keep or to sell the possessed assets?

Taking over the concept related of fair value by the accounting systems generates changes upon the content of what is called accounting valuation. The change is implied right by the presentation of current accounting objectives, starting from the notion of *acknowledgemen*t. The latter means nothing else but noticing the existence of the financial statements elements, that is: assets, own capitals, debts, expenses and incomes. More precisely, it shows the fact which generates the emergence of all these elements, states the criteria according to which an element is registered in the current accounting and is then reported in the annual financial statements.

In regard to the criteria for acknowledging the elements reported in financial statements, it can be identified the possibility of generating future economic benefits, but also the possibility of a reliable (credible) measurement of value. The second criteria mentioned above, related to valuation, involve performing a correct, rational and credible measurement, by using consecrated methods and procedures.

In accordance with the way it is performed, valuation presupposes:

➢ the correct registration of the existing values in the justifying documents, from an accounting point of view, case in which these values become costs of the entity in question;

➢ the adjustment of some values, by means of estimation, when there are no specific justifying documents at the moment when an accounting item enters in management and, respectively, when it is performed an ulterior valuation of some of the accounting items.

In the last case mentioned above, it becomes necessary to estimate some reliable values, determined in good faith, in accordance with all the information that could be obtained at the assessment date, so that the item in question can be acknowledged in financial statements. Thus, it can be easily acknowledged that the old valuation basis – the historical cost – can no longer provide a valid universal background for all the forms currently accepted in the field of accounting valuation. Historical cost is completed by other valuation bases as well, which constitute representations of fair value in accounting, such as: actual cost, accomplishable value and actual (updated) value. For a valuation at a fair value, both FASB and IASB have identified several valuation bases:

➢ market value,
➢ use value or value of future treasury flows,
➢ replacement value

Of the three values mentioned above, **market value** is an objective, neutral value, which is established only on the basis of external information – the market ones, by not taking into account a certain user or the use of the asset in question. Its adjustment may be carried out either through an efficiency method – by starting from cash flows generated by an asset – or by using a method based on market comparisons, the basis being the prices of some recent transactions with similar assets. Market value represents the main objective of any kind of valuations.

The use value resorts also to external information in the adjustment – market information, but also data specific to the entity which owns an asset. The same value is determined by updating cash flows which generate an asset over an estimated period of time, to which the residual value is added at the end of the period.

The replacement value is in exchange based on information typical to an entity, starting from the gross production/replacement cost of the asset adjusted with the relative depreciation.

Knowing that the determination of fair value is the competence of the specialized assessors and starting from the analysis of the accounting norms, valuation norms and the methodology elaborated within specialized literature, there have been identified three approaches of value in practice, as it flows:

- *the estimation of market value* starting from an approach based on market comparisons, through the analysis of transactions with similar assets. Thus, the evaluated asset is compared with other similar ones, commercialized on an active, free market, by starting from the known price of such assets, adjusted in respect of the differences related to the valuated asset, keeping as point of reference the amended value of the asset which has undergone the smallest number of amendments. The objective is that of obtaining a value as close as possible to market value.

- *the measurement of the use value* through an approach based on income, totalizing the future anticipated incomes, generated by the asset in question, under the management conditions exiting within the entity.

- *the establishment of the replacement value* through an approach based on cost, by starting from the replacement cost of its component parts, relived by the depreciation acquired until the valuation date.

3. Fair value versus historical cost

Given that each of the two structures – historical cost and fair value – have both advantages and disadvantages, we cannot speak about the application of a freestanding accounting system, based only on historical cost or only on fair value, but about a combined valuation system.

Although it provides continuity, verifiability and precision, and although is credible and reliable, historical cost, when applied, leads nonetheless to a number of deformations within financial situations, under inflation circumstances.

On the opposite side, although it provides (Deaconu A., 2009) better information and comparison of the present and future performances of an entity, allows to obtain more reliable financial situations, provides a greater accounting objectivity and neutrality, reduces the difference between accounting value and stock exchange value – for rated entities, and improves managers' control upon the patrimony of an entity, fair value, from the perspective of its concrete determination, raises serious technical and financial problems, being difficult to be calculated by an entity's staff, without the help of an assessment expert.

The combined valuation system involves the use of historical cost and, in some cases, of fair value, both for the current registration of transactions and for the elaboration of financial statements. When it comes to the elaboration of financial statements, the combined valuation system can be applied in relation to unique financial statements, within which fair value is used together within historical cost at which some items have remained assessed, but also by elaborating distinct financial statements, within which all elements are reflected at fair value, statements which will be added to those expressed at the historical cost.

4. The Romanian context

In the last years, traditional management – based on the analysis and interpretation of accounting data – has turned out to be incapable to assess and express, in a clear and correct manner, real performance of the entities involved. Traditional financial indexes, such as economic profitability or other performance indexes, which do not integrate comparison with the market, with the profitability of alternative investments, can no longer meet the needs for making decisions at the moment. Under these circumstances, it has been necessary a change in the managers' attitude. Currently, they tend to bend more focused not on the income maximization but on the maximization of the value provided to shareholders, and not on resorting mainly to accounting data, but to the dynamics of cash flows. This is also a result of the fact that the traditional instruments for measuring managers' performance, by being based on accounting data, do not take into account neither risk or inflation influence, nor the opportunity cost.

Thus, in the last period, in what assets are concerned, it has been agreed to set certain payments (particularly those regarding immobilizations) at the estimated value of future flows of incomes provided to entities – recoverable or covering value – rather than at past expenses expressed at their historical cost, a fact which is synonymous to a considerable radical change in accounting. According to such a perspective, the objective of accounting is that of going deeper into and analyzing future, precisely for transposing it into financial circumstances.

Under the current circumstances, which involve the scientific research within the filed, even if the Romanian accounting practice has registered a significant normative progress, by taking over, sometimes up to the point of identifying itself with them, the concepts and definitions existing within financial report standards, Romanian norms do no not offer too many alternatives, by preserving their character of regulations strictly explained, a fact which does not provide the possibility of choosing an accounting remedy or applying a policy established through a professional judgement correlated with the normative requisites.

5. Conclusions and proposals

The Romanian accounting system has undergone a radical reform in the last years, but the preoccupations for the improvement and development of Romanian accounting continue. Many internal and external factors render necessary for the accounting professionals to know IRFS, in a world of globalization and internationalization. At the same time, in order to maintain the general objective of putting at the disposal of financial managers and analysts a common internationally agreed background, related to the elaboration and presentation of financial statements, accounting professionals have the duty to contribute to the elaboration of some accounting policies which can transform accounting in an essential leadership instrument. Although Romanian accounting has registered a significant normative progress, by taking over, up to the point of identifying itself with them, the concepts and definitions existing in standards, Romanian norms still do not offer too many alternatives, by preserving their character of strictly explicit regulation, which offers no possibility of choosing an accounting treatment or of applying a policy established through the professional judgement correlated with normative requests. There has not been yet identified a dialogue possibility between accounting norms and accounting policies, between the freedom to choose accounting procedures and the obligations to provide users with relevant and credible information. Moreover, fiscal limitations do not motivate accounting professionals to apply two types of treatment: an accounting and a fiscal one.

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