Academic Journal of Economic Studies
Vol. 1, No.4, December 2015, pp. 91–102
ISSN 2393-4913, ISSN On-line 2457-5836

Debate Regarding Measuring Accounting Value: Historical Cost against Fair Value

Victor Munteanu[1], Marilena Zuca[2]

[1]*"Dimitrie Cantemir" Christian University, Bucharest, Romania, e-mail: a2c_vm@yahoo.com*
[2]*Romanian-American University, Bucharest, Romania, e-mail: marilena_zuca@yahoo.ro*

Abstract *The transition from historical cost to fair value represents an option with major implications in accounting, because it is a complex process that requires tuning to today's trends of national and global economy. We can state that with all the advantages of using historical cost it has its limitations and it is" getting old". That doesn't mean that will be abandoned but substituted when it is needed with another value. At present, the lack of historical value is inconceivable; many practitioners consider it to be the best method to evaluate assets.*

Key words Fair value, historical cost, evaluation, financial statements, use of accounting information, viable, IASB, IFRS

JEL Codes: M41

1. Introduction

There have been a lot of discussions and literature on *value*, starting from its definition to its role in human life. In accounting value is a result of assets, debt and equity. Through value, accounting mixes the way miscellaneous assets are expressed to quantify the patrimony as a whole. Settling the value of assets, debt and equity have differed in time and space. Accounting has searched the most suited methods to settle the value of patrimony, by rendering a "faithful image „of it and of its results.
Starting from the premises that "accounting globalization is not a reversible process" and taking into consideration the context of the global economic crisis, we considered a good motivation based on science to analyse the measure in which the new values adopted by accounting, especially fair value, are able to answer to informational needs of users today; users that want to know not only how the previous financial period was but how to anticipate future evolutions of the entity based on information from financial statements. Achieving a fair evaluation is in fact the key of success in financial services also, because in order to sell or buy a financial instrument is important to know its value. Also, after buying a financial asset or having a financial debt, evaluation represents the success of risk management of that specific element and a success in reporting the value created

to the shareholders. Considering an economy in full process of globalization it is obvious that changes have occurred in all areas of science, including accounting. Because of economy globalization, comparing accounting data specific to each country and system is a problem, thus globalization is a process that includes all countries at an international level.

The economic and financial crisis that enveloped the whole world revealed a problem that regards evaluation in financial statements. The problem is the lack of information needed by investors, a problem that would have stopped even the best evaluation technique to generate a significant level of accuracy.

2. Literature review

Historical cost accounting - when and to where?

In accounting theory and practice have been proposed several bases of assessment, including: *historical cost, current cost, realizable value, present value, fair value*. The question is which of these measurement bases will be chosen, taking into account the advantages and disadvantages of each. Finally, standard setters concluded that in measuring and presenting accounting information, best suited would be historical cost, because of its reliability, its clarity in definition, and its confirmable character.

Historical cost accounting was developed in the nineteenth century as a result of the industrial revolution, but has its origins in the XVth century, when it was first used in the textile factories. Gradually, the principle of prudence is introduced in accounting, so, today, and we cannot talk about historical costs in accounting without bringing up the principle of prudence. Savary is one of the first authors to include in accounting aspects of the principle of prudence.

Therefore, historical cost is the origin-evaluated, measured and recorded when assets enter in inventory and when debt is created, a consequence of two fundamental principles: the principle of monetary nominalism and prudence (Feleaga and Feleaga, 2007).

As Gelard noticed, historical cost leads to a negative vision of the entity because by respecting the principle of prudence we do not allow recognition of potential loses for elements of assets and never for the winnings (Gelard, 2005). Therefore, historical cost accounting does not anticipate all profits for the entity but anticipates the loss. It is well known that by using historical cost accounting managers can create secret reserves with which they can “play” with (Reis and Stocken, 2005).

Historical cost is oriented towards the past, but unlike other methods of evaluation it has a bigger advantage: *is well defined and confirmable, once settled it stays fixed as long as the asset is owned by the entity*. It seemed that nothing can happen to the historical cost as long as there are these advantages. Then what is the big

disadvantage that makes obsolete historical cost value? The answer is: *inflation* (Jianu, 2012). Determination of the basis of measurement used in determining the various economic elements in the synthesis documents represented one of the most difficult accounting issues. In accounting practice and theory many measuring bases have been accredited: *replacement cost, achievable net value, economical value and historical cost (diminished with amortization or provisions, if necessary).* The question is: which one of this methods should be used by accountants? The makers and users of financial statements considered that is much more useful "*historical cost*". This cost has a greater advantage from the others based on its" *reliability*".
Historical cost is the consequence assessment of various assets, equity and debt entry into patrimony. They are evaluated as follows: goods entered against payment (payment), *at cost*; goods produced by the enterprise, *the cost of production*; assets entered free of charge at the *utility value*; receivables and payables at *their nominal value* (stipulated in the contract, order, invoice or other document).

3. Methodology of research

The starting point of this research was that of theoretical documentation by studying literature specific to focusing on research work that is supported by both the Romanian literature and the foreign research works conducted on the topic, but also on the study of European Directives and International Financial Reporting Standards, normative acts (MFP order no. 1802/2014 for the approval of accounting regulations on the annual individual and consolidated financial statements, MFP order no. 4160/2015 regarding the modification of certain accounting regulations, Law no. 227/2015 on the Fiscal Code, the Accounting Law no. 82/1991, republished) and the evolution of accounting regulations, which allowed the formulation of views and clear structuring aspects of reference for evaluation. The study involved the creation of bibliographic records to synthesize the information, literature translations, consulting databases indexed concerning research work in the field.
During this research we tried to adopt a pragmatic vision that answers the dilemma: should we evaluate at historical cost or fair value?
Our scientific research is based on the current research trend, within positivism, trying to explain through a detailed and deep approach, different sides (conceptual and pragmatical) of accounting evaluation, trying to provide as well some predictions regarding the evolution of regulations and practices in the specified field. Also, this paper tries to combine elements of interpretive and critical trends, addressing different concepts, regulations and practices from financial accounting, in an interpretive manner(a neutral point of view), but also a critical one(a specific point of view). We have used a wide palette of research methods, like: *document*

analysis, compared method, typological method, external observation (non participative) and participative method.

Also, in developing this study we used a set of information sources consisting of: *scientific articles* published in various journals (with national and international recognition), *specialized books relevant to the field of reference, legislation, studies and analyzes related research area, official documents and press releases of different organisms profile* etc.

4. Pros and cons on historical cost

Followers of fair value are against applying historical cost, stating that evaluation at historical cost provides a distorted image of reality, respectively the elements of balance sheet are undervalued and expenses with inventory and amortization from the Profit and loss account are also undervalued, while fair value improves the quality of financial statements and tries to provide credible and relevant information for all users. In the first case the result is overrated and distributing it leads to allocation of capital. We cannot emphasize the fact that evaluating at fair value and not presenting an adequate financial statement in the explanatory notes, can be much more dangerous than evaluating at historical cost, because it can lead to the volatility of the financial result, not knowing the risks of including "*virtual*" elements provided by the market evolution, can lead to potential winnings or loses. Choosing historical cost, although it can have other alternatives, is based on the fact that it is the only cost recorded in the documentary evidence, thus it is confirmable and objective, within market transactions. Furthermore, historical cost emphasizes the true value of patrimonial elements at the time of their entry in the institution, but later, any significant change tends to make historical cost deceivable when making decisions and insuring liquidity or purchasing power of equity. Thus it appears the desynchronization effect between input elements of patrimony at historical cost, and output value based on actual/present value (generally, achievable value, as a present price). Given that the price curve is rising, the effect of lack of synchronization causes an increase without a real basis of the outcome as a result of price variation between two moments of assessment: input - output. Increasing results is based on taxation and profit distribution as dividends, with indirect implications on the economic analysis decapitalization of the entity. *Such an effect forced on accounting evaluation finding different mechanisms* to help decrease**,** until cancellation, the selfdistorsion of historical cost. Therefore, maintaining the historical cost basis of valuation, specialists have searched certain alternatives and corrective measures extending to accounting price changes and revision of financial statements in hyperinflationary economies.

Against historical cost are the *advantages of fair value* favoured by the development of capital markets and the improvement brought by processing information. The fair value as a valuation basis has the most supporters especially in countries with economies centered on the capital market, where it has the following advantages:

- *allows to obtain more reliable financial statements*

In the context of accounting information characteristics, fair value is reliable and pertinent, in the sense that it represents a measuring instrument that allows obtaining reliable information, for example "fair value allows a reliable accounting treatment for operations regarding currency hedge".

- *Provides greater objectivity and accounting neutrality*

Fair value doesn't allow excess in creative accounting from the management, while historical cost is based on subjective estimations under the supervision of the manager of an entity, regarding corrections for recordings of assets depreciation.

- *Allows a better comparability of fungible assets , especially for financial instruments*

Regardless of the initial date of their registration in accounts, fungible assets are converted into actual values.

- *Allows a "more economical „view on assets and capitals attracted by the entity*

Fair value is oriented towards prediction, helping in evaluating an entity and revealing "markets opinion translated into actual value of future cash flow", (Ristea, 2003) which helps the process of making decisions.

- *Provides a better informing and comparison on present and future performances of the entity*

Through fair value, the result would be measured by variation in value of assets, equity and debt, the distinction being made between the result from exploitation and economic and financial result. In the context of *better informing and comparison of present and future performances of the entity*, accounting values don't always allow comparing performances, while daily value helps compare information. This method of quantifying results would improve the expression of economic value in accounting. Considering that any dormant plus or minus generated by, for example, financial instruments in accounting are recorded in the result of the exercise, it would create a global measure of performance.

- *minimizes the difference between book value and exchange value for listed entities*

Using fair value we can easily determine the value of the entity by patrimonial method, fair value assuming the evaluation of all or most of all the elements in a financial statement according to it.

- *Improves managerial control on patrimony of the entity*

By applying fair value managers would provide a valuable database for the calculation and control of indicators that can increase shareholder value. Moreover, such financial statements would allow us to notice how much of the global value of a share comes from the capacity of the entity to generate a higher return of assets on the market, and how much is owed to only owning assets.

- *It provides a consistency of active management of financial risks*

Thanks to fair value, banks especially, can manage the interest rate and exchange rate risk on a daily basis.

- *It has a more universal character than historical cost*

Historical cost is influenced by the peculiarities in local accounting and fiscal law while fair value is not.
Nonetheless fair value has its disadvantages:

- *It doesn't always provide a reliable information*

If we take the example of present value it is necessary to estimate the lifetime of the asset, its residual value, the cash flows they will generate in time, respectively the discount rate. Estimates by nature are subjective. To this may be added the deliberate distortion of the parameters. The valuation model induces an inherent risk and another linked to the deliberate manipulation of information. Of course, to alleviate this criticism on fair value measuring models we can mention ways to minimize the risk in this model which would be an efficient internal control, respectively constituting provisions for this type of risk.

- *Its tangible determination causes numerous technical and financial problems*

If the market value is not at hand and we rely on specific methods of evaluation it is imperative to know the methodology of evaluating assets and to determine market expectations that are not directly noticeable. On the other hand and in connexion with the statements above, the cost of obtaining the application of fair value can be high.

- *Creates difficulties in determining distributable earnings*

New values for assets, equity and debts are dormant potential values. Plus, market value (physical evidence of fair value) is volatile. Still, we would say that a higher volatility in results isn't necessary a negative aspect, because it actually reflects reality. The problem is that we cannot follow at the same time the transparency and denying certain values determined by the market.

- *Doesn't allow the refection of intangible assets*

In this case, certain assets of this type have not been the subject of accounting records, but have contributed significantly to the overall value of the business. Examples are: *qualification and motivation of staff, managers' competence, and the quality of good payer of the entity* (Ristea *et. al*, 2009).

- *It provides a short term vision on the financial situation of the entity*

Obtaining fair value can be achieved by estimating future performances of the entity's assets, followed by an update of the cash flows that will be generated by these elements. Although predictive, the method doesn't reflect the financial situation on a long, medium or short time. This is because the current values obtained by forecasting take into consideration the information existing at the time of the estimate, but the circumstances considered may change, and with them the predicted values. Therefore, the values determined are valid in the short run.

- *It influences the manner of the presentation and analysis of some elements or transactions under evaluation based on fair value*

Considering credit institutions there is the problem of fair evaluation of the results and equity of these entities. Thus, we can talk about the usefulness of the Profit and Loss account, of its results, based on evaluating instruments at fair value and on the obvious influence or not, of the market.

- *It favours one of the categories that uses accounting information, respectively investors*

Fair value offers information regarding stock performances of the entity, and this information is not directly for all users of information that have to receive specific information.

5. Fair value – an accounting model of evaluation

To evaluate an asset at fair value means that you have to assign as value the sum for which it can be exchanged voluntarily between parties, during a transaction that determined a price objectively.

Fair value, is most often, a market value established from the evidence data on the market, through an evaluation made, usually, by qualified professionals. If there are no market data in fair value because of the nature of assets and the declining frequency of transactions, fair value can be established through other methods by professionals in evaluation.
Estimating fair value is necessary for: evaluation of assets obtained gratuitous or ascertained in addition to inventory; evaluation in order to present in balance sheet tangible assets if the entity uses the model of fair value; evaluation in order to present in balance sheet short term financial investments, if they are listed on regulated markets (Order requires the fair value model in this case);settling the inventory value of certain asset categories (tangible and intangible assets evaluated at cost, financial assets and short term financial investments evaluated at cost, inventory) (Ionaş and Manea, 2012).

6. Critics on fair value

Critics brought to fair value address real problems, but the solution to restrict its use is still unsatisfying for at least three reasons. It doesn't bring any viable alternative, ignores the negative impact for losing some information provided in the financial statements and affects the distinction between accounting and prudential concerns, which have in fact different objectives and should be dealt with very carefully (Veron, 2008).
Those that oppose the idea of fair value loose from the start because they fail to accompany their arguments with palpable solutions or in other words with a counter offer. If it is fairly easy to identify and emphasize the faults if fair value in accounting, it's not that easy to find an alternative method to fulfil all the attributes of relevance, credibility, comparability and understanding, which are delivered by a series of principles to the present standards in this field. Literature mentions some alternatives but only occasionally, and the arguments are not satisfying at all. Historical cost would bring a significantly lower level of comparability and information relevance that is why it is rejected by the users of information especially by financial investors.
The support granted to fair value doesn't mean that this is a perfect concept, because there are a series of amendments to the present standards to be achieved in the future, as the president of IASB himself suggested not long ago. Still, the purpose of fair value and market based evaluation is not exaggerated if we consider the characteristics of financial markets in a developing world, a picture reflecting lessons learned from past crisis. Restricting fair value not only wouldn't heal the wounds of the actual financial crisis but would risk aggravating it, decreasing the level of trust that investors and not only them, have in financial institutions. To face

the changes forced by the crisis we need other changes to solve the deficiencies found at all levels.

The transition from an accounting based on historical cost to one based on fair value is considered to be a conceptual revolution in accounting. The objective of fair value based accounting is to reflect market values in financial statements and its changes in the consolidated statement of results obtained by the entity. This already faces many practical issues because estimating fair value is still a subjective process, especially when it has to work in spite of the absence of a market, which involves many professional reasoning and the possibility of manipulating from the one who is evaluating.

7. Fair value and the usefulness of accounting information

Accounting considers an information system that quantifies, processes and transmits information on transactions shown in economic events (facts) that influence the economic and financial situation of an economic unit (Horomnea, 2004).

The concept of fair value, a notion that is no longer a novelty is a step forward in the history of accounting and can provide great benefits for financial reporting and hence to financial statement users. The concept is not wrong even if at the moment is not perfect and can be improved. Problem is related to the measurement of fair value of items that can be measured at fair value, to how to recognize or not, the differences due to changes in fair value and probably to two very important factors, *who evaluates and who confirms the evaluation* (reporting entity and auditor).

Using fair value as a general principle of evaluation poses a lot of practical problems and starts many disputes. Although the qualities attributed to fair value generally flow from deductive reasoning, assumptions, statements even critics often reveal fears and not insufficiencies empirically emphasized. Regarding the utility hypothesis for taking decisions an interpretation is designated to favor the contractual role of accounting figures. As Jeanjean states, introducing an evaluation model for fair value highlights a “disciplinary” function of this device: in deed making a transaction is no longer conditioned by forming a result but by classifying more effectively the actions of the managers in order to eliminate any possibility of management opportunistic gaining possession (Jeanjean, 2001). Moreover, this model would also constitute an accounting framework placing the decisions made by leaders and managers in a logic of value creation.

The issue of introducing fair value into accounting instruments widely exceeds the accounting of financial instruments, even that of the banking sector. Indeed, through the rules of business combinations or impairments of intangible assets, it covers virtually all companies of a certain size. Furthermore, this conceptual shift is the

essence of referential implemented by IASB for the development of future IFRS standards.
The birth of this new accounting model, fair value accounting will require in the future, adjustments for communication practices and financial analysis, and redefining the respective roles of the balance sheet and results statement. Actually, standard setters wishing to restore relevance to accounting information, establish a relationship of coherence between the accounting figures, flight indicators and enterprise value. Since then, the debate that has developed around the introduction of fair value targets reflections on the usefulness of financial statements and on the usefulness of accounting information. It has the merit of placing the debate on the development of accounting rules beyond the purely technical considerations (*is the historical cost a better method to evaluate than the fair value*?) and to put into perspective the effects on resource allocation and underlying economic challenges (*for whom and for do we have to produce this information?).*

8. Fair value and taxation

Historical cost presents a reliable and secure basis for evaluation in a stable economy and may constitute a real support in making decisions. In other conditions, of economic instability, inflation, the effect of desynchronization appears when patrimonial elements enter inventory, an evaluation based on historical cost and when leaving inventory based on actual value (usually achievable value), at different moments in the same financial exercise.
So, the result in historical costs is given by the relation:

Result in historical cost = Revenues valued at current prices at different times during the same year (in RON the time of exit) - Expenses corresponding to historical costs assessed at different times, in different exercises or of the same year (in RON at the time of entry) (1)

And the result at current purchasing prices by the relation:

Result at current purchasing prices = Revenues valued at current prices - corresponding costs evaluated at current costs (2)

The difference between the two results is the desynchronization error, accepted and imposed by tax that makes accounting information to be void of credibility, to the detriment of true and fair view of the financial statements. While accounting in order to restore true and fair view of the financial situation and result operates under rules that entail certain terminology, assessment techniques, caution, uniformity and comparability in time and space of the data used; taxation, belonging to other structures has its principles and rules, which often are not consistent with accounting, being used to obtain maximum tax efficiency. From fiscal point of view, it aims to maximize revenue through a firm evaluation to satisfy its interests while accounting, by changing evaluation methods wants a more real presentation of the company and a proper accounting result. To this respect, taxation is interested in a high taxable mass, while accounting, considering the whole complex of circumstances in which an enterprise operates, considers the need for simple and efficient cost accounting information wants restatement of elements in the financial statements that, if accepted, will make an adjustment to a localized account: profit and loss. Thus, the balance sheet remains unadjusted his posts appearing at historical cost, taking on the effect of all of the entity's restated elements, especially in times dominated by inflation, recorded in the restated income statement.

Fiscal regulations force a certain accounting behaviour regarding evaluation rules that are admitted only if they answer tax interest. The disagreements between accounting and taxation are visible in three areas: income taxation, amortization and evaluation. Because in some EU member states taxation influences accounting, within the 4th Directive, evaluation rules contain clauses that allow emphasizing the impact of taxation on accounting, like:

- processing tax generated by the revaluation reserve must be explained either in the balance sheet or in the Annex;
- if elements of the fixed asset or current asset are subject to exceptional corrections of value in purely fiscal terms, then the sizes of these corrections must be indicated in the Annex;
- It shall be stated that the calculation of the proportion of the financial year was affected by position assessment on a basis other than historical costs, in order to obtain tax advantages.

Unlike accounting regulation, fiscal regulation doesn't obey a faithful image for the enterprise activity, but rather follow the stimulation and inhibition of certain activities. An example is the investment stimulation that is achieved through various fiscal levers such as accelerated tax depreciation, tax relief related to reinvested profits etc. In terms of accounting the income tax, the differences which exist between the accounting and tax result, lead to highlighting some accounting systems specific to income tax account related to these differences [24].

In our country, accounting is connected to taxation, thus there are no sufficient preoccupations regarding the treatment of tax delayed. Even though it is a problem and it is mentioned in Romanian accounting regulation, for individual enterprises is not being emphasized; but for consolidated statements this requirement is necessary.

9. Conclusions

The transition from the historical cost to fair value is a choice with major implications in accounting because it is a difficult process that needs to be redefined in the context of current national and global economic trends. The current economic environment needs a lot of changes in the way entities are being evaluated because they are acting in an unstable environment, subject to rapid, numerous and unpredictable changes, that in result make the information to become uncertain, inaccurate and untimely. The debates on this subject are far from over and will continue for a very long time; this because the concept of fair value is tied to faithful image, both being in a continuous movement and influencing each other.

References

Feleagă L., Feleagă, N. (2007). Financial accounting. An international and European, Economică Publishing House, Bucharest.
Gelard, G. (2005). De l'IASC à l'IASB: un témoignage sur l'évolution structurelle de la normalisation comptable internationale, Revue Française de Comptabilité, no.380
Horomnea, E. (2004). Basis for Accounting. Concepts and Applications, Sedcom Libris Publishing House, Iaşi.
International Financial Reporting Standards (IFRS) (2013). CECCAR Publishing House, Bucharest.
Ioanaş C., Manea, C.L. (2012). "Fair value", available on-line at: http://www.tribunaeconomica.ro/index.php?id_tip_categorie=1&&id_categ=9&id_revista=864&id_nr_revista=31&mod=arhiva
Jeanjean T. (2001). Juste valeur et décision , in J.F. Casta et B. Colasse (éd.), Juste Valeur: enjeux techniques et politiques, Ed. Economica.
Jianu, I. (2012). Accounting evaluation. Method and theory, Economică Publishing House, Bucharest.
Law no. 227/2015 regarding Fiscal Code, Romanian Official Gazette no. 688/2015.
M.F.P. order no. 1802/2014 for approving the Accounting Regulations on the annual individual and consolidated financial statements.
Munteanu, V. (coordinator) (2015), Enterprise financial accounting, Universitară Publishing House, Bucharest.
Reis R.F., Stocken P.C. (2005). "Strategic Consequences of Historical Cost and Fair Value Measurements "available SSRN: http://ssrn.com/abstract=975445
Ristea, M. (2003). Basis and alternatives in enterprise accounting, Tribuna Economică Publishing House, Bucharest.
Ristea, M., Dumitru, C.G., Ioanas, C., Irimescu, A. (2009), Accounting for commercial entities, vol. 1, Publishig House Universitara, Bucharest.