ISSUES REGARDING VALUATION IN ACCOUNTING. FROM HISTORICAL COST TOWARDS FAIR VALUE

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ABSTRACT: A primary goal of financial reporting is aiding investors in making economic decisions. A primary economic decision investors make is assessing the value of firms in which they are invested or consider investing.

The role of accounting numbers in valuation has been of fundamental interest to analysts, investors and researchers alike. Much of the empirical research in accounting based valuation has revolved around analyzing historical and forecasted accounting numbers.

In my paper I will present few accounting model used in evaluation and the implications of choosing one of those models: historical cost model, fair value model.

KEYWORDS: Accounting models, conservatism, earnings, valuation

INTRODUCTION

The IASB focus on assets and liabilities as the primary elements of financial statements contrasts starkly with "traditional" accounting practice. Until recently, accounting practice was generally based on historical cost and focused on accounting for transactions, underpinned by the concepts of "realization", under which profits were not recognized until they were realized, "matching", under which revenues were matched with costs, and "prudence", which implied an element of conservatism, but was seen by some as a means by which companies could inappropriately smooth their profits through the creation of hidden reserves or excessive provisions. The inadequacy of the historical cost, transaction-based approach for dealing, in particular, with derivatives (which have little or no initial cost but can expose companies to very substantial financial risk) and diminutions in the value – impairments – of assets, encouraged standard-setters to espouse an asset/liability approach to recognition and a "fair value" basis of measurement of assets and liabilities.

EVALUATION IN ACCOUNTING – THE CONCEPTUAL FRAMEWORK FORESIGHTS

It is generally considered that accounting is a measurement as well as a communication discipline. By measurement is meant "the assignment of numerals to object or events according to rules". The first step in accounting is to identify and select these objects, activities or events and their attributes that are deemed relevant to users before actual measurement takes place. Naturally, limitation of availability of data as well as specific characteristics of the environment, like uncertainty, lack of objectivity and verifiability, may create constraints to measurement. Where measurement is inadequate or infeasible, non quantifiable or non-monetary information may be provided in the footnotes.

Types of measurement

Various types of measurements are possible in accounting:

Accounting measurement can be direct or indirect. Direct or primary measures are actual measures of an object or its attributes. Indirect or secondary measures are derived indirectly by an algebraic transformation of a set of numbers that themselves represent direct measures of some objects or attributes.

With respect to decision time dimension, accounting measures can be classified as past measure, present measure or future measure to refer respectively to a measure of a past, present or future events.

To refer to accounting object or its attributes measures belong to a past, present or future event relative to the time at which measurement is made, the accounting measures can be classified as a retrospective measure, a contemporary measure or a prospective measure.

Measures can be:

- Fundamental measurement where the numbers can be assigned to the property by references to natural law and not to rely on the measurement of any other variables.
- Derived measurement which rely on the measurement of two or more quantities and depend on the existence of a verified empirical theory linking the given property to other properties.

Measurement can be made when confirmed empirical theories may be used to support their existence or made by fiat, based on arbitrary definition.

Types of scales

Every measurement is based on a scale. Scales can be described in generally terms as nominal, ordinal, interval or ratio.

- A nominal scale assist in the determination of equality; it is a simple classification system like the case of a chart of account. The numbers reflect the objects themselves rather than their properties.
- An ordinal scale assists in determination of greater or lesser; it is an order of preference system. One problem with ordinal scale is that the differences or intervals between the numbers are not necessary equal.
- An interval scale assists in the determination of the equality of intervals or difference. It assigns equal values to intervals between assigned numbers.
- A ratio scale assists in the determination of the equality of ratios, with the additional feature of the existence of a unique origin, a natural point zero, where the distance from it for at least one object is known.

According to Conceptual Framework, measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognized and carried in the balance sheet and income statement. This involves the selection of the particular basis of measurement.

A number of different measurement bases are employed to different degrees and in varying combinations in financial statements. They include the following:

Historical cost. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Current cost. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

Realizable (settlement) value. Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values; that is, the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

Present value. Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

The measurement basis most commonly adopted by enterprises in preparing their financial statements is **historical cost.** This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realizable value, marketable securities may be carried at market value and pension liabilities are carried at their present value. Furthermore, some enterprises use the current cost basis as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets.

The historical cost accounting is characterized primary by:

- ☑ The use of historical cost as the attribute of the elements of financial statements;
- ☑ The assumption of a stable monetary unit;

- ☑ The matching principle;
- ☑ The realization principle.

FAIR VALUE VALUATION

As if the shift to IFRS in itself were not enough for the financial reporting system to digest, there are further, even more fundamental matters that the adoption of IFRS will bring to prominence. These centre arounds the valuation basis for assets and liabilities that the IASB has adopted in many of its new standards. The valuation approach that the IASB has embraced is rapidly introducing "fair value" as the primary basis of asset/liability measurement. As a result, a substantial portion of a reporting entity's assets and liabilities will be stated in the balance sheet at "fair value" – including pension assets and liabilities, derivative financial instruments, certain other financial assets, financial liabilities held for trading, tangible and intangible fixed assets that have been acquired in a business combination, impaired or revalued, assets held for disposal, share-based payment liabilities, investment properties, provisions and biological assets. The IASB has adopted what is essentially a market value definition of fair value, and expresses it in most of its standards as follows: 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction'.

Valuations required for many asset types in financial statements, and for different purposes, including:

- Establishing the carrying amount on balance sheet
- Treatment of surplus assets
- Establishing lease liabilities
- Calculation of depreciation charges
- Establishing value of assets acquired in takeover

The objective of a fair value measurement is to estimate an exchange price for the asset or liability being measured in the absence of an actual transaction for that asset or liability. Thus, the estimate is determined by reference to a current hypothetical transaction between willing parties. Willing parties are presumed to be marketplace participants representing unrelated buyers and sellers that are (a) knowledgeable, having a common level of understanding about factors relevant to the asset or liability and the transaction, and (b) willing and able to transact in the same market(s), having the legal and financial ability to do so. Fair value presumes the absence of compulsion (duress). Accordingly, the amount that forms the basis for the estimate is the price that would be observed in a transaction other than a forced liquidation transaction or distress sale. In all cases, that price shall be estimated without regard to an entity's intent to currently enter into such a transaction.

Like other estimates, a fair value estimate, using present value, is made under conditions of uncertainty because the cash flows used are estimates rather than known amounts. In many cases, the amount and timing of the cash flows will be uncertain. Even contractual amounts, like the payments on a loan, will be uncertain if there is risk of default.

Marketplace participants generally seek compensation for bearing the uncertainty inherent in cash flows (risk premium). For example, marketplace participants will place a higher value on an asset with promised (contractual) cash flows and no uncertainty than on an asset with expected cash flows of the same amount that are uncertain. The lower value reflects compensation for bearing risk. Similarly, marketplace participants will demand more to assume a liability with cash flows that are uncertain than a liability with cash flows of the same amount and no uncertainty. The higher value reflects compensation for bearing risk. An estimate that excludes compensation for bearing risk would not faithfully represent fair value if it is apparent that marketplace participants would seek compensation for bearing that risk.

The objective of including risk in the estimate of fair value is to replicate the market's behavior toward assets and liabilities with uncertain cash flows, using as a benchmark the rate on monetary assets that are essentially risk free and that have maturity dates or durations that coincide with the period covered by the cash flows (risk-free interest rate).

Fair Value is used in the following cases:

- Expensing share options (IFRS 2)
- Assets acquired in takeover (IFRS 3)

- Surplus assets (IFRS 5)
- Carrying amount on balance sheet (IAS 16 and 40)
- Measurement of lease assets and liabilities (IAS 17)
- Impairment Reviews (IAS 36)
- Measurement of embedded derivatives (IAS 39; IFRS 7)
- Agricultural Assets (IAS 41)
- Important to note that in many cases Fair Value is optional as an alternative to cost:
- IAS 16 – Property plant and equipment may be put on balance sheet at historic cost or fair value
- IAS 40 – Investment property – cost or value, although if cost adopted fv must be shown in notes to accounts

CONCLUSIONS

The need to finance high growth and manage the interests and needs of investors make value creation a critical concern for businesses. Almost any financial endeavor, such as attracting new investors or making investment decisions, necessitates the consideration of the equity value created by the endeavor. The perceived value creation has a direct effect on the percentage of the firm outside investors will require if they are to invest in the business.

In today's business environment, companies face tremendous pressure to create value.

This pressure comes not only from shareholders but also from a wide array of market observers such as the financial press, financial institutions, and shareholder activists**.** Business owners must understand that maximizing value creation is possible only when their company maintains a well-planned and well-controlled operation that efficiently integrates the company's resources. Planning and controlling for value creation requires an ability to measure and relate the creation of value to current and prospective owners.

Of course, value is a relative term that can be viewed differently by the various stakeholders that have an interest in the company. Job creation, personal fulfillment and community pride adds to the general level of energy and optimism in society.

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