HISTORICAL COST VERSUS FAIR VALUE

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The current process of accounting globalization is based mainly on the concept of just value. This concept has been the source of vivid debates with regards to its meaning in contemporary accountancy, both in theory and in practice. The increased importance of the concept of "just value", as well as the constantly increasing importance of financial assets have created the framework for developing a new value-based accounting model. The reshaping of the value-based accounting model consists of reconsidering the basic principles of valuation, allowing accountancy to progress from the system of historical cost to that of just value.

Keywords: historical cost, fair value, valuation, accounting system.

JEL codes: M41

In order to understand fair value, the concept must be presented relative to or as opposed to historical cost, as both are, essentially, systems used for valuating the components of financial statements.

One must note that the "historical cost valuation system" is based both on the accounting principle that bears its name and on the principle of prudence. This means we are dealing with an amended historical cost. Firstly, it's a matter of amortization, which is inherently artificial and rigid, and secondly it's a matter of depreciation adjustments, which have limited applicability (Tournier J.C., 2000).

According to some authors (Deaconu A., 2004) the fair value and the historical cost are not mutually exclusive. Quite on the contrary, the two concepts are complementary, as each has both strengths and weaknesses.

Amongst all the values that are submitted to accounting valuation, the most utilized one is historical cost. This component can be verified, as it is recorded in the document that proves the property right over a certain asset, such as a promissory note or a debt. The accounting system based on historical cost is widely accepted by accountants due to its objective nature, as it is supported by transactions that have already been completed, and it's generally easily understandable to its users. (Ristea M., 2003).

Unlike historical cost, the other components are inherently subjective. They are based on estimates made by a qualified person who uses only the objective data made available to him or her, and utilizes well established valuation methods, but still applies his or her personal interpretation, processing and methodological application of such data. So that the people who make valuations-estimates have a certain qualification and training in the microeconomic and macroeconomic fields, they have certain mind abilities and a certain professional skill. That is why it may be said that no valuation conducted by several people for the same item submitted to valuation will be identical.

In fact, when an asset has a current value that differs from the accounting value, accounting principles place that asset under doubt (Damodaran A., 2002) The market value, for instance, is often considered as too unstable and that it is too easy to manipulate, which makes it unsuitable to be used as an estimate for the value of an asset. It follows from this that it would be even less certain to make an estimate based on the flows expected in the future from the use of that asset. To be more specific, the method of estimating the just value based on future receipts (or, at the most, current receipts) rather than past ones is likely to influence the annual result.

Historical cost reflects the real value of items at the date of their entering the company. But any significant subsequent change tends to make the historical cost inaccurate and thus inappropriate for making decisions and ensuring the financing capacity or the purchasing power of the own capital. So that, notwithstanding all the advantages of historical cost, this also leads to a regular under-valuation of the assets, given that it doesn't take into account the effects of price increases on the market. Under these circumstances the accounts don't always reflect the most relevant information for the users to make decisions with. In fact, the conflict between relevance and credibility is the central accounting issue in most professional debates.

Historical cost valuation was first questioned during the periods marked by inflation, when it was noted that an accounting system based on historical costs is an inaccurate reflection of the actual situation. The assets are under-valuated and the performance of the company cannot be correctly assessed because profit is over-valuated; the company is subjected to an inflation tax and distributes false dividends, which leads to its decapitalization.

These effects have forced the discovery of alternatives that would allow recording the price variations and the re-discussion of financial statements in inflationist economies. So that the countries that had to deal with inflation opted for an inflation accounting system, that allowed them to update the financial statements either directly or by presenting an annex to the financial statements. This accounting system is still in use in some countries that have unstable currencies.

But, as some authors have noted (Deaconu A., 2004) inflation accounting systems fail to reveal the actual value created by the company. This system only re-assesses past transactions based on the observed price raise. So that it still uses historical cost, although it is an updated one.

Beside the irrelevance of historical cost during periods of inflation, some authors (Dumontier P. & Teller R., 2001) also believe that the traditional accounting model is no longer pertinent, and they most often bring the following arguments in support of that:

- *an increase of immaterial investments, in research and development*

Thus, for all the companies that invest a significant part of their resources in immaterial assets, the traditional accounting model fails to reflect the actual capacity of generating future profits, which expresses the actual value of the company (particularly in the case of companies in the field of services and of state-of-the-art technology, for which the main assets reside in the intellectual capital they hold);

- *the "itemized", non-recurring elements that affect a company's results*;
- *the accounting losses accumulated by companies that apply the principle of prudence*. Thus, by recording probable expenses and by not recognizing latent surplus values, companies accumulate accounting losses that don't genuinely reflect their potential.

So that, by not taking into account the company's prospective performance, as described above, and by failing to reflect accurately, in the accounting system, the non-tangible assets, the traditional accounting model falls under doubt of unreliability.

There is another view on the reasons for replacing traditional accounting indicators of performance with other indicators that would provide an image of how value is created for the shareholders, and this view holds the following advantages for the latter system (Casta J. F., Colasse B., 2001):

- they ensure a connection between the value created by the company and its stock market evolution;
- the system allows all executive managers to become aware of the costs incurred by all the capitals used;
- they outline the performances broken down in profit-generating units;
- they establish a relation between the salaries of managers or even other employees and the processes that create value for the shareholders.

Given this change of views with regards to accounting models, one may argue that we are facing a genuine accounting revolution or we are seeing the dawns of a "new accountancy". This change

is imposed by the market and the need to find a value that is closer to economic realities, a value that would allow the system to reflect more visibly the processes that create value for the shareholders.

The determining factors of the accounting revolution are derived from the ones that led to an increase in the importance of creating value for the shareholders; among them, the following have a direct impact on the accounting system:

- The development of capital markets

The pressure exerted by capital markets on creating value for the shareholders has had strong effects on accounting models. So that the concept was transposed to accountancy also, particularly with regards to asset valuation, a process that was initiated by companies listed on the American capital market.

-The need for a uniform accounting system throughout the world

In present days there is a visible increase in the number of companies that are purchased at often high prices. The purchase price is based on the future of the purchased company, which is to say it is based on its future flows. Under these circumstances, the past accounting values related to the assets are no longer significant in front of a high purchase price used for purchasing the whole of these assets.

- The increased importance of institutional investors

The behaviour of institutional investors, that has also been imitated by national companies listed on that country's capital market, has rendered obsolete the strictly accounting indicators, such as the period's output or the distributed dividends. As explained above, these investors are interested in the value created by the company issuing the securities.

The fact that the valuation based on historical cost has lost its relevance, and the need to adapt the accounting model to the investors' requirements, has imposed new solutions, one of which was to utilize other valuation bases than historical cost. During recent years, accounting regulation organizations have established the practice of valuating assets based on the fair value, and that to such a wide extent as to include almost all the elements of the balance sheet.

Currently, the need for valuating assets based on the fair values is mainly a requirement of the investors, who are interested in administrating their share of the capital, while other users of the accounting information (banks, suppliers, customers, employees or public institutions) have different informational needs with regards to the company's accounting system. Company management is currently focused on maximizing the value for the shareholder. Creating value for the shareholder is much more than just a way of managing a company, as it has been known for over twenty years, along with the development of capital markets. Beginning with the 1980's, it became an essential element of management culture, a genuine ideology that is applied in practice in the management of an ever increasing number of companies.

The main principle of the system that creates value for the shareholder is the cost of invested capital, relative to which it becomes possible to assess the company's performance. And that is because any result obtained is not valuable by itself but only by comparing it to the resources or capitals invested in the company by shareholders and creditors, as well as to the cost of such resources. The very concept of creating value is a prospective one, as it refers to the expected, comparative result to be obtained. The performance achieved on the market of goods and services (in the company) can be constantly compared to the performance offered by the capital market.

So that, during recent years, under the pressure of investors and with the contribution of accounting regulation organizations (FASB, IASB, etc.) we are witnessing a change of the traditional accounting model based on historical cost, which has turned into an *accounting model based on the fair value* (the market value of assets and liabilities if there existed efficient markets), which would meet the requirements for *„maximizing share value"* A company creates value only to the extent to which the income brought by its activity is higher than the cost of

means utilized to carry out its activity. That is to say that value is created if the payment for an activity is higher than the payment for the means utilized for that activity (Tournier J.C., 2000).
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Traditional indicators, such as economic profitability or other performance indicators that, however, did not fit the market comparison, can no longer meet the requirements for making administrative decisions.
There are more and more companies interested in establishing and analysing the profitability of invested capitals relative to the cost of such capitals. The cost of capitals is assessed relative to the expectations of investors from other placements, which, in their eyes, have minimum profitability. The privileged reference for estimating the costs of capitals is the capital market. It is this market that shapes the behaviour of managers and validates their decisions. At the same time, the capital market forms an accessible data base that constantly provides information on performance standards.
The controversy that exists between supporters of the two valuation methods did not start from doubting the relevance of the information based on market values. The debate was, and still is, rather around the issue of the period (the moment) for which it is relevant to use the prices chosen for the accounting valuation. While historical cost makes use of market prices at the time when the assets were acquired or the debts were contracted, fair value opts for current ones.
The advantages of fair value as compared to the restraints of historical cost are presented briefly in the table below (Hague I. & Willis W.D., 1999):

The characteristics of fair value and historical cost

Fair value	Historical cost
It improves the comparability by valuating similar elements in a similar way	It fails to ensure the comparability of information, as similar elements are valuated for inhomogeneous values (according to the date of their registration)
It provides information about the benefits expected from the assets or about the "burdens" taken by contracting debts, under current economic circumstances.	It provides information about the benefits expected from the assets or about the "burdens" taken by contracting debts, according to the economic situation existing at the date of their purchase or contracting.
It reflects the management's decisions whether to keep the assets/debts or to take up new ones, and their effects on the financial performances and position of the company.	It reflects the effects of the decisions whether to purchase assets or contract debts, but ignores the effects of the decisions whether to keep or not contract them.
It reports the gains or losses resulting from price changes, when such changes occur.	It reports the gains or losses resulting from price changes, when they are obtained by selling or cancelling them, even if their selling or cancelling have not been the cause of such gains or losses.
It requires that accounting reports be compiled according to the current market price, which might imply making accounting estimates and	Accounting reports are drafted based on prices resulting from past transactions, with no reference to market prices.

would create problems as to the credibility of the information.	

According to some authors (Shortridge R. P., Schroeder A., Wagoner E., 2006) the controversies around fair value valuation are rooted in the debate over the relevance and dependability of accounting information. Thus, the supporters of fair value argue that financial statements made based on historical cost are not relevant because they don't provide information about the current value of elements. The critics of fair value argue that the information provided by financial statements made based on just value are not dependable because they are not based on verifiable transactions and, therefore, they cannot constitute grounds for making decisions.
In comparing the accounting system that is based on historical costs to the one based on fair values, some authors (Shortridge, Rebecca Toppe, 2006) note that the accounting system based on historical cost puts more stress on conservatism in valuation, and that is why its worst-case scenario is reported in the financial statements, while the accounting system based on fair value allows managers to come forward with "better" values for the investors, ignoring the concept of conservatism.
Some of the advantages of fair value valuations, as mentioned in specialized literature, (Penman S. H., 2007) are as follows:
- investors are interested in value, rather than costs, so that's why information must be reported using fair value;
- in time, historical cost becomes irrelevant for establishing the company's financial situation. Prices provide an updating of the information regarding the value of the assets;
- the accounting system based on fair values reports an economic result;
- the fair value determined based on market prices is not affected by factors that are specific to certain companies.

On the other hand, some authors (Wallace W. A., 2008) believe that replacing the historical cost with the market value and cancelling most of the differences between the gains and the losses, both made and hypothetical, would be a major mistake. In support of these statements, the author of the current paper expressed the following concerns: If we paid US$ 40,000 for a house, and since that moment the value of that house has varied between US$ 35,000 and US$ 300,000, and its current value is of US$ 200,000, how do we assess our investment? Is it right to say that we have lost US$ 100,000 or that we have won US$ 160,000? Isn't the actual assessment of the investment related to the moment when the investment was purchased, respectively sold, rather than to the market value existing between the two moments?
The relation between historical cost and fair value may allow us to define, and in some cases apply, some of the following accounting systems:
- the accounting system based on historical cost, which involves using historical cost both for the current registration of transactions and for drafting financial statements;
- the accounting system based on fair value, which involves using the fair value both for the current registration of transactions and for drafting financial statements;
- the mixed accounting system based on historical cost and just value, which involves using historical cost and, in some cases, the just value, for the current registration of transactions and for drafting financial statements.

In that which concerns drafting financial statements, fair value may be utilized as follows:
- within a single financial statement, along with the historical cost for which some elements were valuated;
- within distinct financial statements, in which all the elements are reflected at their just value, and they come as an addition to the ones expressed in terms of historical cost.

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