THE YEARBOOK OF THE „GH.ZANE" INSTITUTE OF ECONOMIC RESEARCH
VOL. 23, ISSUE 1, 91-98, 2014

INESA IACOB (married TOFĂNICĂ)[1] The progress of ideas

# FAIR-VALUE ACCOUNTING – BETWEEN INNOVATION AND NEED

**Abstract**

*This article deals with the changes that occurred in accounting in the recent period. Although the transformation has taken place in a slow pace, it is still evident. One of the main factors that contributed to it is the globalisation. Mainly, capital markets have an increasing importance nowadays, because companies tend to reach funds from investors all over the world. Starting from ideal models of accounting systems proposed by Müller (2013), defining features of each system are described. As we are talking about an ideal system, it is obvious that deviations from it are allowed, and this could be subject for further research. Taking the described classification, one could notice the preference of the accounting regulators for the fair-value accounting, which is also accused for exacerbating the downturn of capital markets in the recent global financial crisis.*

**Keywords:** *accounting system, fair-value accounting, innovation, performance.*

## 1. Introduction

The comparability of data from financial statements has always been a concern for accounting professionals, commentators, and regulators. The idea of different converging accounting standards has known a recent ascending, but it has rapidly developed and spread over the world.

The rhythm of globalization from the last decades has lead companies, but also information users to reach a greater clarity, simplicity and comparability of the understanding of organizational and evaluation of economic performance processes at a global level.

Although the idea of accounting harmonization at a global level has known a wide acceptance, it can be just partially explained by the need for comparability of financial data and financing from the international capital markets. The path of accounting harmonization was not always smooth and demarcated by technical resolution concerning the comparability, arguments pro efficiency of different accounting standards or cost-benefit analysis of convergence options.

First regarded with scepticism (Bhimani, 2008), IFRSs have known a large acceptance at worldwide level. The turning point was represented by the reporting crisis from 2001-2002 with the collapse of the giant Enron, when inappropriate accounting practices were unveiled. The crisis has generated disputes about the adequacy of American generally accepted accounting practices (GAAP), as they were very detailed and thick.

A long period of disputes followed, with comments and suggestions regarding the best suitable accounting principles. Finally, a consensus was reached when it was established that for listed companies should be used international financial reporting standards (IFRS) in financial statements. IFRSs are elaborated by IASB – International Accounting Standards Board, created in 2001. IASB is the independent body for standards` normalization of the IFRS Foundation.

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Aknowledgement: This paper is supported by the Sector Operational Programme Human Resources Development (SOP HRD), financed from the European Social Fund and by the Romanian Government under the contract number POSDRU/159/1.5/133675;

IFRSs are the international reporting standards used at global level, but in the same time they allow the “personalisation” in their implementation. They can be shaped by each company`s needs, leaving room for adjustments.

Still, IFRSs are subject to criticism, too. Some authors suggest they are too complex, burdening and expensive (Guerreiro et al., 2008; Callao et al., 2007). Others refer to the negative influence on the financial reporting relevance (Callao et al., 2010; Hung and Subramanyam, 2007), and local comparability, as a consequence of “double standards system” (Street and Larson, 2004; Callao et al., 2007).

Profound changes have taken place lately among the accounting standard setting, and IFRSs are just one of them, but, in the same time, the most important. The adoption of IFRSs at international level has been declared by some “an accounting revolution”, “a paradigm shift”. This approach could be exaggerated, but still we are witnessing a qualitative and systematic change, and not some random, not connected transformations, which could leave the fundamental nature of accounting system unaffected.

There are two important aspects of the fundamental shifts, i.e. innovation, in this sense. The first aspect concerns the “government” of international accounting standards` creation. Since the privatization of standards` creation, the countries gave up their sovereignty and transferred this right to a private international body, i.e. IASB. The second aspect concerns the shift to IFRS and the increasing use of fair-value accounting (Müller, 2013).

In order to justify the second paradigm shift in accounting, Müller proposes two ideal accounting systems. They are built on accounting principles` particularities when preparing annual accounts. The change we are talking about could be related to the rise of *financialization*, i.e., the rising importance and size of financial markets.

The literature on accounting and financialization contains an enormous series of subjects. The relationship between financialization and accounting was also studied. Newberry and Robb (2008) speak about the companies` complicity in “cheap financial dodges” (Froud et al. 2000, p. 19) in order to “make the numbers” more attractive for investors on capital markets. Another debated aspect concerns the rising importance of financialization and the shift to IFRS, namely the fair-value accounting (Andresson et al., 2006, 2007; Nölke and Perry, 2006, 2007; Walker, 2010). In the present article are exposed the politic and economic frameworks of the paradigm shift in accounting. The understanding of the general tendencies of accounting standardization helps us understand why IFRSs and fair-value accounting have a greater importance nowadays.

## 2. A real accounting revolution?

Although accountants are considered a conservative bunch, recent transformation have lead to comments from academia, but also from the accounting professionals, regarding the fundamental upheaval. In 1999, Nobes, former British IASC delegate, proclaimed “The begging of the end of conventional accounting”, referring to the expansion of fair-value accounting. In another context Damant predicts “a new era” in accounting and argues that constant application of fair-value in international accounting standards and the shift of financial information on investor`s usefulness will have revolutionary consequences (Damant, 2003).

According to Thomas Kuhn`s theory of scientific revolution (1996), natural sciences don`t make progress by the gradual increase in the sum of knowledge, but through periods of upheaval when the sciences are thoroughly redefined, followed by periods of “normal science” (Barlev and Haddad, 2003; Dodd et al., 2008, p. 43).

The so-called accounting revolution did not start in practice, but at the academic level. In the early 1960s a few accounting scientists from the United States of America have tried to bring in elements of fair-value in practice (Zeff, 1999, pp. 93-95). The approach, however, failed due to practitioners and SEC`s (Securities and Exchange Commission) resistance. In time, however, these ideas have been accepted both by practitioners and standard-setters.

Starting with the `90s we can find references on fair-value both in academia and, more important, in accounting standards. Moreover, many recent articles are published by people involved both in academia and in standard setting (Christofer Nobes și Richard Barker), people actively involved professionally in standard setting (David Damant). This sounds hopeful for fair-value accounting, since the subject is debated by scientists that have influence in practice.

Accounting changes did not take place overnight. Moreover, standard setting bodies can not cancel suddenly accounting practices. They have to organize a public debate on the changes, even if the debate is not public in the sense of including the general public, but the professionally and commercially "public", as their activity is affected by the transformation. For this reason, IASB and FASB (Financial Accounting Standards Board) must consider economic players from different places all over the world when creating the standards. The influence of certain changes often goes beyond company`s economic activity due to the economic interconnections, if we refer to the recent global economic crisis. In the recent discussion on the crisis are also involved high-ranking politicians, criticising in particular the fair-value and its opportunity in the measurement of financial instruments.

IFRSs consist from old standards, adapted after American GAAPs, and from new ones, which are the shared work between IASB and FASB. Moreover, IFRSs are subject to continuous review process or creation of new standards.

## 3. Historical cost accounting versus Fair-value accounting

Historical cost and fair-value can be separated by three dimensions. There is a logical connection between them, and choosing one of them will strongly determine the value for the other two.

*A. Assets measurement*

Littleton (1935) proposes two financial evaluations: value or cost.

When completing annual accounts, one of the two evaluation methods can be used, depending on the choice of the assets evaluation: should they be recorded and carried at historical cost, or should some form of current value be used? In the past, the common valuation was the historical cost, although few elements of fair-value were allowed (the principle of the minimum cost between the historical one and the market one, a prudence principle).

The use of fair-value has known a large expansion in the latest decades, mostly thanks to IASB. According to IASB, fair-value can be defined as follows: "The amount for which an asset could be exchanged, or a liability settled, between informed, willing parties in an arm`s length transaction." (IFRS 9 *Financial instruments*, Appendix A). Fair-value accounting offers many measurement options at market price. The choice of a price can take place according to measurement date, or choosing between entry or exit price (Bryer, 2004, pp. 8-9). Problems can occur when there is no market for the measured assets, or the market is illiquid or otherwise "distorted".

By contrast, the historical cost supposes "following" the costs from the entry to their eventual regrouping, until their exit from the unit.

„ (...) accounting for costs involves three stages: (1) ascertaining and recording costs as incurred, appropriately classified; (2) tracing and reclassifying costs in terms of operating activity; (3) assigning [i.e. matching] costs to revenues. The third stage is crucial from the point of periodic income measuremen." (1957, p.69)

Historical cost is largely described by Scmalenbach. He recorded little about measuring income but treated historical cost as default measurement (Schmanlenbach, 1962, p. 224).

*B. Income measurement*

There are two approaches regarding the methods of income determination: the asset-liability- and the revenue-expense- approaches. The former concerns the income (or firm performance in general) in terms of total assets and liabilities, the latter as the balance between revenues and expenses.

Opting for fair value involves, as a logical consequence, following the asset-liability approach in determining the income. On the other hand, historical cost approach is closely related to revenue-expense approach.

The option is subsequently related to different ideas about the *purpose* of the financial statements. When a company gives priority to *wealth* as a performance indicator, fair value is chosen as reference. On the other hand, when the focus is on *comparable periodic performance*, in the sense of business efficiency, revenue-expense approach is appropriate.

In order to appreciate the regular performance under the asset-liability approach, every increasing company`s wealth is recorded as profit. In the view of revenue-expense, the difference between periodic efforts (expenses) and achievements (revenues) is the profit (or loss) (Wüstemann and Kierzek, 2005, pp. 77-78).

The income statement is focused on the amount of money resulted from selling goods or providing services, which are then compared to the costs of production or providing the services. So the profit or loss of the firm is the result of its operations, more or less successful. In the asset-liability approach, the profit or loss are defined in terms of the value change which can occur in assets and liabilities. In this case, the income or expense is regarded as „a *residual* from recognizing and measuring increases in assets and decreases in liabilities" (IASB, 2007 a, b, para. 14).

The asset-liability approach has a wider definition of income and expense and includes many elements which are not recognised in the revenue-expense approach. Indeed, the IASB Conceptual Framework groups in the definition of "income" operating income, non-current gains (or losses), and, more important, unrealized gains or losses from re-evaluation of assets and liabilities. In this context the connection with fair value becomes relevant. This paragraph from the Framework has fuelled many debates in the context of the recent global economic crisis, because the use of fair value measurement in financial instruments is accused by some that has worsened the financial sector`s downturn.

The connection between (a) fair-value and asset-liability approach and (b) historical cost and revenue-expense approach (Dichev, 2008; Krumwiede, 2008, p. 34; van Mourik, 2010, pp. 197, 207) is strengthened by the fact that they suppose different relationship and hierarchy between income statement and balance sheet. In the case of historical cost, the balance sheet is rather a passive or auxiliary document because it only records and "stores" results of past activities and transactions recorded in the income statement and balance sheet. Most assets can be seen as deferred costs in this case because their costs are spread over several accounting periods. The balance sheet represents a "parking lot" for hanging items awaiting release in the form of income (Schmalenbach, 1962, pp. 66-75; apud. Paton and Littleton, 1957, p. 25).

In fair value accounting, the balance sheet becomes more active and it does not represent a storage place for past operations because it records assets at liabilities at current market prices. This also makes it more volatile. The hierarchy between it and income statement is reversed – according to the notion of profit as the change in net worth - income statement is "forced" to follow re-evaluations that are recognized in the balance sheet. Therefore, many standards requiring fair-value also require that changes in fair values are recorded in the income (e. g. IAS 40, IAS 41). This changes the basic idea of accounting profit`s source because the focus shifts away from the operating results (Bignon et al., 2004, p. 22; apud. Biondi and Suzuki, 2007, p. 590).

Permission or requiring of unrealized income or losses gave rise to controversy and criticism, both in academia and in the political and professional environments, especially for having introduced artificial volatility in earnings. Therefore, fair-value accounting is so blamed in the current global economic crisis. Due to the use of fair-value at an increasing scale and in order to correct the problem of volatility, a new concept of income was proposed, namely "comprehensive income", together with a new format of income statement (Camfferman and Zeff, 2006, p. 392; Whittington, 2005, pp. 147-148).

*C. Theory of the firm*

The third and perhaps the most important key dimension regarding the differences between historical cost and fair-value is the company's vision. There are two options in this regard: the entity theory and the proprietary theory (Edwards, pp. 72-74; Gynther, 1967, Zambon and Zan, 2000, pp. 808-810). The first approach sees the entity as an investment of the owner / owners and it is not separated from the latter. Therefore, accounts are prepared from the owner`s view. By the other hand, the entity assumes that the firm is separate from the owners and all assets (liabilities) are owned (owed) by itself, as is the income (or loss) are generated by their use.

*Entity theory:* assets = equity + liabilities

*Proprietary theory:* equity = assets – liabilities

The notions of "equity" and "liabilities" are not interpreted in a similar manner in the two theories, but they show the point of view from which the balance is realised. In entity theory the right side of the equation shows company's funding sources. From this point of view there are no major differences between equity and liabilities, as they are both external claims on the reporting entity. The equation can be rewritten as: assets = liabilities (i. e. external claims). The proprietary theory gives us a vision of balance sheet as the difference between assets and liabilities in order to discover company`s residual amount.

From the entity point of view, what matters is continued revenue generation to cover claims from external groups such as creditors, the state authorities etc. Therefore, this view is based on income and profit or loss-account. The owner's point of view gives clear priority to a single group of people, and has an affinity for the shareholder. The priority for the company is to create value to satisfy investors (Gynther, 1967, pp. 279, 282). The entity theory does not support any specific investor so that this approach is more suitable for communication to a wide range of investors.

There is also a link between entity theory and historical cost. Reporting entity is less concerned about the purposes of evaluation, but is more interested in determining the efficiency of the company by reporting earnings to the efforts used to achieve them.

As for proprietary theory, when net worth is the reference of company`s performance, accurate and current measurement of assets and liabilities is of great importance.

„A proprietary view supports a view of income as being the net change in assets and liabilities over the period. Taken to its logical conclusion this could mean that all assets and liabilities should be measured at current value, and the profit for the year would include value changes as well as transactions and non-recurrent items". (van Mourik, 2010, p. 207)

We might expect the IASB (and FASB) to be follower of proprietary view, but existing standards and ongoing discussions do not provide conclusive indications. In the Conceptual Framework Project of IASB and FASB the preference is clearly expressed for entity theory (IASB, 2008, paras. OB5, BC1.11 - 1.16). This is due, apparently, to the purpose of meeting the needs of a wider range of users than the capital providers.

Official statements of standard-setters are ambiguous, but they showed an “explicit preference” for proprietary theory. Depending on what theory they adopt, they will give different answers to specific accounting issues (Lorig, 1964, pp. 570-572).

### 4. Ideal systems

After reviewing the dimensions according to which one can distinguish between historical cost and fair-value, we can draw the line and present the model developed by Müller (2013). The author proposes two ideal accounting systems - one based on historical cost accounting (HCA) and another based on fair value accounting (FVA).

**Table 1**

**Accounting ideal types**

| | Ideal Type 1 (HCA) | Ideal Type 2 (FVA) |
|---|---|---|
| Asset measurement | Historical cost | Current value (as exit price) |
| Income determination | Revenue-expense approach | Asset liability approach |
| Theory of the firm | Entity theory | Proprietary theory |

*Source:* Müller, 2013

The accounting revolution can now be interpreted as a shift from accounting system type 1 (HCA) to accounting system type 2 (FVA). The first accounting system was common for listed companies from 1900 until 1990. The second system prevails since 1990 and now aims to become the global standard, both because of the IASB and FASB, as well as political and economic conditions that allowed the revival of monetary capital. IFRS, however, are not a pure fair-value accounting system; they are still a hybrid but with a tendency to strengthen FVA characteristic elements.

Of course this classification is not complete and some elements may be overlooked, but the purpose of the classification is not to gather the whole range of features, but rather to highlight the essential ones, so its purpose is to simplify (Rudner, 1966). The systems presented are not pure ones, so this enables discussions on matters that do not fit neatly into one of the systems.

### 5. Conclusions

The recent history is characterized by capitalism with expanding financial markets and investment in non-financial markets. In this context, fair-value accounting is the trend in financial accounting. It is, in other words, the *financialization of accounting* (Chane-Alune, 2006, p 28).

Analyzing the changes that have occurred in accounting, one can realize they did not take place in a short period of time and are always incomplete. However there has been a systematic qualitative change from historical cost accounting to fair-value accounting, particularly in order to meet the changing economic factors. Fair value accounting has known a wide acceptance throughout the world, but nevertheless it is the target to criticism, if we refer to the global financial crisis that hit the world recently. Accounting professionals and academia actively debate this issue by proposing new solutions. For this reason, changes in accounting will know no end, as standards, both new and old ones, are object of systematic reviews and changes.

The classification of ideal accounting systems leaves room for further research. IFRSs and the Conceptual Framework of IASB and FASB can be studied in order to see to what extent their concepts are diverging from fair value accounting. Differences can be analyzed in connection with the re-politicization of accounting standards bodies and the global financial crisis turmoil (Bengtsson, 2011); or as a result of effective lobbying by large industries, whom specific operations do not lend themselves to fair value accounting.

**Acknowledgement**

This paper is supported by the Sectoral Operational Programmer Human Resources Development (SOP HRD), financed from the European Social Fund and by the Romanian Government under the contract number POSDRU/159/1.5/S/133675.

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