HISTORICAL COST ACCOUNTING OR FAIR VALUE ACCOUNTING: A HISTORICAL PERSPECTIVE

Valentin Gabriel CRISTEA*

Abstract

The two paradigms about the accounting valuation systems are discussed: historical cost accounting and fair value accounting. The advantages and disadvantages of the historical cost accounting and fair value accounting in the historical perspective are balanced.

Each of two estimation bases could not resolve all the problems. The value of the items presented in the financial statements is a key aspect, being more dependent on more evaluation systems, that may estimate and reproduce the exact reality of the entity.

In 2009, Bignon, Biondi and Ragot argue that the usage of FVA is limited by asymmetries of information, complementarities and specificities. In presence of these conditions, the evaluations based on fair value can endanger the reliability of accounts and introduce the risk of incorporating financial volatility into the accounts. They have chosen for the historical cost.

In 2008, Ronen considered the fair value as a methodology that encompasses different approaches for the estimation of exit values.

In real economy, the concept of physical maintenance of capital should prevail and, in it, the "original" series should be restricted to the "numeraire" values: cash and cash substitutes. The elements considered as "derivative" value are evaluated by means of the only reliable method: the HCA.

This would allow to define, in the most complex generalization, a mixed "system", where every entity could assess each items that are financial investments then evaluated according to FVA. Then, they are attributed to the first series, and the items belong to a 'physical combination ordered to the production of income'. Then, they are evaluated according to HCA.

Keywords: *historical cost, fair value, fair value measurement, historical cost measurement, valuation, accounting.*

1. Introduction

The *fair value measurement* has got a disputed position within the accounting regulatory committees and the accounting theory since 2008.

As it is known, the fair value measurement implies that financial assets and liabilities are measured at their „market value"[1] where the value under the theoretical assumption of a perfect, efficient and complete market that should therefore imply that the financial statements meet the needs of investors and creditors[2].

IASB proposed to use a model for measuring the value of the flows generated by the assets, if the market is imperfect and incomplete.

The fair value debate is before the financial crisis in 2008.

The analysis of the studies on accounting indicates the existence of critics between the effectiveness of the fair value measurement in time and the stability of the economic system.

In specific literature, there are two opposite central paradigms of evaluation: the *Fair Value Accounting* (FVA) and the *Historical Cost Accounting* (HCA).

1.1. Fair Value Accounting (FVA) versus Historical Cost Accounting (HCA)

By analysing the accounting literature, it seems that they are different because of the typology primary criteria used to choice between FVA and HCA are the different typologies of economic contexts and markets and financial reporting information.

By assuming that the market is perfect and complete, FVA measurement can continue to provide relevant information for investors and creditors.

Laux and Leuz, in 2009, said that adoption of HCA instead of FVA can not be fruitful in times of crisis.

The critics on fair value measurement do not translate in support of historical cost measurement. By assuming that the market is imperfect and incomplete,

HCA measurement can focus on little relevant information to the management while the fair value measurement can provide a misinterpretation of the items of the balance sheet.

---

* PhD Candidate, Faculty of Economic Sciences, „Valahia" University of Târgoviște (e-mail: valigabi.cristea@gmail.com).

[1] The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (IFRS 13 paragraph 9).

[2] Costa, M., Guzzo, G., Fair Value Accounting versus Historical Cost Accounting: A Theoretical Framework for Judgement in Financial Crisis, VIRTUS NTERPress (2013) pp. 147-153.

2. Fair Value Accounting (FVA) or Historical Cost Accounting (HCA): A Historical Perspective

The choosing of the model of the accounting evaluation has been debated more from traditional evaluation at historical cost to the evaluation at market values to justify the investment decision. The results are the notions as "accounting at market value" or "accounting at fair value".

The need of a fair value measurement for financial reporting appeared mainly from the investors searching better management of their share capital, thus resulting the choice of managers to the concept of shareholder value by maximizing profits. In this view, the managers are interested in increasing the market value of shares, increasing business value and the size of dividends.

Considering that the value may be more useful than the price, managers use evaluation alternatives, usually with favorable implications for the value of the entity's assets. There is a debate that the investors must have equal rights with the suppliers, employees, customers, community, not a coalition of interests.

The managers must search the entity's common wealth maximization, approaching thus the concept of stakeholder value, which regards beyond the monetary value, including a moral value[3].

The IASB conceptual accounting frameworks gives some evaluation bases: historical cost, current cost, realizable value and present value without indicating a preference for one or other of these evaluation bases.

According to IFRS 13, "Fair value is the price that would be received to sell an asset or to pay in order to transfer a liability from a common transaction between the market participants at the date of the evaluation."[4]

In 2009, Deaconu said that the fair value measurement provides better information and comparison on the current and future performance of the entity as it comprises a current information, offered by the market which facilitates comparability of the information[5].

Fair value measurement reduces the difference between the accounting value and the stock value for listed entities, it involves evaluating all or most of the elements of financial statements at amounts based on the capital market information.

Fair value measurement has a more universal character than the historical cost.

As the disadvantages of the fair value, Deaconu enumerated that it does not always provide reliable information because it is difficult to calculate by the staff entity without the contribution of an evaluation expert, especially in the case of unlisted entities for which the stock market does not give a clue.

The fair value creates difficulties in determining distributable income, if we consider that the new values of the assets, equity and liabilities are potential, latent and volatile values.

Fair value measurement provides a short-term vision on the financial situation of the entity.

The compared analysis of the evaluation bases of assets and liabilities based on the entity's financial position is valuated, proves that they differ in terms of credibility and relevance to the users of the information presented in the financial statements, lacking general applicability, and, it is difficult for the accounting standards and setters to satisfy the interests of all users.

At international level, fair value measurement raises a number of issues due to the diversity and complexity of individual cases of the economic reality to be translated.

If no evaluation is absolutely satisfying, the European accounting rules were targeted without specifying historical cost and the fair value, they were later updated so that they could not exclude historical cost combined with other evaluation bases, or using alternatives, thus reproducing the international norms.

The main idea of fair value measurement is that the entity's assets and liabilities are presented in the balance sheet at values close to those existing on the market.

In practice, fair value would be: utility value or the value of future cash flows, market value, replacement value, net book value. In view of international approaches there are debates about the content of the concept of fair value, the methods of obtaining and its applications as it is a much broader concept than the market value.

In 2010, Tournier claimed that the concept of fair value is assigned either the basic quality of evaluation, convention or accounting principle, or an application of the market value and not least an estimation and not a conclusion as with the market value, and an objective of the evaluation[6].

In 2003, Ristea stated that historical cost accounting is the accounting system accepted without reserves by the accounting profession thanks to the merit of being objective, being based on transactions already made and being generally understood by users.

The deficiencies consecrated to the historical are criticized, being considered that they are based on older principles generated by the needs of industrial enterprises, thus explaining the absence of recognition in the balance sheet structures of the derivatives. The historical cost measurement helps leaders to manage financial risks.

---

[3] Ene, G.S., Chilarez, D., Dindire, L.M., Relevance and credibility of the fair value measurement during the crisis, Procedia Economics and Finance 8 (2014) p. 308.

[4] IASB, IFRS 13 Fair ValueMeasurement, (2011) http://www.ifrs.org/IFRSs/Documents/IFRS13.pdf ACCA, Policy Paper on Fair Value. www.accaglobal.com/economy.

[5] Deaconu, A., "Valoarea justa. Concept contabil". Bucuresti: Editura Economica (2009).

[6] Tournier J.C., La Révolution Comptable - Du coût historique à la juste valeur Paris Éditions d'Organisation (2000).

As the drawbacks of applying the historical cost evaluation model it is mentioned: the undervaluation or overvaluation of some elements in the financial statement, the real value of the items in the balance sheet and the profit and loss account. The current requirements of fidelity, imposed by the financial statements, is justified to evaluate all elements in the financial statements with the historical cost measurement or other evaluation bases.

The accounting research concentrates on the comparison between two approaches to accounting: the approach based on the principle of *fair value* and the approach based on the prudence and *historical cost* principles. The IASB led to the change of accounting measurements to the FVA, while the European legislation had focused on the Historical Cost Accounting (HCA) before IFRS adoption. Many researchers suggested that FVA standards in the financial reporting played a major role. The crisis shows the trade-off between relevance and reliability of accounting information in markets that are above all imperfect and incomplete.

In crisis situations, there is a gap between market value and real value of assets and liabilities appearing on the financial statement of firms.

In 2009, Bignon, Biondi and Ragot argue that the usage of FVA is limited by asymmetries of information, complementarities and specificities. In presence of these conditions, the evaluations based on fair value can endanger the reliability of accounts and introduce the risk of incorporating financial volatility into the accounts[7]. They have chosen for the historical cost.

In 2008, Ronen considered the fair value as a methodology that encompasses different approaches for the estimation of exit values. Ronen proposed to compare the fair value or the exit value of assets and liabilities with the use value of asset combinations[8].

Edwards and Bell, highlighting income, proposed to use ex post accounting income to evaluate performance on the base of current cost measures.

In 2008, Whittington shows that it is more important not to search for a theoretical and universally valid measurements method, but to define a clear objective and choose the measurement method that best answers that objective with reference to specific problems[9].

An argument against to the fair value measurement in financial reporting is that does not indicate the real and useful 'value' of the items of the balance sheet for the firms.

Besta suggested in the accounting system in Italy the Substitution-Cost Accounting, that belongs, to the main domain of FVA[10].

Paton, in 1922, found a strong ideological support in HCA. The historical cost is a basic criterion of evaluation of nearly all assets and liabilities. The historical cost measured exactly with the cash or cash substitutes ("numeraire") needed for buying (selling).

3. Conclusions

Each of two estimation bases could not resolve all the problems. The value of the items presented in the financial statements is a key aspect, being more dependent on more evaluation systems, that may estimate and reproduce the exact reality of the entity.

Problems arise when the estimation of the evaluation should be made at market value in the event of a market in periods of growth or decline, or in the absence of an active market.

Each situation involves professional judgment and the possibility of manipulation by the person making the necessary estimates.

In real economy, the concept of physical maintenance of capital should prevail and, in it, the "original" series should be restricted to the "numeraire" values: cash and cash substitutes. The elements considered as "derivative" value are evaluated by means of the only reliable method: the HCA.

This would allow to define, in the most complex generalization, a mixed "system", where every entity could assess each items that are financial investments then evaluated according to FVA. Then, they are attributed to the first series, and the items belong to a 'physical combination ordered to the production of income'. Then, they are evaluated according to HCA.

According to Wittington, we must define a clear objective and choose the measurement method that best answers that objective.

References

- AIDEA, Gruppo di studio e di attenzione, L'Analisi degli Effetti sul Bilancio dell'Introduzione dei Principi Contabili Internazionali IAS/IFRS, Vol. 1°, Roma: RIREA (2007)
- Arnold, P. J., Global financial crisis: The challenge to accounting research. Accounting, Organizations and Society, 34, (2009), 803-809
- Besta, F., La ragioneria, Parte Prima – Ragioneria generale, Vol. I. Milano: Casa Editrice Dottor Francesco Vallardi (1922)

[7] Bignon, V., Biondi, Y., Ragot, X., An Economic Analysis of Fair Value: Accounting as a Vector of Crisis, Prisme No. 15, (2009), Electronic copy available at: http://ssrn.com/abstract=1474228, 1-38.

[8] Ronen, J., To Fair Value or Not to Fair Value: A Broader Perspective. Abacus, Vol. 44, No. 2, (2008), 181-208.

[9] Whittington, G. Fair Value and IASB/FASB Conceptual Framework Project: An Alternative View. Abacus, Vol. 44, No. 2, (2008), 139-168.

[10] Besta, F., La ragioneria, Parte Prima – Ragioneria generale, Vol. I. Milano: Casa Editrice Dottor Francesco Vallardi (1922).

- Bignon, V., Biondi, Y., Ragot, X., An Economic Analysis of Fair Value: Accounting as a Vector of Crisis, Prisme No. 15, (2009), Electronic copy available at: http://ssrn.com/abstract=1474228, 1-38
- Bizon M., Poli de opinie cu privire la utilizarea valorii juste în condițiile economice actuale, Revista Audit Financiar, nr.5. (2010)
- Capron, M., Chiapello, E., Colasse, B., Mangenot, M., Richard, J., Les normes comptables internationales, instruments du capitalisme financier. Paris: La Découverte (2005)
- Costa, M., Guzzo, G., Fair Value Accounting versus Historical Cost Accounting: A Theoretical Framework for Judgement in Financial Crisis, VIRTUS NTERPress (2013) pp. 147-153
- Deaconu, A., "Valoarea justa. Concept contabil". Bucuresti: Editura Economica (2009)
- Deaconu A., Bonaci C., Valuaţion of inventors considering the fair value option, Analele Universității din Oradea , Științe economice, Tom XVII, vol.3. (2008)
- Di Pietra, R., Dai "principi" agli "standards" contabili internazionali. Riflessioni sul cambiamento metodologico in atto. Contabilità e Cultura Aziendale, Vol. 6, Fascicolo 1, (2006), 70-94
- Ene, G.S., Chilarez, D., Dindire, L.M., Relevance and credibility of the fair value measurement during the crisis, Procedia Economics and Finance 8 (2014) 306 – 312
- Hopwood, A.G., Some reflections on "The harmonization of accounting within the EU". The European Accounting Review, 3(2), (1994), 241-253
- Hopwood, A.G., The economic crisis and accounting: Implications for the research community. Accounting, Organizations and Society, 34, (2009), 797-802
- IASB, IFRS 13 Fair ValueMeasurement, (2011) http://www.ifrs.org/IFRSs/Documents/IFRS13.pdf ACCA, Policy Paper on Fair Value www.accaglobal.com/economy KPMG, (2011) http://www.kpmg.com/RO/en/IssuesAndInsights/ArticlesPublications/Newsflashes/Advisory/
- IFRS-Briefingsheet/Documents/IFRS_26_RO_aprobat.pdf
- Laux, C., Leux C., The crisis of fairvalue accounting: Making sense of the recent debate. Accounting, Organizations and Society, 34, (2009a), 826-834
- Laux, C., Leux C., Did Fair-value Accounting Contribute to the Financial Crisis?. National Bureau of Economic Research, Cambridge, Working Paper 15515, (2009b), http://www.nber.org/papers/w15515, 1-41
- Magnan, M., Fair Value Accounting and Financial Crisis: Messenger or Contributor?. Montreal: CIRANO (Centre Interuniversitaire de Recherche en Analyse des Organisations), (2009), 1-16
- Matis D., Bonaci C., Raportarea financiară și învățăminte în vremuri de criză, Universitatea Babes Bolyai (2009) www.seap.usv.ro/.../Matis%20and%20Bonaci%20 prezentare.ppt
- Noyer Ch., A review of the financial crisis, Speech at the Hearing before the Finance Commission of the Assemblée nationale, Paris (2008) http://www.bis.org/review/r081028a.pdf
- Paton, W. A., Accounting Theory New York Ronald Press (1922)
- Pizzo, M., Il fair value nel bilancio di esercizio Padova Cedam, (2000)
- Popa, A., Criza financiară face ravagii în Statele Unite și Europa, (2008) http://www.conso.ro/citeste-comentariu/24/info/Criza-financiara-faceravagii-in-Statele-Unite-si-Europa.html
- Pozen R.C., Is it fair to blame fair value accounting for the financial crisis?, Harvard Business Review (2009), http://fbkfinanzwirtschaft.files.wordpress.com/2009/11/hbr11_09-is-it-fair-to-blame-fair-value-accounting-for-the-financialcrisis.pdf
- Power, M., Fair value accounting, financial economics and the transformation of reliability. Accounting and Business Research, Vol. 40, No. 3, (2010), 197-210
- Prochazka D., Should we really blame fair value accounting for the financial crisis?, Recent Researches in Sociology, Financing, Environment and Health Sciences, (2010) available online at http://www.wseas.us/elibrary/conferences/2011/Meloneras/SOMMEM/SOMMEM-27.pdf
- Quagli, A., Dal fair value al fairy value: coerenza concettuale e condizioni di impiego del fair value negli IFRS. Financial Reporting, 11Fascicolo 1, (2009), 98-118
- Quagli, A., IFRS 13: Fair Value Measurement. Amministrazione e Finanza, Vol. 26, (2011), 6
- Ristea , M., Baze și alternative în contabilitatea întreprinderii. Bucureşti Editura Economică (2003)
- Ristea , M., Dumitru, G.C., Libertate si conformitate, în standardele și reglementările contabile. Bucureşti Ed. CECCAR (2013)
- Rodríguez, G., Slof, J., Solà, M., Torrent, M., Vilardell, I., Assessing the Impact of Fair-Value Accounting on Financial Statement Analysis: A Data Envelopment Analysis Approach. Abacus, Vol. 47, No. 1, (2011), 61-84
- Ronen, J., To Fair Value or Not to Fair Value: A Broader Perspective. Abacus, Vol. 44, No. 2, (2008), 181-208
- Shortridge R. P., Schroeder A., Wagoner E., Fair-Value Accounting.Analyzing the Changing Environment, The CPA Journal (2006) http://www.nysscpa.org/cpajournal/2006/406/essentials/p37.htm
- Sprague, C. E., Teh Phylosophy of Accounts, (1908), reprinted by Kessinger Publishing in September 2010
- Stefan-Duicu, V.M., Stefan-Duicu, A.,. Short Presentation of a Futuristic Concept:" The CUNEITALE Judgment". *Global Economic Observer*, *4*(1), (2016) p.130
- Stefan-Duicu, V.M., Stefan-Duicu, A., Trans-boarding the Doctrinal Phenomenon within the Management Sciences towards a Creative Dimension. *Procedia-Social and Behavioral Sciences*, *188*, (2015) pp. 259-263
- Tournier J.C., La Révolution Comptable - Du coût historique à la juste valeur Paris Éditions d'Organisation (2000)
- Whittington, G. Fair Value and IASB/FASB Conceptual Framework Project: An Alternative View. Abacus, Vol. 44, No. 2, (2008), 139-168
- Zappa, G., La determinazione del reddito nelle imprese commerciali. I valori di conto in relazione alla formazione dei bilanci. Roma: Anonima Libraria Italiana (1920-1929)