

HISTORICAL COST ACCOUNTING OR FAIR VALUE ACCOUNTING FROM THE EARNINGS AND ASSET IMPAIRMENT PERSPECTIVE

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Abstract

This article studies the earnings and practice of depreciation of assets through the two accounting valuation systems: fair value accounting or historical cost accounting. It balances the methods used in each of the two accounting valuation systems: historical cost accounting and fair value accounting.

Many firms that did use value in use to arrive at their asset impairment loss will have declined a net realizable value figure as this would have been reduce than the value in use figure. If the firms had used net realizable value instead of value in use, this would have cause a higher asset impairment charge.

For the firms that use net realizable value for the purposes of determining the asset impairment charge this indicates that their net realizable value is higher than any calculated value in use figure.

In this way, that many firms report using more than one valuation method depending on the type of asset that is impaired and the results become difficult to indicate any conclusions based on the information available, despite the initial observation that value in use appears very used.

I claim that the use of fair value concept may have a different effect on the earnings quality for Romania because of less liquid or inactive markets. In this way, fair values will more probably be estimated by the use of valuation techniques which enables earnings management and could lead to lower quality of reported earnings.

Then, earnings under more fair value-based reporting system have less aggregate quality rankings for firms in Romania. I get the evidence that the extent of more fair-value-based other comprehensive income is negatively related to aggregate earnings quality for firms.

Keywords: *historical cost accounting, fair value accounting, valuation, earnings, asset impairment.*

1. Introduction

The concept of asset impairment relates closely to that of an asset write-down¹.

Elliott and Shaw² in 1988, Walsh, Craig and Clarke in 1991, Elliott and Hanna in 1996, Jordan and Clarke 2004, Sevin and Schroeder in 2005, Andrews in 2006, Ball and Shivakumar in 2003, Watts in 2003, LaFond and Watts in 2008 claimed that the asset impairment loss recognition is linked to both the issue of earnings management and the principle of conservatism.

Trueman and Titman³ in 1988, Walsh et al in 1991, Bartov in 1993, Basu in 1997, Burgstahler and Dichev in 1997, Healy and Wahlen in 1999, Shaw in 2003, Jordan and Clark in 2004, Sevin and Schroeder in 2005 staded that asset impairment constitutes a form of income smoothing in terms of managing the earnings.

Basu⁴ in 1997, Ball and Shivakumar in 2003 obtained the fact that in the current financial reporting

regime, earnings tends to be skewed towards loss recognition.

1.1. The fair value accounting of earnings qualities

Christensen and Demski⁵ in 2003, Ronen and Yaari⁶ in 2008 showed that earnings quality provide valuation relevant information and provide contracting-relevant information. The accounting information have two roles: informativeness and stewardship.

Ronen and Yaari accentuate that informativeness role appeares from investors' demand for information to predict future cash flows and assesses their risk.

In 1990, Watts and Zimmerman showed that he stewardship objective of accounting comes from separation between ownership and management in public companies.

We wonder: Is income growth the result of changing regulations related to asset depreciation testing?

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¹ Alciatore, M., Dee, C. G., Easton, P., Spear, N., 'Asset write-downs: A decade of research', Journal of Accounting Literature, Vol. 17, ., (1998) pp.1-39.

² Elliott, J., A., Shaw, W., H., 'Write-Offs as Accounting Procedures to Manage Perceptions,' Journal of Accounting Research, Vol. 26, Supplement, (1988) pp. 91-119.

³ Trueman, B., Titman, S., 'An Explanation for Accounting Income Smoothing,' Journal of Accounting Research, Vol. 26 (Supplement), (1988) pp. 127-139.

⁴ Basu, S., 'The conservatism principle and the asymmetric timeliness of earnings,' Journal of Accounting and Economics, Volume 24, Issue 1, (1997) pp. 3-37.

⁵ Christensen, J. A., Demski, J. S., Accounting theory: an information content perspective: McGraw-Hill/Irwin (2003).

⁶ Ronen, J., Yaari, V., Earnings Management: Emerging Insights in Theory, Practice and Research Springer (2008).

2. The earnings and asset impairment perspective

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 evaluation⁷."

Nissim⁸, in 2003, Hitz⁹, in 2007, Ryan¹⁰, in 2008, Fiechter and Meyer¹¹, in 2009, Chen et al.¹², in 2010, stated that the estimation of fair value (marking-to-model) creates opportunities for the exercise of management judgment which can decrease the quality of financial reporting.

Dechow and Schrand, in 2004, define that a high-quality reported earnings reflect actual operating performance, indicate further performance.

The majority of the studies on fair value accounting and earnings quality are oriented on developed, market-oriented countries.

Barth¹³, in 1994, Ahmed and Takeda in 1995, Petroni and Wahlen, in 1995, Eccher et al, in 1996, Venkatachalam in 1996, Park et al., in 1999, Carroll in 2003, Khurana and Kim in 2003, Hassan et al., in 2006, Bhat in 2008, Goh et al., in 2009, Kolev in 2009, Song et al, in 2010, Bischof et al., in 2011, studied fair values of financial assets, while Barth and Clinch¹⁴, in 1998, Aboody et al., in 1999, Richard Dietrich et al., in 2000, Easton et al., in 2003, worked on fair values of fixed assets. Moreover, Aboody et al.¹⁵, in 1999, in their research, have given the existence of association between the changes in fair values of fixed assets and future operating cash flow and future earnings.

Hill¹⁶, in 2009, underlined that the empirical results regarding predictive ability of fair values could not be generalized to more volatile market conditions and more subjective applications of fair value valuation.

Dhaliwal et al.¹⁷, in 1998, Biddle and Choi, in 2006, Casta et al., in 2007, Chambers et al, in 2007, Goncharov and Hodgson, in 2008, Kanagaretnam et al.,

in 2009, Jones and Smith, in 2011, investigated fair value gains and losses through other comprehensive income.

Hitz¹⁸, in 2007, pointed that change in fair value consists of an expected and unexpected component, so gains and losses from fair value re measurement could be correlated in time for some assets.

IAS 36 Impairment of Assets¹⁹ claims that an asset is impaired when the recoverable amount of the asset is lower than the book value.

Then, recoverable amount is exact as the higher of net realizable value and value in use. In this view, value in use represents the budgeted discounted future cash flows expected from continued use of the asset.

Value in use has been the preponderant disclosed valuation method and this can appear to indicate a high degree of discretionary choice in terms of management's decision of the amount of an asset impairment charge.

Moses²⁰, in 1987, Strong and Meyer, in 1987, Beatty and Weber, in 2006, Cotter et al., in 1998, Zucca and Campbell, in 1992, Beattie et al., in 1994, Francis et al., in 1996, Peek, in 2004, Jordan and Clark, in 2004, Sevin and Schroeder, in 2005, Walsh et al., in 1991, Elliott and Shaw, in 1988 and Riedl, in 2004 outlined that there was a discretionary choice available to firms for fair value measurement to determinate the asset impairment loss.

Using the annual reports of the sample of 94 corporations in U.K., experts has analyzed to assess the preferred method of valuation used in the determination of an asset impairment loss.

Bonbright²¹, in 1937, claimed that "the valuation method employed in order to arrive at the reported asset impairment loss is important as the decision is based on the deprival value concept".

⁷ IASB, IFRS 13 Fair Value Measurement, (2011) <http://www.ifrs.org/IFRSs/Documents/IFRS13.pdf> ACCA, Policy Paper on Fair Value. www.accaglobal.com/economy.

⁸ Nissim, D., Reliability of banks' fair value disclosure for loans. *Review of Quantitative Finance and Accounting* 20 (4) (2003) pp. 355-384.

⁹ Hitz, J.-M., The decision usefulness of fair value accounting—a theoretical perspective. *European Accounting Review* 16 (2) (2007) pp. 323-362.

¹⁰ Ryan, S. G., Fair value accounting: understanding the issues raised by the credit crunch, White Paper prepared for the Council of Institutional Investors (2008).

¹¹ Fiechter, P., and C. Meyer. 2009. Big bath accounting using fair value measurement discretion during the financial crisis: Mimeo.

¹² Chen, F., Lam, K., Smieliauskas, W., Ye, M., Fair value measurements and auditor versus management conservatism Evidence from the banking industry Working paper, University of Toronto, (2010).

¹³ Barth, M. E., Fair value accounting: Evidence from investment securities and the market valuation of banks. *Accounting Review* (2000) pp. 1-25.

¹⁴ Barth, M. E., Clinch, G., Revalued financial, tangible, and intangible assets: Associations with share prices and non-market-based value estimates, *Journal of Accounting Research* 36, (1998) pp. 199-233.

¹⁵ Aboody, D., Barth, M. E., R. Kasznik., Revaluations of fixed assets and future firm performance: Evidence from the UK. *Journal of Accounting and Economics* 26 (1) (1999) pp. 149-178.

¹⁶ Hill, M. S., Fair value earnings as a predictor of future cash flows, Working paper, University of Alabama (2009).

¹⁷ Dhaliwal, D., Subramanyam, K., Trezevant, R., Is comprehensive income superior to net income as a measure of firm performance? *Journal of Accounting and Economics* 26 (1) (1999) pp. 43-67.

¹⁸ Hitz, J.-M., The decision usefulness of fair value accounting—a theoretical perspective. *European Accounting Review* 16 (2) (2007) p. 351.

¹⁹ IASB, International Financial Standard 13 – Fair Value Measurement, edited by I. A. S. C. Foundation. London IASB (2011).

²⁰ Moses, O. D., 'Income Smoothing and Incentives: Empirical Tests Using Accounting Changes' *The Accounting Review*, Vol. 62, No. 2, (1987) pp. 358-377.

²¹ Bonbright, J.C., *The Valuation of Property*, McGraw-Hill (1937).

Barth et al.²², in 1995, Bernard et al.²³, in 1995, Hodder et al.²⁴, in 2006, Plantin et al.²⁵, in 2008, Sole et al.,²⁶ in 2009, Magnan²⁷, in 2009, Sun et al.²⁸, in 2011, emphasized that historical-cost-based reporting does not recognize changes in values until the asset is sold. Some empirical studies almost prove that the move towards fair value accounting leads to increased earnings. Barth, in 1994, underlined that financial statement volatility was not an indication of flawed financial reporting. Barth said that the uncertainty and timing of future cash flow is a complete financial reporting. Barth has found three possible sources of financial statements volatility associated with fair values: inherent volatility, estimation error volatility and mixed measurement volatility.

Practicing of the concept of fair value accounting, it involves recognition of economic losses as well as economic gains and less asymmetry of losses relative to gains²⁹.

Goncharov and Hodgson³⁰, in 2008, have empirically confirmed that unrealized fair value gains (losses) in other comprehensive income. They pointed out that that use of fair value concept may have significantly different effect on the earnings quality for Eastern European countries due to business entities in continental Europe rely to a greater extent on debt capital.

To resume, when analyzing previous research regarding the association between application of fair value accounting and earnings quality measures, we get the following conclusions: there is mixed and inconsistent evidence. There were previous research examines earnings quality using single earnings attributes or a subset of earnings attributes.

Fair value accounting is established by income approach. Then changes in fair values can be stated as gains and losses through net income or other comprehensive income.

Andrew³¹, in 2009, claimed that the corporations had used net realizable value instead of value in use, this would have produced a higher asset impairment charge and lower reported earnings and asset values then has been stated.

Thus, we examine the influence of fair value gains (losses) through other comprehensive income and through net income on earnings.

Bad news are reflected by conservative earnings more quickly than good news. Thus, historical cost accounting causes timely recognition of losses than gains.

Historical cost accounting causes improves quality of accounting information in the context of corporate governance and loan agreements. Asymmetric recognition of losses relative to gains is defined as conditional conservatism.

3. Conclusions

I agree with Ball and Shivakumar that “defines loss recognition as arbitrary, not contemporaneously related to any particular event due to the arbitrary nature of bias in terms of reporting low book values and incomes unconditionally as a result of being conservative”³².

Many firms that did use value in use to arrive at their asset impairment loss will have declined a net realizable value figure as this would have been reduce than the value in use figure. If the firms had used net realizable value instead of value in use, this would have cause a higher asset impairment charge.

For the firms that use net realizable value for the purposes of determining the asset impairment charge this indicates that their net realizable value is higher than any calculated value in use figure.

In this way, that many firms report using more than one valuation method depending on the type of asset that is impaired and the results become difficult to indicate any conclusions based on the information available, despite the initial observation that value in use appears very used.

I conclude that the use of fair value concept may have a different effect on the earnings quality for Romania because of less liquid or inactive markets. In this way, fair values will more probably be estimated by the use of valuation techniques which enables earnings management and could lead to lower quality

²² Barth, M. E., Landsman, W. R., Wahlen, J. M., Fair value accounting: Effects on banks' earnings volatility, regulatory capital, and value of contractual cash flows, *Journal of Banking and Finance* 19 (3) (1995) pp. 577-605.

²³ Bernard, V. L., Merton, R. C., Palepu, K. G., Mark-to-market accounting for banks and thrifts: Lessons from the Danish Experience *Journal of Accounting Research* 33 (1) (1995) pp. 1-32.

²⁴ Hodder, L. D., Hopkins, P. E., Wahlen, J. M., Risk-relevance of fair-value income measures for commercial banks, *The Accounting Review* 81 (2) (2006) pp. 337-375.

²⁵ Plantin, G., Sapra, H., Shin, H. S., Marking-to-Market: Panacea or Pandora's Box? *Journal of Accounting Research* 46 (2) (2008) pp. 435-460.

²⁶ Sole, J., Novoa, A., Scarlata, J. G., Procyclicality and fair value accounting. Vol. 9 (2009) International Monetary Fund.

²⁷ Magnan, M. L., Fair Value Accounting and the Financial Crisis: Messenger or Contributor? *Accounting perspectives* 8 (3) (2009) pp. 189-213.

²⁸ Sun, P., Liu, X., Cao, Y., Research on the Income Volatility of Listed Banks in China: Based on the Fair Value Measurement, *International Business Research* 4 (3) (2011) pp. 228.

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³⁰ Goncharov, I., Hodgson, A., Comprehensive Income In Europe: Valuation, Prediction And Conservative Issues *Annales Universitatis Apulensis Series Oeconomica* 1 (10) (2008).

³¹ Andrews, R., Fair Value, earnings management and asset impairment: The impact of a change in the regulatory environment, *Procedia Economics and Finance* 2 (2012) pp. 16 – 25.

³² Ball, R., Shivakumar, L., Earnings quality in UK private firms: comparative loss recognition timeliness. *Journal of Accounting and Economics* 39 (1) (2005) pp. 83-128.

of reported earnings. Some empirical findings from research support experts' predictions³³.

Then, earnings under more fair value-based reporting system have less aggregate quality rankings for firms in Romania. I get the evidence that the extent of more fair-value-based other comprehensive income

is negatively related to aggregate earnings quality for firms.

I noticed that many studies on this topic are realized in common law countries such as US, United Kingdom or Australia and there is few research regarding fair value accounting in countries of Eastern Europe.

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³³ Šodana, S., The impact of fair value accounting on earnings quality in eastern European countries, *Procedia Economics and Finance* 32 (2015) pp. 1769 – 1786.

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