FAIR VALUE - THE UMBRELLA OF THE VALUATION BASES USED IN ACCOUNTING

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Abstract:
Recent deliberations by both the International Accounting Standards Board (IASB) and the Financial Accounting Standard Board (FASB) in the United States have focused on how fair values of assets and liabilities should be measured. According to the international framework, the financial statements use different valuation bases: the historical cost, the current cost, the realizable (settlement) value, the present value (the present value of cash flows). The choice of the valuation basis and the capital maintenance concept will eventually determine the accounting evaluation model used in preparing the financial statements of a company. The multitude of accounting valuation models differentiate one from another through various relevance and reliable degrees of accounting information and therefore, the preparation of financial statements must try to equilibrate these two main qualitative characteristics of financial information.

Keywords: fair value accounting, historical costs, current costs, realisable (settlement) value, present value.

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INTRODUCTION

Due to the ever increasing importance of the concept of fair value, particularly visible lately, we have decided it was relevant to focus our research work on the analysis of this concept, also trying to describe the essential features that characterize it. To achieve this, we have tried to identify the means for quantifying the fair value, starting from the valuation bases provided by accounting norms and ending with an analysis of the practical applications for each valuation basis.

Lively debates on defining the concept of fair value existed and continue to exist, especially related to the means of obtaining it. When it comes to the *content of the concept*, there are some opinions considering its main quality to be the valuation, some stating that it represents a certain application of the market value, and others that consider it to be a convention or an accounting principle showing that the fair value is an estimation and not a finding as it is the case of the market value. Continuing the ideas mentioned above or concluding them, FASB (Financial Accounting Standards Board) confirms within the norms it elaborated in 1999 that the fair value is not a new mean of assets valuation, but a purpose of the valuation, being an "attribute of the value" (Casta J.F. and Colasse B., 2001).

The methodology of scientific research used in this paper is based on **qualitative research,** our purpose being that of providing a general image on the valuation bases used in accounting. One of the most frequently used research methods in this paper is the **comparative method** that generates a comparative analysis of different valuation bases endorsed by the accounting theory and practice, in order to define their main limitations and qualities.

The disadvantages related to historical cost valuation and the necessity of adapting the accounting model to the needs of the investors imposed the finding for new solutions, one of them is to use other valuation bases instead of the historical cost. During the recent years, the accounting regulation bodies devoted the valuation process mainly to fair value that tends to cover all the elements from the balance sheet.

The concept of fair value attracted the attention of many theoreticians, practitioners and accounting regulation bodies who expressed their opinions on its definition. According to the definitions one may find in the specialized literature, the concept of fair value is equivalent to the

one of market value with no clear distinction between the two. The origin of this association is the type of asset that required the estimation of another value besides the accounting value. This refers to financial instruments quoted on the capital market that offered at any time a market value represented by their stock exchange rate. Subsequently, the use of the market value in valuating other elements from the balance was a necessity too. As their nature, the means of using them in companies and the conditions on the specific markets were different, the actual market value proved to be impossible to track.

The market value is considered to be an application of the fair value and the cost of replacement, the realizable and present value, the main difference between them being the objectivity of the calculation, given the fact that the first is based on the information from the market.

When lacking external quotations for the most of the elements in the balance sheets, the fair value has to be calculated in the companies by using models that are difficult to conceive, accomplish and control.

In order to quantify the fair value, one will start from the valuation bases used by the accounting valuation. The most frequently adopted valuation basis by trade companies when preparing their financial statements is the historical cost – the original cost of the transaction. The imput values are corrected, if the case, with the amount of allowance or depreciation adjustments. Based on the hypothesis (principle) of stable currency unit, the principle of historical costs is to respect the nominal value of the currency without taking into account the variations concerning its purchasing power. Although it is not clearly stipulated by the national regulations, this principle applies to the Romanian accounting system too.

Determining the valuation basis used to present different elements in financial statements represented and still represents one of the most difficult problems in accounting. The general framework IASB (International Accounting Standards Board) accepts four valuation bases, namely:

- Historical cost
- Current cost
- Realizable value
- Present (adjusted) value

The position of IASB related to the fair value is presented in several IAS (International Accounting Standards) and IFRS (International Financial Reporting Standards) issued in time. These standards refer to certain assets or operations/transactions that request the estimation of the fair value, however there is no norm specified for the means of quantifying the fair value.

However IASB has issued an Exposure Draft, "Fair Value Measurement", for comment by September 29, 2009. The proposed guidance deals with how fair value should be measured where it is required by existing standards. The ED specifies how, not when, entities should measure assets and liabilities at fair value. If adopted, the proposals would replace fair value measurement guidance contained within individual IFRSs with a single, unified definition of fair value, as well as further authoritative guidance on the application of fair value measurement in inactive markets.

The Board's objectives for publishing the proposed IFRS are:

(a) To establish a single source of guidance for all fair value measurements required or permitted by IFRSs;

(b) To clarify the definition of fair value and related guidance in order to communicate the measurement objective more clearly;

(c) To enhance disclosures about fair value to enable users of financial statements to assess the extent to which fair value is used and to inform them about the inputs used to derive those fair values.

At the European level, as well as in Romania, the same valuation bases are used, according to the accounting regulations applied starting with 2005, corresponding to the European Directives, as well as before that for corporations, starting from 2001.

When it comes to the plan of the accounting regulations, the European Directives don't offer any indications on the definition of the fair value and the means of obtaining it. When discussing

the accounting valuation in general, these regulations stipulate just the fact that besides the historical cost, other valuation bases may be also used.

The accounting regulation bodies from the USA classify the valuation bases into five types that cover the content of the IASB bases. These bases are the historical cost, the current cost, the market value, the realizable net value, and the present value of the treasury cash flows. Therefore, *SFAC 5 Trade Companies' Financial Statements Recognition and Evaluation* adds to the valuation bases stipulated in the IASB General Framework the **present market value** defined as the value of cash equivalent that can be obtained by selling assets according to their liquidity. One may notice that the American regulators consider the market value to be a separate valuation basis of the financial statements, not only an application of other valuation bases (requested for example by IASB).

As compared to IASB, the American institution of accounting regulation (FASB) issued in 2006 the financial accounting standard FAS 157 "Fair Value Measurements" in order to present the means of quantifying the fair value in financial statements. The reason behind the elaboration of the standard FAS 157 concerning the assessment of the fair value was to reunite the means of calculating the fair value stipulated in several norms. Specifications were also required in order to carry out relevant, credible estimations of the fair value in certain circumstances, especially when lacking market prices.

The FAS 157 supports the use of the market inputs (information) in estimating the fair value of an asset of a debt. Also the FASB facilitates the assessment of the fair values by establishing a *hierarchy of value*. The hierarchy grants the main priority to market inputs that reflect the prices of an active market for assets and identical debts (either discounted prices of some concluded transactions, or offered/requested prices). According to the hierarchy the input with lowest importance are the company inputs determined using own estimations and assumptions.

The hierarchy of value divides the inputs to be used for fair value assessment in three categories or levels, as it follows:

- Level 1 of estimation, that uses the market references

It is useful to be aware of the active market to which the company has *direct access*. If the company can access several markets, the most attractive market will be chosen. The market prices don't have to be adjusted for this type of estimation, as it is the case for all the other levels.

- Level 2 of estimation

This is the case when no market prices can be found for *identical* assets and debts. The procedure is to gather market information on *similar* assets and debts that are adjusted according to differences if the information is available.

- Level 3 of estimation

This level of value assessment is used if no identical or similar assets and debts are found, or if there is no reliable possibility to determine the differences between similar elements. In particular, the multiple evaluation techniques (the approach based on market, price and cost) are used if the required information is available with no additional costs or efforts.

The standard FASB specifies that level 3 of estimation entails a professional reasoning when choosing and applying the techniques and the important inputs. Furthermore, if multiple evaluation techniques are used, an analysis of the effect entailed by their use is also required, taking into account the relevance and the credibility of the inputs that are used.

In that which follows, this paper will discuss the valuation bases stipulated by IASB that are used in Romania as well. One may assume that the fair value is obtained after applying three of the valuation bases mentioned above, namely: the current cost, the realizable value and the present (adjusted) value. Sometimes, even the rectifications of the historical cost represent a fair value at the date when the elements of the financial statements enter the company.

The content and the practical application of the valuation bases are described below:

Table no. 1 The content and the practical application of the valuation bases

Valuation bases	Content	Practical application
Historical cost	For the assets, the historical cost is represented by the cash paid, or the amount equivalent to cash, or the fair value of the conterperformace carried out in the moment when the assets were received. For the debts, this cost is the value of the equivalents obtained for the liabilities or, in some cases (taxes) the value expected to be paid in cash or using cash equivalent in order to settle the debt. The historical cost is the original cost and it reflects the value of the element on its initial identification.	*The purchase or the production cost, the service fee, the delivery charges, the contribution and utility values (the market value adjusted according to the utility, condition and the place of the asset).*
Current cost	*For the assets,* the current cost represents the cost covered by the company to obtain instead of a current value a good similar to the one that is subjected to valuation (the value paid in cash or the equivalent to cash should be paid if a similar good is purchased or produced at present). The *debts* are evaluated at their cash value or the equivalent to cash required for discounting the liability at present.	*(Net)* replacement cost
Realizable value	The realizable value is the value a company would receive if it sold the assets or if it used them to settle a debt at present. *For the assets,* the realizable value is the cash value or the equivalent to cash a company would obtain by selling them. *For the debts,* the realizable value is the initial cash or equivalent to cash that has to be paid to settle the debt according to the normal course of the business activity.	*The market value* diminished by the cost related to finalizing and selling the asset.
Adjusted value	*For the assets,* the adjusted value is represented by the adjusted value of the net cash flows that will be generated by using the product in the future. *For the debts,* the adjusted value is represented by the adjusted value of the future net cash outputs expected to be paid in order to settle a debt.	It is obtained by applying an adjustment (depreciation) rate to the evaluated treasury flows. For the assets (except for the outstanding receivable), the practical application of the adjusted value is the *use value.*

Therefore, the means of quantifying the fair value is generated by the practical application of the other valuation bases besides the historical cost. In that which follows, this paper will present in detail the mean of calculating the values to be used instead of the fair value.

REPRESENTATIONS OF THE CURRENT COST

The application of the current (adjusted) cost is the net replacement cost that is also called the depreciated replacement cost, the reconstruction cost or the replacement value. This value represents the cost of maintaining the production capacity of a company, as compared to the evolution of prices specific to certain categories of assets.

When calculating the current cost, the asset taken into account has to allow the maintaining of company production, conditions where establishing a certain value in a context of permanent technical progress is a difficult task.

The procedure of evaluating the net replacement cost is the following *(Matiş D. & colectiv, 2005):*

- The "new" cost is estimated, valid at the date of the evaluation for an asset identical or similar to the one subjected to valuation, with the possibility of having two solutions:
  - ✓ Either to collect information about the prices of the recent transactions on the market specific to these assets or the price lists of the suppliers;
  - ✓ Or, in the absence of updated market information, to adjust the historical cost of the asset with an index that reflects the corresponding currency depreciation, and the evolution of prices for raw materials, materials and manual labor entailed by that asset.
- The new cost calculated as described above is subjected to the corresponding discounts that reflect such aspects as asset's location, its actual physical wear, the condition for current use, the influence of external factors.

Using this difference between the new cost and the asset depreciation, a new net cost of the asset is obtained, a value valid to the date when the evaluation is carried out.

REPRESENTATIONS OF THE REALIZED VALUE

The application of the realizable value is the **market value** that represents the *price that can be obtained for an asset if there is an exchange market specific to that asset and open for everybody* (Tournier J. C., 2000).

According to the professional evaluation standards, the market value, which is estimated including for accounting registration, represents the *estimated amount for which an asset will be exchanged at the valuation date between a decided buyer and a determined seller in a transaction where the price is calculated in an objective manner, following a corresponding marketing activity, where the two sides acted knowingly, prudently and with no constraining factors involved.* (International Evaluation Standards, *IVS 1 The market value as a valuation basis, chapter 3.1*).

The market value is usually obtained by collecting from the market discounted prices for assets identical or similar to the one subjected to evaluation, these prices are adjusted by adding or decreasing amounts according to differences of type, model, age and exploitation conditions between the evaluated asset and the asset it is compared to.

If it's the case, the market value estimated as described above is subjected to deductions related to the costs of completing and selling the asset. Some of these costs are the following: production costs to be fulfilled for the goods in production or for semi-products that are still in the technological process, transportation expenses related to the selling process, advertising expenses and selling commissions.

The net price thus obtained is presented in the Romanian accounting regulations as the *estimated price that can be obtained while carrying a normal activity, minus the estimated costs related to product completion, if the case, and the required estimated costs entailed by the selling process (OMFP 3055/2009).*

In the French variant of the General Chart of Accounts which stipulates a net amount of additional expenses, the market value, also called the venal value established at the date of the accounting inventory, is the *net amount that can be obtained by selling an asset after a transaction concluded in normal market conditions, minus the output cost.* The output costs are represented by the external costs directly referred to asset output, except the financial expenses and the expenses related to tax on generated result.

Certainly, one should not forget about the difficulties entailed by calculating the realizable net value. As mentioned above, this value represents the differences between future income obtained after selling a product (if this product is sold) and the expenses involved in this process. In other words, this value is the net amount received after selling an asset. There is no doubt that the process of calculating the realizable net value would be difficult to carry out as long as the product was not sold. According to some authors (Feleagă N. and Feleagă L., 2006) every member of the accounting service and every manager has his own point of view regarding this matter. Furthermore, what is the expected rhythm of adjustment for this price? During an exercise, a

company may want calculate the benefit several times. Some products can remain in the stock of a company for many years. Each time a company has to calculate the income, it has to assess a price for every element of the assets to be sold, with all the aspects involved.

REPRESENTATIONS OF THE ADJUSTED VALUE

The adjusted value is a present estimation of the value according to the future cash flows to be obtained in the course of a normal business activity; that is by updating a value expected to be available subsequently.

For the assets (except for the outstanding receivable), the application of the adjusted value is the **use value**, that corresponds to *the adjusted treasury entry and outputs values estimated to be obtained by using the asset, including a potential treasury flow at the end of the period of use* (Matiş D. and collective, 2005).

According to another paper, the use value is applied especially to capital assets and represents *the amount of the estimated expected economic advantages obtained by using the asset.* Another value adds to these advantages obtained during the life cycle of the assets called the residual value obtained from selling the asset (Tournier J. C., 2000).

Such a presentation of the use value is also offered by the accounting standards in their current form. According to IASB, this value reflects *the adjusted value of estimated treasury flows expected to be obtained by continuing to use an asset and its disposal at the end of its useful life cycle* (IASB, International Accounting Standards Board, IFRS 5). *The use value represents the adjusted value of some possible inputs and treasury flows expected to be generated by an asset or by a cash generating entity* (IAS 36 Assets depreciation).

The estimation of the use value of an asset includes the following stages: the estimation of the future treasury entries and outputs generated by continuing to use the asset and up to its final exit; the application of the appropriate adjustment rate to these expected treasury flows. The following aspects have to be taken into account when estimating the future treasury flows required to calculate the use value:

- ✓ The projections of treasury flows have to be based on rational documented hypotheses that represent the best estimation of the management concerning all the economic conditions that will exist during the rest of the period of time when the asset is to be used;
- ✓ The projections of treasury flows have to be based on the most recent financial budgets (previsions) that were approved by the management department; the projections established base on these budgets have to cover a period of maximum five years, except the case when longer periods can be justified;
- ✓ The projections of treasury flows have to take into account the period covered by the most recent budgets, after applying to their values a constant growth or a decrease rate for the years to come, and except the situation when a growing rate has to be adjusted; this growth rate doesn't have to be higher than the average long term growth rate for the products, sectors of activity or country (countries) where the company operates or on the market where the asset is used, except the case when a higher growth rate can be justified (Feleagă N. and Feleagă L., 2006).

The estimations of the future treasury flows and the adjustment rate reflect coherent hypotheses on the price increase generated by the inflation. Consequently, if the adjustment rate includes the price increase effect generated by the general inflation, the treasury flows are estimated in current prices. If the adjustment rate does not include the price increase effect generated by the general inflation, the treasury flows are expressed using constant prices.

The assessment of the future treasury flows have done for an asset, taking into account its current condition. The estimation of the future treasury flows doesn't have to include any future treasury inputs or outputs expected to be received: from a process of reorganization the company did not start at that time; from the future investment expenses that will improve

and raise the level of performance of an asset as compared to its initial level of performance; from financing activities; or from operations related to tax on result.

The *adjustment*, as a specific method applied both for assets and liabilities, is about transforming an expected amount to be cashed or paid into present (adjusted) value.

To adjust a future amount is to apply an adjusting factor of $1/ (1+ d)^{n}$. The gain (profitability) of the capital (that is many times received from the financial market as an interest) included in its adjustment factor, imposes penalties on the amounts to be obtained, because, apart from the inflation, their value is lower today due to the potential risks that can affect them in the future, as well as the risk of losing the opportunity to invest the same amount today on another market with an expected profitability, *d*.

In the case of *outstanding receivables and payables* **the adjusted value** is obtained by applying the method of adjusting estimated amounts to be obtained in the future using a capital gain rate.

CONCLUSIONS

Presently, no agreement has been reached on using a certain valuation basis or another. Each valuation basis presents both advantages and disadvantages and even if the advantages are clearly superiors to the disadvantages, most of the times the application of other valuation bases besides the historical cost cannot be justified by the cost-benefit relationship.

In that which concerns the fair value assessment one has to state that the accounting theory and norms did not make a clear distinction between the fair value, its application and interpretation, therefore the fair value doesn't seem to be a well founded concept. According to the specialists (Deaconu A., 2009), the fair value is a general term, a desideratum, similar to the objective of the accounting activity which is to provide a accurate image of the facts. It is neither a valuation base included in the conceptual accounting framework, nor a certain type of value. The fair value is a merely accounting concept the professional valuators and bodies representing them tried to analyze and master, trying to find clear applications in practice.

Therefore it is required to clarify the content of the fair value instead of stopping to use it, for it improves the informational accounting system. When it comes to the possibilities of applying this value in practice, one has to resort to substitutive models when the market doesn't offer sufficient information to assess the fair value as a market value. It is true that it implies a higher degree of subjectivity from the accounting professional. The solution for this is an adequate qualification on evaluation an accounting professional must have when elaborating financial statements (otherwise, he would have to refer to the services provided by a professional valuator).

Although slow, the transition to fair value seems to be an unstoppable trend, given that more and more specialists consider it to be the best method for asset valuation. This also results from the pressures exerted by accounting regulating bodies, which strongly support fair value in the standards they issue. The debates around the controversial issue of using fair value are far from over, and they will go on for a long time, since the concept of fair value is closely tied to the one of accurate image, and both concepts are still evolving and influencing each other.

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