

## PRELIMINARY VIEW ON OWNER’S AND MANAGER’S APPROACH TO VALUATION

Jiří STROUHAL \*, Dana DVOŘÁKOVÁ \*\*, Bohuslava KNAPOVÁ \*\*\*

### Abstract

*There is a strong pressure from investors to report accounting items using fair value concept upon economic boom. The financial crisis period may raise an issue of revival of conservative concepts in financial reporting, e.g. historical costs measurement and application of prudence principle. Conceptual solution of valuation issues need not to come out from current economic situation and it is impossible to change this concept every time when economic conditions tend to change. Unsystematically changes of valuation concepts may conduce to instability of economic system.*

*Research comes out from the analysis of benefits and risks of variant measurement bases upon various periods of economic cycle. There will be examined the applicability of these measurement bases upon the period of economic boom as well as upon financial crisis. Measurement bases will be evaluated from the aspect of information needs of investors, owners and managers. Study therefore pays attention to the interaction of financial and managerial accounting in valuation issues.*

**Key words:** valuation; owner; manager; financial accounting; managerial accounting

**JEL classification:** M41, G30

### 1. Introduction

Valuation (measurement) in financial accounting is one of factors which determines the quality and reliability of presented information. Solution of measurement issues is one of the key problems in current financial theory and practice. There may be seen a conflict between the requirements for relevance and timeliness of measurement on one side and the reliability and conclusive evidence on the other side. However, it shall be stated that the important problem of measurement issues is the possibility of subjective manipulation with values, which is possible when using certain measurement bases.

During last 20 years financial accounting faced globally the shift of reporting paradigms from the historical costs concept towards fair value measurement. Another phenomenon is the harmonization of financial reporting applying International Financial

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\* Jiří STROUHAL (strouhal@vse.cz) , PhD, Senior Lecturer , University of Economics , Faculty of Finance and Accounting, Prague, Czech Republic.

\*\* Dana DVOŘÁKOVÁ (ddvorak@vse.cz) , PhD, Aassociate Professor , University of Economics , Faculty of Finance and Accounting, Prague, Czech Republic.

\*\*\* Bohuslava KNAPOVÁ (knapova@vse.cz), PhD, Senior Lecturer, University of Economics, Faculty of Finance and Accounting, Prague, Czech Republic.

Reporting Standards (IFRS) or US GAAP (US Generally Accepted Accounting Principles). Summarizing previous researches in this field we notice them focusing primarily on two basic aspects – the reliability and the correctness of the valuation [e.g. Aisbitt, 2001; Emenyonu & Grey, 1996; Herman & Thomas, 1995]. According to Alexander & Nobes [2004], the factors affecting the development of accountancy in a given country can be defined as follows: colonial and external influences, impact of capital providers, character of the legal system, impact of taxation, impact of the accounting profession.

A key aspect for the approached area of reporting is that before the IFRS standards were adopted in the European Union, it was stock exchanges in particular which required that listed companies present financial statements in compliance with the IFRS or US GAAP. Previous researches dealing with the probability of using multinational standards [El-Gazzar et al., 1999; Murphy, 1999; Ashbaugh, 2001; Dumontier & Raffournier, 1998; Leuz, 2003] indicate a positive correlation between the listing of companies on foreign markets and the level of disclosure and use of multinational standards as basis for financial reporting.

## 2. Valuation Issues in Financial Accounting

Applied principles of measurement and their regulations are interdependently correlated with the informational needs of external users (especially investors) and internal users (managers). Owners of the company may behave as external users (e.g. minority shareholders) or as internal users. Requirements on content of accounting information given by the used accounting (and measurement) method are strongly connected not only with the group of users (internal versus external) but also with economic environment. Actual economic environment strongly affects the requirements for measurement requested from users.

Upon economic boom there can be seen higher optimism of investors which leads towards requirement of measurement of all accounting items at fair value, which mainly represents current market prices of assets. Using this concept means the turn from the prudence principle and conservative historical costs concept in financial accounting. Moreover fair value concept in financial accounting leads to higher tendency of revaluation assets or liabilities affecting profit or loss of the company.

Upon economic crisis conditions users reevaluate their views on accounting methods, especially the measurement bases. When we try to find out the reasons of economic crisis, we can hear opinions that it was very optimistic information given by fair value accounting in the period of economic boom. But history used to repeat: the greatest moment was of course Black Friday at New York Stock Exchange, after which the crisis smite almost all world in 30s of 20th century. Also at that time there was often heard that accounting was unable to provide the information which may help users to predict this abrupt change [Musílek, 2008; Marek, 2008]. The reaction on the mentioned crisis was the evolution of US GAAP – national standards which may be allowed to face the problems like this. Of course, it shall be stated that after the period of crisis economy tends to break up strict conservative rules and principles because of the pressure of the investors' requirements; there can be seen divergence from the prudence principle towards measurement based on actual market prices (or so called fair values). This evolution was visibly seen during last decades, not only at international level (standards IFRS and US GAAP) but also at national level (requirement to measure certain assets at fair value given by Czech Accounting Act). As a good example shall be stated the essential material of IASB (International Accounting Standards Board)

prepared by group of Canadian experts which dealt with the measurement of assets and liabilities upon initial recognition and declared the divergence from historical costs measurement towards fair value concept. Quite important was also the common discussion paper of IASB and FASB (Financial Accounting Standards Board) which dealt with unification of fair value concept in IFRS and US GAAP [Dvořáková, 2008]. Of course all these materials were presented before eruption of current economic crisis. We think that the tendency of fair value measurement results from the investors' pressure: the main objective for investors was capital spillover and maximization of short-term profit. It is impossible to ignore the fact that all these requirements were strongly connected with economic boom conditions.

Current economic crisis may evoke the renaissance of conservative approaches in measurement, especially the applicability of prudence principle. Confidence in financial market upon crisis is thrilled; there can be seen strong price swings. Swings in market prices of financial instruments or breakdown of real estate market may also evoke valid doubts whether the fair value concept (and market price is the most reliable evidence) is really the most objective and most reliable approach suitable for wide spectrum of users of accounting information.

The research in the area of valuation and measurement is necessary to handle not only from concrete economic situation and current market conditions, but it is essential also to discuss the potential risks which are connected with such restricted view. Too "optimistic" approach applied upon economic boom is based on fair value approach. The high value of assets which is given by active market or it is based on the estimates in case that active market does not exist, leads towards rising equity as well as balance sheet sum and in case of revaluation through profit or loss also towards fictive profits which can be distributed to owners. It shall be also stated that the estimates of fair values for non-financial assets, but also for certain financial assets (e.g. shares) used to have low level of reliability because of subjective estimates of valuator or based on mathematical models which are connected with restrictive assumptions.

On the other hand the approach based on accounting conservatism and prudence principle in recession periods may (jointly with inflation) lead towards erosion of company's substance and deepen and prolong the recession.

Financial reporting outputs are intended for presentation of the company to external environment, i.e. to external users, who determine the requirements for reporting outputs (i.e. financial statements and annual report). These requirements are (in certain level) mapped to system of normative regulation of accounting in countries, or in global (multinational) level. The influence of external users on content of accounting information is dominant during last decades and the role of owners and managers is conformed to investors' interest. In case those companies want to come across a market and receive necessary sources of capital for their businesses, they have to provide investors required information. In many countries (Czech Republic included) dominates strict accounting rules which provide to companies only very small maneuvering space for presentation of information according to their specifics as well as investors' requirements.

### **3. Valuation Issues in Managerial Accounting**

Accounting data from financial accounting are intended not only for external users, but further to information from managerial accounting also for internal users and owners. These

requirements were much more respected during last phases of accounting evolution. It is essential that financial accounting shall rely on prudence principle and its connection with the relevance of accounting information not only from the investors' point of view, but also from the view point of owners and managers. Therefore we assume to concentrate our research objective on deeper connection of financial and managerial accounting.

Hence, it is necessary to solve the question, whether the system of transfer prices for purposes of regulated financial accounting can exist without the system of transfer prices from managerial accounting. With the valuation of outputs it is also necessary to difference internal transfer prices (intradepartmental prices) and transfer prices for the valuation of concern outputs.

Transfer prices are used for management purposes in many directions: (i) as a measurement of the performance and the motivation instrument influencing the general behaviour of a company (concern); (ii) as an instrument of the delimited competence and responsibility for the part of results of the company (concern); (iii) as a tool of the allocation of costs and revenues (by incurrence or responsibility), then to increase of the concern net profit by decrease of the total income tax and the paid import duty, but also to increase of the concern net profit at the expense of minority owners of the company, first of all by the distortion of the actual profitability. Therefore it is logical, that the valuation issues diffuse both information systems: financial accounting and managerial accounting [Strouhal et al., 2009].

Managerial accounting as a specific information system uses transfer prices just for the performance measurement and the motivation of responsibility centres, as well as an instrument of the delimited competence and responsibility for results of supplier and customer centres and also for allocation of costs and revenues among appropriate centres and on particular outputs.

The valuation of corporeal and incorporeal outputs from the managerial point of view takes on greater importance in consideration of the optimization of entrepreneurial processes and the perspective performance management of the company [Drury, 2004]. The development of computer techniques and information technologies enables to manage the company from the other place than is current location of production and the sale of outputs, with the possible separation of owners' and managers' positions.

Companies with entrepreneurially oriented business and geographical action, of different law forms and with various business object are differed by various organizational and economic structure of centres, which "communicate" together, create outputs by requirements of external customers and give each other often services in dependence on the character and difficulty of the part of the entrepreneurial process, which secure; every responsibility centre should be managed with the aim of the achievement of the highest efficiency of their costs [Russell et al., 2002].

Internal transfer prices are considered for suitable and motivation management tools of the centre economy; they are assigned on various levels of costing structure of particular items of valued outputs, although their content will be noted by the development of contemporary financial crisis and this fact will be logically "projected" to the valuation of particular transactions of centres under conditions of each company.

Managerial accounting is primarily oriented on such demand in the relation to transfer prices, how correctly to determine and use intradepartmental prices for management purposes of the own entrepreneurial process. Transfer prices are considered as a traditional tool of the value management in this information subsystem and their application starts from long-term experiences and from practically verified theoretical basis. As they operate in the

external unregulated information system, they must be determined by such way, which respects specifics of the company and its relevant needs in the area of the output, responsibility, process or customer oriented value management [Král, 2006].

As for intradepartmental prices and their using as effective tool of the responsibility management, three assumptions should be fulfilled with their determination. Firstly, the intradepartmental price influences decisions of a centre, unless is assigned advance, eventually if rules for its assignment are determined advance. Therefore it is suitable as to be relatively invariable and as to be given conditions, when its changes can come. Secondly, intradepartmental price is the function instrument of the management, unless works with other instruments of the internal responsibility management, mainly with budgets of responsibility centres; the clear way of the assessment and the content of the intradepartmental price as the positive management tool are important for its assumption by supplier centre and customer centre. Thirdly, intradepartmental price of the homogeneous output should be assessed on the same level without relation to the fact, if other centres take the appropriate output or the output is sold to external customers.

Successful responsibility management supposes the invention assignment of intradepartmental prices of internal outputs given by centres. The customer recognizes the rationality in the case of the external revenue; he is willing to pay the market price for the required output. The internal recognition of the purposefulness in connection with interests of the company is concerned with the case of the internal revenue expressed with the help of the intradepartmental price. Furthermore it is possible to characterise in both cases the revenue as recognition of the benefit connected with the rational making of the activity.

Intradepartmental prices based first of all on costs (variable costs, full costs, full costs with the counting of the profit mark-up), intradepartmental prices based on the market price or assigned by the agreement among centres are used with the valuation of internal outputs.

The choice of the intradepartmental price has the influence on decisions about the centre motivation, about the structure and volume of given outputs of the customer centre and supplier centre, therefore the assignment and using of particular types of intradepartmental prices are different.

The main content difference between the intradepartmental price and market price follows from the various levels, when the purposefulness of the created output is recognized. The benefit on the border relation of the company and the market environment is expressed so, that the economically independent customer is willing to pay for a sold output the price answering by his opinion to usable parameters. On the other side the valued output of a centre shows only partial, from the company level the internal recognition of its purposefulness. Unless the output is given to the other consumption or evaluation inside the company, customer centre is restricted with the choice of the similar output from the external environment by the priority of interests of the company as a whole.

The intradepartmental price is not a form of the application of market relations in the internal company structure, but the instrument of the responsibility management, which has to coordinate intradepartmental relations pointing to the optimal fulfilment of targets of whole company [Wickramasinghe, 2007].

It is possible to deduce functions (from the top target), which intradepartmental prices shall fulfil in three directions. Intradepartmental prices should motivate workers of responsibility centres to such behaviour, which will be economical not only for them, but mainly for the company as a whole; unless these two views will be in a conflict, needs of the company should have always the priority. Then intradepartmental prices should perform as the

measurement of centre activity and lead up to the ascertainment, how economically appropriate centres participated in the total economy result of the company. Also intradepartmental prices should reflect the level of the delimited competence and responsibility on particular centres, namely not only in vertical relations of the superiority and subordination, but in horizontal cooperative relations, too; they should be as tool of the elimination, "delimitation" of results achieved by supplier centre from results of the centre, which receives intradepartmental output.

The significance and using of transfer prices are fundamental for the company management. Upon period of the current financial crisis it is necessary to give the sufficient attention to its aspects in the sequence on existing system of intradepartmental prices (and its using for management purposes of companies), which will be modified in the certain measure just by results of this newly incurred financial crisis. Appropriate results will be shown both in transactions among supplier and customer centres inside the company and in valuation transactions of concern companies.

#### **4. Methodology of Research**

We assume the research follow-up connected to the results of the particular research which was performed in this area. The final research report will synthesize theoretical, analytical and subjective elements. It will leads towards practical recommendation for companies, investors and regulatory bodies in the Czech Republic.

There were used following research methods: (i) mathematical and statistical methods; (ii) comparative analysis of accounting standardisation and its influence on reliability of reported accounting information (from the external and internal users point of view); (iii) analysis of financial indicators (based on particular valuation approaches), their modelling and testing upon particular periods of economic cycle; (iv) field research; evaluation of the valuation approaches, generalisation of the results and practical recommendation for particular groups of users.

#### **4. Conclusions**

The background for the research in the area of valuation is the detailed analysis of the evaluation approaches under national and international financial accounting principles including their comparison based on statistical and non-statistical indicators. The future research will be divided onto two phases.

First phase will be the base of this fundamental research and its objective will be the complex evaluation of all relevant approaches to valuation and measurement. There will be especially discussed two major (and alternative) approaches: historical costs measurement and market value approach. During the analysis of market value approach there will be analyzed two major alternatives: fair value measurement (which is based on active market and is independent on the position of the company) and measurement which is based on the market position of the evaluator (i.e. seller or buyer). Sellers will measure these items using realization values; buyers will measure these items using replacement prices. Measurement which is based on the position of the evaluator we will mark as an "entity specific value model".

All these alternatives will be tested from the relevance, objectivity, reliability and risk level point of view. Risks will be evaluated depending on the valuation base.

Upon the analysis of risks which are connected with the market based valuation (fair value model and entity specific value model) there will be evaluated the risk of the market price swings, proof of valuation and the risk from the possibility of the subjective manipulation with accounting information. There will be also treated the risks connected with the determination of fair value (or market value) in case of non-existence of active market when shall be used certain estimates, mathematical models etc.

Upon the analysis of risks which are connected with the historical costs approach there will be evaluated the risk of inflation underestimation of assets which may lead towards the erosion of company substance. We will also deal with the reliable determination of historical price, especially for the self-made assets (tangibles as well as intangibles), as it may leads to the important risks in the way of manipulation of profit. Finally there will be also discussed the topics concerning impairment of the assets.

The potential risks of all valuation approaches will be furthermore evaluated based on the particular phases of economic cycle as well as from the information requirements of particular groups of accounting information users (investors, owners, management).

The consequent research in the area of managerial accounting will be oriented on the valuation of internal outputs for the value management. The valuation of internal (corporeal and incorporeal) outputs is made on such basis, which the company can determine, on the contrary the valuation in financial accounting must be in context of used accounting principles and legislative regulations.

Information about the valuation in managerial accounting is determined to the using for the top management and particular managerial levels, i.e. for internal users. Their requirements on the valuation are reflected also to the accounting system; in case that company uses double ledger-bookkeeping system of ordered accounting information, this system provided the information not only for management decisions but also for financial accounting. That's why the aim of the research is among others to find out and solve the dual valuation approach in financial and managerial accounting.

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