

CONSIDERATIONS ON APPLYING FAIR VALUE IN ROMANIA

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Abstract

The disadvantages of preserving an accounting system based on historical cost and the need to adapt the accounting model to the investors' requirements, has made it necessary to find solutions; one such solution is to use other valuation bases, instead of historical cost. The reshaping of the value-based accounting model consists of reconsidering the basic principles of valuation, allowing accountancy to progress from the system of historical cost to that of fair value. The concept of fair value has been the source of vivid debates with regards to its meaning in contemporary accountancy, both in theory and in practice. 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 how this concept was adopted in Romania.

Keywords: fair value, empirical study, historical cost, evaluation

JEL classification: M 41

1. INTRODUCTION

In present times, the need to replace historical cost with other valuation bases arises from investors, who have a direct interest in assessing the real value of a company, since they have to decide on how to manage their share of capital.

The valuation system based on fair value is currently much debated, so that it has both supporters and numerous critics. The main accusation against this system is the fact that it can lead to highly volatile results. The reason for that stands in the fact that valuation systems based on fair values involve including certain "virtual" elements in the result, as are generated by the market's evolution, and these elements are only potential gains or losses. Such a result, obtained from adjustments of the elements of the balance sheet in accordance with the market value or estimated value, is inconstant and is generated by causes that, as a rule, cannot be controlled through decisions of the company's managers.

Four our country, the concept of fair value, as well as all the other amendments of the accounting system starting with the year 2001, are quite new. We still find it difficult to explain it as concept, and even more difficult to apply it to practice. To this respect, we all have several questions whether it would be appropriate to introduce an accounting system that would include fair value or even be based on fair value.

The first mentioning of the fair value was within the Romanian accounting regulations aligned to the international standards in 2001, and then again in 2002 when the choice was made to connect the Romanian accounting system to the international accounting norms and, subsidiarily, the European ones (which hadn't been updated with regards to international level convergence). Currently, by renouncing the above-mentioned norms and adopting others that are compliant with the European Directives (updated) we maintain the spirit of the international accounting standards and thus the acceptance of fair value. But we must note that the current accounting regulations recommend valuations based on fair value only when re-valuating fixed assets, for asset swaps and for the goods received for free. The accounting regulations compliant with the European directives request that fair value be used also for the financial instruments in consolidated financial statements. That is why the choice was made to use a mixed system, based on historical cost and fair value, which involves using historical cost and, in some cases, fair value, so that the elements of the financial statements are expressed, most of them, in historical costs.

As we have shown above, the system based on fair value serves mainly the interests of shareholders. If the purpose was to cover the interest of the minority shareholders, the company would need to adopt an independent fair value system, which would basically lead to accounting all potential surplus values into the results. But if the purpose was that of protecting the traditional creditor, ideally there should be found a version of fair value accounting that could combine with historical cost accounting. That is to say that, when valuating the elements reflected by financial statements, the lower of the two, either historical cost or fair value, should be chosen.

As it follows from this, the choice of the accounting system should take into account all categories of users for whom the financial statements are meant. And that is because the accounting reference system issued by the IASB has attracted an ever increasing number of critics from certain categories of investors, who believe that the international accounting standards are meant mainly to the benefit of investors and fail to take into account the needs of other users or the realities within companies, so that "they are meant to allow an optimal comparability of the performances of invested capitals, regardless of the domain of the compared companies" [Gil, 2002, 31].

Although international regulating bodies aim to extend the practice of using fair value for the valuation of all the elements of the balance sheet, regardless of the companies' field of activity, valuation systems based on fair value are still a rather controversial issue.

Thus, it is thought that the valuation of balance sheet assets for their fair value has a certain risk of result manipulation, because fair value is only an accounting estimate that leads to such behavior as creative accounting (accounting manipulation). As a consequence, the application of a valuation system based on fair value is not strongly encouraged at an international level since "in all environments, and not only in Europe, not only with French banks, we have observed resistance against fair value" (Gelard Gil, member of the IASB). Off all the criticism expressed against fair value, the most consistent one come from insurance and bank specialists, who fear that if they registered the loss of value of the assets relative to their market value, that would only increase the result's volatility, and that would create panic among clients, which is a risk factor for these institutions.

Under these circumstances, we can only wonder what the future holds for fair value in Romania. Will there be a new accounting system, based on fair value, or will there be a choice for a combination between the two systems? In order to answer these questions we have attempted an empirical research on the perception of accounting practitioners over an

accounting system based on real assets. Through our empirical research activity we aimed to determine and analyze the options and prospects for applying various valuation basis within an accounting system, taking into account the fact that the international accounting regulations display an ever increasing interest for valuations based on fair value, and establishing the degree of practical applicability for the recommendations of the national and international regulating bodies with regards to the assessment of financial statements elements can provide us with an image of the progressive path that valuation bases have taken in their use in accountancy.

2. RESEARCH METHODOLOGY AND ESTABLISHING WORKING HYPOTHESES

As research procedure I have used a questionnaire that includes a pre-established set of questions thus conceived as to ensure the possibility of analyzing the opinions of the people who responded. Combined with the procedure of the questionnaire, I have also used the method of the survey, based on the use of a batch of people as research instrument.

An important step that needs to be completed in order to achieve the aims of the empirical study we were conducting is establishing the batch of people to be questioned. This process consists of selecting individuals out of a community, based on certain rules, so as to ensure that their opinions are representative to the community.

A first stage for establishing the representative batch of people was *defining the base population* out of which the batch was to be selected. Thus, we have resorted to the statistic population made of the group of financial auditors in Romania, physical persons, which includes 2862 active members, consisting of physical persons that are members of the Chamber of Financial Auditors (as per the data currently published on the site of the Chamber of Financial Auditors).

When establishing the target population, our reasoning was based on the fact that auditing means performing a critical analysis on financial statements and suggests solutions for improving the accounting system. Thus, given that, part of the financial audit is verifying financial statements also with regards to their compliance to accounting principles, rules, concepts and valuation methods for the elements of financial statements, as well as basic accounting treatments and alternatives to be used for valuation, we have found it appropriate to approach active financial auditors in order to examine the options and prospects concerning the accounting application of various valuation bases.

The method of choice for data gathering was *the questionnaire*, which is a data-collection technique that involves a set of questions established so as to allow reaching the proposed aims by analyzing the results that were obtained. The questionnaire was sent to 530 financial auditors, with a response rate of 21%. Although this is a low rate, we have found it acceptable, as it is a well-known fact that a low response rate is the main drawback of such data-collection methods. The auditors were selected at random from the website of the Chamber of Financial Auditors, as we attempted to include all the districts in Romania, in view of ensuring a high relevance at a national level.

The questionnaire that we used for conducting this study was made of 11 questions, some of which were *close-end questions* (providing the respondent with a choice between pre-established answers), whereas others were *semi-close-end questions* (used for obtaining more detailed information by allowing the respondent to suggest another opinion, not included among the choice of pre-established answers).

The structure of this empirical research has been organized around two large grounds of interest:

1. Establishing the degree of application for the recommendations of regulating bodies with regards to the assessment of financial statement elements. This degree of application has been reviewed from the perspective of the following areas of interest:

- The criteria taken into account when choosing the valuation bases used within an accounting system;
- The compliance with the provisions of the national accounting regulations and international norms with regards to conducting valuations;
- The importance of the fiscal aspect when choosing valuation bases;
- The importance of trustworthy accounting valuations and estimates in preparing useful financial statements;
- The role of the accounting professional in conducting valuations on elements of financial statements.

2. Determining the difficulties that arise in applying various valuation bases.

At this level, we focused on identifying the main difficulties that arise in applying various valuation bases, as their analysis may lead to identifying possible suggestions for improving the valuation of financial statements elements.

Within the empirical study we have completed, we aimed to verify the following working hypotheses, as presented in the following table (table no. 1):

Table no. 1 Formulating working hypotheses

<i>The main purpose of the empirical research</i>	<i>Secondary aims</i>	Working hypotheses
Analyzing the options and prospects for applying various valuation bases in order to improve the quality of financial statements	Establishing the level of compliance with the provisions of the national regulations and international accounting regulations with regards to valuation	<i>1. Most companies use historical cost as a valuation base for the elements of financial statements.</i>
		<i>2. The re-valuation of assets should be done on a regular basis, to ensure an accurate image of the company's financial position</i>
		<i>3. The fiscal regime of re-valuations is a critical factor when conducting re-valuations.</i>
		<i>4. The possibility of an accounting professional conducting a re-valuation based on certain indexes would be an encouraging factor for conducting re-valuations.</i>
		<i>5. Valuations based on fair value should be extended to all the elements of the balance sheet only for the companies that are present on the exchange market, and for which the main users of the financial statements are the investors.</i>
		<i>6. In the near future, a mixed system will be used, based both on historical cost and fair value.</i>
	Identifying the main difficulties that arise when applying various valuation	<i>7. The confusion between fair value and market value makes it more difficult to apply fair value to practical purposes if there is no active market.</i>

	bases	8. <i>Accounting norms don't provide a clear delineation between fair value and its applications or interpretations, so that fair value doesn't appear like a well founded concept.</i>
		9. <i>The need for an appropriate training of the accounting professional, with regards to valuation, makes it difficult to use other valuation bases but historical cost</i>
		10. <i>The high cost involved by using an authorized valuator is a factor that discourages the application of fair value</i>
	Identifying the options for improving the assessment of financial statements elements	11. <i>Using historical cost and the principle of prudence for calculating the distributable result and using fair value for calculating the global result that would reflect the creation of wealth for the shareholders.</i>

3. ANALYZING THE OBTAINED DATA

At the beginning of the questionnaire we have used a few questions aiming to collect general information about the respondents, such as:

- professional experience as financial auditor over the past 5 years, measured through the number of audit tasks that the respondents actually participated in;
- the percentage of trading companies submitted to audits that fall in the category of public interest companies, which apply the International Financial Reporting Standards;
- the percentage of trading companies submitted to audits whose securities are accepted for trading on a regulated market.

We have appreciated it that the respondents have a rich professional experience with regards to financial audits (49% of the auditors have participated in over 20 audits tasks), as well as the fact that many of them have had a high and very high percentage of audits performed on legal entities that apply the International Financial Reporting Standards.

In the following stage we aimed to test the respondents' opinions on the fact that most companies use historical cost as valuation base within the accounting process. It's worth mentioning that the opinions concerning this aspect are very mixed, as half of the respondents believe this to be normal, and the other half believe it is inappropriate because historical cost does not reflect current prices applicable at the date when the financial statements were prepared. These results allow us to accept hypothesis 1 (**Most companies use historical cost as a valuation base for the elements of financial statements**).

Another issue of interest that we have aimed at within our research was directed towards obtaining the respondents' opinions with regards to the need for performing asset revaluations on a regular basis, in order to achieve an accurate image of the company's financial status, given that the accounting regulations that are in line with the European directives allow companies to proceed with the revaluation of tangible assets existing on stock by the end of the accounting period.

By analyzing the structure of the answers received we find that most of the respondents believe that the revaluation of assets is strongly required in order to ensure that they reflect an accurate picture of the company's financial status, which allows us to accept hypothesis 2

(The re-valuation of assets should be done on a regular basis, to ensure an accurate image of the company's financial position).

Next, we have found it necessary to learn the respondents' opinion with regards to **the influence of the fiscal regime of revaluations** (amortization deductibility, discounting the tax due for revalued assets) **over the regularity of revaluations**, keeping in mind that, in our country, the choice of the accounting system is still strongly impacted by the tax regime.

The answers received for this question indicate that the frequency of revaluations is strongly impacted, among others, by their tax regime. Thus, 67% of the respondents believe that the deductibility of the amortization and the discounting of the tax due for revalued assets influence to a large or very large extent the frequency of revaluations. These results allow us to accept hypothesis 3 (***The fiscal regime of re-valuations is a critical factor when conducting re-valuations***) and prove that, in Romania, the accounting procedures are still closely tied to the tax regime, so that fiscal aspects take precedence over the necessity of ensuring an accurate representation of the company's financial status and performances.

Another problem with regards to the reevaluation of the assets relates to the appointment of the persons who have to conduct the reevaluation of the assets given that the legislation in force in this field (Government Decision 1553/2003 on the reevaluation of the tangible assets and the establishment of the book value) leaves it up to the companies to choose between an independent valuator and an internal valuation board comprising members who have technical training in this field. We considered it as relevant to find out what the opinion of the auditors who answered our questionnaire would be with respect to this matter, trying, at the same time, to figure out what the best solution would be according to them.

Reviewing the answers received, we notice that the overwhelming majority of the respondents claim that the reevaluation should be conducted by a valuator outside the company, and this outcome causes us to reject hypothesis 4 (***The possibility of an accounting professional conducting a re-valuation based on certain indexes would be an encouraging factor for conducting re-valuations***).

A most modern problem, that has been causing debates in specialized literature, arises from the *fair-value valuation of all the elements of the balance sheet*. Fair value has been taking an increasingly prominent position as of late, and one may notice a tendency in the evolution of accounting systems, which tend to move from the system based on historical cost to the one of fair-value. The concept of fair-value still gives rise to vivid debates with regards to its meaning for contemporary accounting systems, both in theory and practice. Under these circumstances, we have found it appropriate to question the respondents on their opinion with regards to the need for extending fair-value valuation to all the elements of the balance sheet, so as to ensure an accurate representation of the company's financial status and performances.

By analyzing the structure of the answers received we may conclude that *most (41%) of the financial auditors would choose to extend fair-value valuations to all the elements of the balance sheet, regardless of who the main users of the financial statements are*. On the other hand, a relatively high number of respondents (32%) believe that fair-value valuation should not be applied to the whole of the balance sheet and its elements, due to the technical challenges incurred, whereas 20% of the respondents believe fair value should only be applied for public companies, listed on the stock exchange, which issue financial statements meant primarily for the use of investors.

The results we have obtained prompt us to reject hypothesis 5 (Valuations based on fair value should be extended to all the elements of the balance sheet only for the companies that are present on the exchange market, and for which the main users of the financial statements are the investors). We must keep in mind that the opinions concerning this issue, which has given rise to many debates in specialized literature, are very mixed, as there are an almost equal number of supporters and opponents to the accounting system based on fair value.

Following up on the logical line of reasoning, we have found it relevant to learn the respondents' opinion on the future of the relationship between fair value and historical cost within the accounting systems used by companies.

An analysis on all the answers received has shown that most respondents (49%) believe that the future belongs to a mixed accounting system that will be using both historical cost and fair value, and that fair value will be used within single financial statements together with historical cost. The structure of the answers received allows us to accept hypothesis 6 (In the near future, a mixed system will be used, based both on historical cost and fair value). We must keep in mind, nevertheless, that a somewhat significant percentage of respondents (27%) believe that, in the future, a fair-value based accounting system will be the instrument of choice.

Another interesting matter under consideration during our research was relating to the difficulties encountered in the implementation of other evaluation bases than the historical cost and their importance. Reviewing the answers received it is safe to conclude that the most important of all the difficulties encountered while implementing other valuation bases than the historic cost is the high cost that the employ of an authorized evaluator would entail. To this we might also add, according to some of the respondents, the biased opinions that could occur in any evaluation. The structure of the answers received leads us to accept the working hypotheses no. 7, 8, 9 and 10. Thus, the main difficulties encountered in the implementation of the various evaluation bases are:

- *The confusion between fair value and market value makes it more difficult to apply fair value to practical purposes if there is no active market;*
- *Accounting norms don't provide a clear delineation between fair value and its applications or interpretations, so that fair value doesn't appear like a well founded concept;*
- *The need for an appropriate training of the accounting professional, with regards to valuation, makes it difficult to use other valuation bases but historical cost;*
- *The high cost involved by using an authorized valuator is a factor that discourages the application of fair value.*

The fact that accounting regulations don't provide a clear difference between fair value and its applications or interpretations, which results in making it seem like fair value is not a well founded concept, has been found by respondents as the least important of the challenges.

Given that the main criticism against the fair-value based accounting system stands in the fact that it involves including, within the result of the accounting period, certain "virtual" elements that are only "potential gains or losses, and therefore, distributing such a result might lead to a decapitalisation of the company, we have thought it appropriate to learn whether the respondents believe that the use of historical cost and acting cautious when cal-

culating the distributable result and the fair value for calculating the overall result might be a solution for increasing the usefulness of financial statements.

Using historical cost and being cautious when calculating the distributable result and the fair value for calculating the overall result is supported by the vast majority of financial auditors (62%), since, by doing so, the “virtual” result created through the recording of the latent gains and losses resulting from a fair-value valuation will not be distributed, lest it might lead to a decapitalisation of the company, even if preparing two sets of accounting records, one based on historical cost and the other one based on fair value, is not always an appropriate solution in terms of the cost to benefit ratio. This result allows us to accept hypothesis 11 (*Using historical cost and the principle of prudence for calculating the distributable result and using fair value for calculating the global result that would reflect the creation of wealth for the shareholders*).

4. CONCLUSIONS

We believe that, both in Romania and at an international level, in the near future we will use a mixed type of valuation, characterized by using historical cost and fair value together. Fair value will be used mainly for drafting consolidated accounts, since they are meant almost exclusively for shareholders and managers.

Among the obstacles to adopting fair value, we have considered the following:

- the theoretical reflections on alternative valuating methods in accountancy and the concept of fair value are insufficiently developed [Deaconu A., 2009, 121];

- in Romania, there still are regulations under effect that consider juridical and fiscal aspects as having priority to economic ones. That is why historical cost has been requested, and will be requested in the future too, as the value to be used when establishing the tax base, as far as fiscal regulations go, and organizing two sets of financial statements, both for historical cost and fair value, isn't always a good option in terms of the cost-benefits ratio;

- the accountant's mentality, as he refuses to adopt the new concept and accept the changing of a valuation system he is familiar and works easily with;

- the imperfect economic conditions don't allow us to obtain market information;

- the accounting system and accounting professionals have a reduced capacity of applying valuation systems based on fair value. So that connecting some or all of the parts of financial statements to market values (or versions of market values) is either a yearly operation or a series of periodical operations that require specialized knowledge (in business or asset valuation), time, and money, either from the company, through a specialized person or department, or from its consultants. But, as some authors noted [Deaconu A., 2009, 121], we are not well prepared for any of these two requirements.

When speaking of specialized knowledge we refer to knowledge acquired by a person who has completed specialized training in various forms or by a certified valuator, whether or not a member of a professional association, who applies the valuation standards adopted in Romania (that is, the international valuation standards, IVS, as of 2004). In that which concerns the people who should conduct valuations for the elements of financial statements, opinions vary. Some believe that an accounting professional, with specialized knowledge, could successfully apply fair value. But others think that estimating fair values should be a task assigned to an evaluator independent of the company or, at least, an internal valuator

who is a different person than the accounting professional. There is the belief that accounting tasks should be separated from valuation tasks.

Obviously, there's also the issue whether the result obtained by including certain gains, resulting from the use of fair value as a valuation method, can or cannot be distributed, given that it's only a potential value. A solution would be using historical cost and prudence when calculating the distributable result and using fair value for calculating the global result, which would reflect the creation of wealth for the shareholders" [Hoarau & Teller, 2001, quoted by Ionascu, 2003, 156]. Another solution is offered by Jose-Maria Roldan, general director of the department for accounting regulations within the Central Bank of Spain (quoted by Huw Jones, 2009), who suggests recording latent gains in a reserve fund.

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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