ACCOUNTING BASED ON THE HISTORICAL COST VERSUS ACCOUNTING BASED ON THE FAIR VALUE

DIANA ELENA BRÎNZĂ [1], MARCELA BENGESCU [2]
[1] ***Universitatea Piteşti, Argeş, Romania***
e-mail: diana_branza@yahoo.com
[2] ***Universitatea Piteşti, Argeş, Romania***
e-mail: m_bengescu@yahoo.com

Abstract: *The accounting theory and practice has developed a wide range of possible approaches regarding measurement in accounting. Fair value versus historical cost issue has been and continues to be one of the most challenging problems in literature. Switching from an accounting based on historical costs to one based on fair value was classified as a conceptual revolution in accounting. In our article we shall present a comparative analysis of these two types of accounting in view of shaping the future accounting system.*

***Key words**: historical cost, fair value, accounting system, financial reporting, relevance*

INTRODUCTION

Financial information is an important vector of communication between economic entities. Accounting information presented in the financial statements must be relevant and provide an accurate representation, so as to render a correct picture of the financial position of the economic entity and of its performance.

Accounting information is made available to decision makers through financial statements. This is why economic entities must ensure that the financial statements are sufficiently explicit to users. Fair value versus historical cost issue has been and continues to be one of the most challenging problems in literature.

The accounting based on the historical costs is considered relatively simple and economical, simple because it involves only the determination of the acquisition cost of the property by the company, economical because it doesn't involve changing the registration value in the balance sheet. However, many others think about historical costs that they still embody the most logical basis for measuring the financial statements, since it is more prudent and reliable [11]. Establishing the market value is the objective of fair value accounting. Achieving this goal is difficult, since the absence of an active market for asset evaluation.

MATERIALS AND METHODS

In this article, we achieved a qualitative research using methods such as external observation, comparative method, documents analysis. We shall begin with a brief overview of the literature on historical cost accounting and fair value accounting and we shall present the opinions of specialists in the field on the advantages and disadvantages of these two types of accounting and outline a comparative picture of them.

RESEARCH RESULTS

For reasons of reliability, clarity and comparability of accounting data at an international level, we shall try an harmonization of accounting evaluation [15].

The historical cost principle provides reliability because everyone can agree on initial purchase price of an asset. However, the historical cost does not necessarily provide relevant information [9].

According to Nguyen [10], despite the predominantly objective character of the historical cost method, this also presents aspects of subjectivity. Estimation is involved in the valuation of inventories, allocation of indirect and common costs and evaluation of possible debts. Therefore, not all aspects of the historical cost result from business transactions independently verifiable. Moreover, the choice to define the cost using FIFO and LIFO methods or standard cost will also affect revenues. Therefore, the value of the profit is not unique every time and may be subject to gains manipulation and management.

Given the complexity of the economic world, the development and globalization of financial markets and the increase of the influence of theory on the value from the shareholders' point of view, the historical cost accounting has become somewhat outdated [12]. To keep pace with these developments of reality, the accounting regulatory bodies have replaced gradually the principle of historical cost with the fair value.

Fair value is claimed and accepted largely because it is the most efficient and practical method of accounting for financial instruments so far. A very early study (Jones, 1988, quoted by [4]) on issues related to fair value versus historical cost in accounting for financial instruments reached some constructive conclusions. They noted that the historical cost evaluation issues have arisen as a result of the strong diversification of financial instruments. The historical cost was unable to reflect the reality on derivatives.

Through its financial position, fair value accounting highlights a correct accounting value to evaluate a company, which cannot be said in the case of the accounting based on the historical costs.

It is not necessary to establish the balance sheet at the fair value to meet the objective of evaluation. The assessments can be made from the profit or loss account using the historical cost.

Assuming that someone knows the necessary capital income, in principle there is no reason to say about fair value accounting that is better than historical transactions accounting. Settlement depends on how much the measurement draws away from ideal. Historical cost comes with considerable measurement problems. Does fair value measurement bring a solution?

Perhaps more than anything else, the misunderstanding of historical cost accounting creates confusion in the discussion about fair value versus historical cost. Historical costs are considered "old charges", costs which don’t indicate the current values and fair value accounting is often proposed as a remedy. Historical cost accounting is considered to be "with a view behind."

Barlev and Haddad [1] claim that accounting based on fair value (as opposed to historical cost accounting) can contribute to the harmonization and comparability of international accounting and due to the coordination of measurements, fair values are "globally acceptable". Also the two experts believe that changes in purchasing power don’t cause serious distortions over time on the fair value and values are independent of the location where they are based on the international market prices and subjectivity is reduced because current prices are not specific to the economic entity. The widespread use of fair value leads to globalization and harmonization of capital markets, which in turn facilitate the fair value accounting. A small problem is the absence of active markets; potential reliability issues are considered to be outweighed by the more serious problems caused by local nature of historical cost accounting-both in time and geographically. Hitz's [5] theoretical considerations lead to an entirely different conclusion: the concept of income based on the fair value does not really exist and it is very upsetting for non-financial topics in smaller markets.

The followers of the fair value accounting claim that this value imputable to assets, liabilities and equity reflects current market conditions and therefore provide timely information, thus increasing transparency ([6], [9], [13]). On the other hand, opponents ([3], [7], [8]) argue that fair value is not relevant and, moreover, is potentially misleading for assets held over a long period of time. I am also of the opinion that prices could be distorted by market inefficiencies, liquidity problems and that fair values based on models are not reliable. As a result, literature has some concerns about the reliability of fair value assessment and for this reason a return to historical cost accounting is often disputed.

Palea [11] believes that historical cost and fair value should not be considered as competitors because they serve different purposes. Historical cost offers investors information on the cost of an investment, while fair value gives an assessment of what the entity expects to obtain in exchange for this cost. Knowledge of fair value is important, although not enough. Users should be aware also of the investment cost. In fact, knowing how many resources were sacrificed to obtain fair value, they could effectively evaluate their management, which is also an objective of financial reporting.

The author concludes that it should be provided to users both historical cost and fair value, as only together they can provide complete and useful information for investors. Consequently, the adoption of a dual system of measurement and reporting should be considered and discussed at the level of standards development.

Relying on studies from literature, we shall synthesize the historical cost versus fair value debate through **Table 1:**

Table 1

Comparison between fair value accounting and historical cost accounting

Concept	Fair value accounting	Historical cost accounting
Relevance	Fair value measurement is more relevant to investors and creditors as it reflects the current market price of an asset or liability. It gives a value of feedback in time.	Financial statements at historical cost don’t provide information that may be relevant for investors. The information is out of date.
Reliability	Fair value assessments based on inactive markets may prove to be unreliable.	It is based on current transactions, the amounts recorded are secure, verifiable and lack the management influence.
Comparability	Fair values increase comparability when they can be measured reliably. We still need to improve the comparability of fair value measurements.	Historical cost assessments can impede comparability by not identifying similarities between similar items and differences between different elements.

Coherence	A single approach of the assessment in time is applied constantly by using the fair value.	Historical cost is a mixture of assessment methods. It reports previous transactions to historical amounts while current transactions are reported at fair value.
Financial reporting	The balance sheet is the main means of information communication to shareholders. The profit or loss account does not give information about value but evaluates periodic changes in value, thus informing us about possible risks.	The profit or loss account is the primary means for communicating information about the value to shareholders and not the balance sheet.
Result management (earnings management)	Income does not inform us about future earnings and value; these are changes in the value and thus do not predict changes in the future value.	Historical cost accounting creates opportunities for revenue management.

Source: author's projection

If the accounting regulatory authority is a state institution and when there is in the respective country a connection between accounting and taxation, the criteria for selecting the valuation method may be heavily influenced by the fiscal interests of the state (accounting is subject to taxation) and by other needs of the state administration.

According to Strouhal [14] when choosing an evaluation basis from the "whole" provided by the accounting regulatory bodies, these may consider the following criteria:

- Users'decision ;
- Qualitative characteristics of accounting financial information (fundamental qualitative characteristics - relevance and faithful representation, amplifying qualitative characteristics);
- Concepts of assets, liabilities and equity (cash flow attributed to these elements);
- The cost / benefit ratio.

The final selection of criteria always depends on the decision of standards development bodies which can and in fact must prioritize the interests of certain groups of users of accounting information.

Although the fair value accounting is approaching the perspective of current value, these fair values can be misunderstood by some potential or existing investors of the economic entity. Even if the historical cost due to its reliability and ease of application is used more often, the fair value measurement is an important step, especially in relation to investors in order to support the economic decisions [2].

CONCLUSIONS

We believe that fair value accounting is an advantage mostly for the investors by providing them information on the stock performances stock of the unit.

In our opinion the most important qualities and critics attributed to historical cost accounting and fair value accounting are related to relevance and reliability. The historical cost is reliable, but is not relevant, while the fair value is relevant, but it cannot be considered reliable. It is also very important to remember that the results of the historical cost can give a false impression of a business development.

Weighing the pros and cons of both types of accounting, the fair value accounting continues to be the best available method for financial reporting. In good times it helps economic entities to reflect the immediate impact of revenue growth and value creation. In crisis situations, it is the best way to give investors the necessary information.

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