

HISTORICAL COST AND FAIR VALUE WITHIN THE CONTEXT OF FINANCIAL CRISIS

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Abstract

Financial crisis determined the fast extension of global financial bankruptcy upon the world, representing at the same time the first crisis of the accounting term of "fair value", under the shade of which subsists a number of standards which request to the institutions to estimate at the market value much of the assets they possess. The Council for International Standards in Accountancy (IASB) revised the rules regarding the accountancy at the fair value, as a reaction before the critics which sustains that the accountancy rules at the fair value were the basis of volatility of financial market. The alternative for "fair value" – the historical cost of assets – has little admirers within the financial crisis. In the pages of the present article, we will try to achieve an incursion through specialized literature while analysing the two methods of valuation within the context of financial crisis.

Keywords: valuation in accountancy, historical cost, fair value.

Introduction

The end of 2008 and the beginning of 2009 were marked by a historical event: the global economy was affected by the most serious crisis amplified by a dangerous collapse of developed financial markets, the United States of America being in the epicentre of the global storm. The nucleus of our article is represented by the analyse of two methods of valuation (historical cost and just value) in the context of financial crisis.

Valuation represents the process through which are quantified and expressed in monetary units the assets, debts and elements of own capitals as well as the economic and financial operations with the modifications intervened upon these elements. The monetary unit is identified with money, Leu (RON) being the measure unit of economic value in Romania. The value established after the valuation is the value of assets, debts and own capitals presented in financial situations. This value has to be as real as possible and correctly established, because on the basis of information presented in the financial situations, there are taken the most important decisions at the level of economic entity. Therefore, the presentation of false values of assets, debts and own capitals in financial situations will lead to wrong decisions, with repercussions on long term upon the trading company.

In order to find solutions at the present moment, it is important to analyse the causes and not the symptoms of crisis, which created an unprecedented situation, undermining the thrust in free markets. In this context, there are necessary also unprecedented measures, with a more systematic and global character than those applied till present. Financial crisis was the first big test for European Central Bank and it was the first crisis of the accounting term of "fair value", under the shade of which subsists a number of standards which request to the institutions to estimate at the market value much of the assets they possess. The Council for International Accounting Standards Board (IASB) revised the rules regarding the accountancy at fair value, as a reaction to the criticism which sustains that the rules of accountancy at fair value were at the basis of volatility of financial market.

In the pages of this article, we shall make an incursion into the specialized literature, trying to find some answers regarding the advantages and disadvantages of a valuation at fair value or of the historical cost in the present economic environment.

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Paper content

Opinions of different authors regarding the causes of financial crisis.

The financial shock produced by the bankruptcy of mortgage market (underestimated rate of mortgage credit - subprime mortgage market collapse) in United States in August 2007, led to the slowing down of global economic growth in alarming rhythms (reduction with 6.3% in the last trimester of 2008, as compared to the growth of 4% in the previous year). In fact, it is the first global economic contraction after the Second World War (World Economic Outlook, April 2009, pp.49; . IMF Tweaks Loan Program in Bid to Attract Borrowers, by Bob Davis, March 20, 2009). The global financial bankruptcy extended rapidly in the world.

It is important to examine the sources of financial system crisis which gathered cumulatively over the last decades (Ceslav Ciobanu, December 2009). Martin Wolf, analyst at Financial Times newspaper, published in 2008 the book "Fixing Global Finance" where he characterizes the crisis as a result of a series of "obvious bankruptcies" to understand and estimate at fair value(Martin Wolf, 2008, pp. 8-9):

- The inherent risks of liberalized financial markets and of decisions of the respective market institutions;
- The increased risks given the terms that cash flows cross the frontiers, especially for fragile economies of future markets (as it is the case of Romania)
- The inherent risks of loans in foreign currency of debtor countries and the importance of an increased monetary and financial discipline;
- The connected risks of the exchange rate assumed not only by creditors but also by debtors in a world of liberalized circulation of capital;
- The risks of the activity given the terms of instability of exchange rate in the multi-currency exchange world;
- The importance of modernization of global institutions according to the demands of present time.

The credits' crisis appeared in 2007 was the cause of the loss of jobs for many financial managers, but also of the bankruptcy or sale of many financial institutions. After a time, two big problems proved to be at the root of this crisis. One of them is represented by the patterns used in the determination of fair value of those instruments for which there were used entry data of 3rd level, patterns too narrow to have the capacity to connect the modifications appeared in the price of buildings at the values of those financial instruments which were their active support through a structure more or less complex. The second problem consists in the lack to provide information that should be known by investors, lack which would have stopped even the best technique of valuation from generating a significative level of accuracy (Deventer, 2008).

Other sources from specialized literature consider that at the root of present financial crisis there is also the high level accepted in the last years by the mortgage credit market for an indicator specific to the domain of the mortgage credit, that is the value of credit weighted in the value of mortgage property (eng. *Loan-to-Value - LTV*). This indicator represents in fact a lever similar to the one used for entities, determining the weight of loan (mortgage credit) in the total value of the asset (property value), and as for entities, a growth of this lever determines a growth of the risk associated to mortgage credit. Thus, the growing number of beneficiaries of credits who don't cope with payments is directly associated to a higher level accepted for this lever (Matiş, Bonaci, 2009).

Given this situation, one can state that the present financial crisis is due to the relaxation of the process through which it should have been estimated the probability that those granted mortgage credits to be refunded (eng. *underwriting process*) and to a lever too high accepted in the last years for mortgage credits granted on the market (Wallace, 2008).

Many analysts disapprove of the concept of "fair value" as a cause of credits' crisis in USA, arguing that this can determin a descending spiral of prices, by encouraging institutions to sell the

assets quickly, obliging them at the same time to register in accountancy at "fair" lower prices their principal assets.

The fact that "the fair value" was accused of being so dangerous reflects yet the complexity of products, as well as the present situation of the market. In any conditions, it's difficult to establish a price for derivative products which were repeatedly "repacked, collateralized and structured". "The price of four thousand parts that compose a Porsche is more difficult to estimate than the entire Porsche, and the sum of parts is not equal with the whole," shows Bill Michael adviser at KPMG.

Obviously, some banks underestimated the risk of liquidity. The reports coming from the financial-banking domain indicate that institutions which showed prudence developed since long time ago internal patterns of valuation, using them even when the prices from the market could be estimated very clearly; those which didn't use such instruments, hurried up then to appeal to such patterns when the market came "up", but losing a series of opportunities. Many banks overlooked the opportunity to transform the lack of liquidity in costs of financing.

It is certain that at the present, the effects of crisis succeeded to propagate even at the level of some economies which tended to present optimistic scenarios, hoping that a certain drawback of little developed national capital markets will constitute this time an advantage, the lack of efficiency representing theoretically an obstacle in transmitting the information at the level of market.

IFRS (International Financial Reporting Standards) pointed out rapidly the problems of valuation arisen by this situation of financial crisis.

In these conditions, some lessons should be forgotten. The use of market value can transform an unfavourable momentary evolution in a real collapse, prices being more difficult to establish because of the lack of liquidity, and the valuations more liable to be influenced by psychological factors. This fact underlines the volatility and determines the managers to calculate the risks more attentively. If prices decrease very much, investors can become interested to buy those assets.

But beyond the concept of fair value itself, it should be tackled yet the aspect of implementation, often underestimated even at the level of Europe (Veron, 2008). The quality and consistency at international level regarding the implementation of an accounting referential are vital for the ensuring of a financial stability, as the Banking Supervision Committee from Eurosystem showed even before the first signs of manifestation of crisis (European System of Central Banks - Banking Supervision Committee, 2006).

The present financial crisis was of use, if we can say this about such a phenomenon with many negative implications, in bringing the financial instruments and especially their fair value in the searchlight, taking of our shoulders the charge to try to convince the readers about the importance of this theme. Even if at present the financial instruments are called toxic assets and the fair value received more criticism on this occasion than it would have received in the absence of such events which did nothing but favour misinterpretations, let's look at the full part of the glass, since in fact and after all the negative publicity is also publicity (Matiş, Bonaci, 2009).

Another important aspect underlined by specialized literature is the fact that such a serious crisis as the present one is not and cannot be caused by a single involved part, but implies the incapacity of the entire ecosystem which failed to estimate the risks connected to the fast growth of structured risks of mortgages, the other side of the coin in the growth of buildings' prices and an unprecedented lack of market liquidity (Ryan, 2008). There were all these factors that brought on the surface an inadequate character from the part of investors and from those who borrow or are borrowed, making them ignore what the common sense would have showed them, that is never forget to value at fair value the real implied risk.

At present, more than ever because of the global economic crisis, the fair value must be correctly interpreted. This was accused of being one of the important causes of crisis, contributing to the global writedowns. Gottdiener presents four keys for ensuring a superior valuation of assets (Gottdiener N., 2008):

- Establishing of some complex valuation hypothesis and of high technical level;

- Precise settling down of objectives and valuation goal;
- Realization of an objective and independent analysis;
- Ensuring of transparency by the clear presentation of the valuation methodology;

In all these stages, it is presumed the contribution of professional and ethic standards of valuation, especially the global ones of IVSC.

The support offered to the concept of fair value is not even far resulted from considering that this is a perfect one, being aware of the existence of a series of amendments to present standards that will be realized in the future, as the IASB president itself suggested not long ago (Tweedie, 2008). Despite of all these, the goal assigned to the fair value accountancy and valuations based on market, it doesn't seem an exaggerated one if we integrate it in the picture which represents the characteristics of financial markets in a world in full development, picture reflecting also the lessons learned from anterior crisis. A restrictioning of fair value not only will it cure the wounds of present financial crisis, but on the contrary, it would risk to make them worse, diminishing the level of thrust that investors, and not only them, have in financial situations of financial institutions (Veron, 2008).

In the opinion of an expert evaluator, one of the positive aspects of present financial crisis is that to have made light during debates regarding the concept of fair value from the point of view of two key aspects, stimulating us to give up to a certain accounting utopia which tends to install in present environment and to come back to the financial reality (Rérolle, 2008). The first aspect to which Rérolle makes reference (2008) is the fact that from a conceptual point of view, the drawing up of a balance sheet which have the capacity or should offer a real image of the entity's market value, is an imposing ideal in the context in which the market is much too complex to be surprised by some accounting system.

The second aspect is that the valuation process implies a high degree of subjectivism, and the framing of this process in a series of accounting rules can be dangerous. At the same time it is to appreciate the fact that restrictions imposed to expert evaluators practitioners were fortunately relaxed (Rérolle, 2008). As a result, the single administration of ascending doses more and more powerful of fair value within accounting literature didn't necessarily generate an image more realistic upon entities, being necessary the conscientiousness not only of limits inherent to accountancy by its nature itself, but also the complexity of economic reality whose reflection it proposes to realize.

The specialized literature mentions some alternatives regarding the valuation at just value occasionally, but the arguments are not enough convincing. The historical cost would offer a degree significantly low of the information's comparability and relevance, being obviously rejected by the users of this information, especially by financial investors. Other sources make reference to the use of some notional prices established by public authorities, these representing the fundamental accounting principle of economies of collectivistic type, but these enjoy of more reduced credibility, at least among the majority of economists and participants within capital market.

The alternative for "fair value" – historical cost of assets – has little admirers within financial crisis. "Is it better to keep hidden the losses and not to present the situation to shareholders?" asks John Smith from International Accounting Standards Board (IASB).

Conclusions

The use at present of the fair value as valuation basis doesn't make but to impose to banks to recognize the existence of some real problems earlier, making thus possible also the taking of measures to solve them, because they will not disappear without saying, no matter what the deferral period. Even more, these problems not being recognized, the mechanism could have continued, involving also other naive investors.

In the present context there were formulated pro and con arguments regarding the fair value.

Pro arguments:

- It is the only basis of valuation which surprises the derived instruments;

- It comprises the present information;
- It limits the marking practices of gains through the discretionary sale of assets;
- Better an unprecise system but transparent and based on fair value than a precise historical cost but irrelevant;
- The inexistence of active markets doesn't justify the renunciation of fair value but the development of valuation methodologies;
- The fair value hasn't generate the financial crisis and its renunciation will not solve the problems generated by this crisis;
- Renunciation at fair value when markets are in decrease would deprive investors of useful information and affect the neutrality of accountancy and the independence of the normalization organism.

Con arguments:

- The fair value cannot ensure the precision of historical cost;
- The lack of active and liquid markets makes subjective the fair value;
- It doesn't reflect the intention of the management to keep the asset but just to sell it;
- The goal of accountancy is not to value the entity;
- At the market decrease, the valuation at fair value can determine the non-fulfillment of criteria to maintain the capital;
- The fair value is procyclical in the sense that accelerates the market decrease by encouraging sales in order to accomplish the capital conditions.

According to an analysis realized by GfK group, Romanian consumers together with the Greek ones, felt the effects of financial crisis and the high level of debt of countries of origin the most intensely of Europeans last year. At the opposite pole, there are the citizens of Germany. GfK group, present also on the Romanian market, is one of the biggest organizations of market research in the world. The company develops its activity in over 100 countries.

The present crisis is the most serious challenge for the stability and perspectives of future markets, but at the same time it is also an opportunity to restructure them, to bring to a normal state their existing unbalances and weaknesses. The worst thing for these markets is the assumption that "what it has been worse it consumed". At the same time, it is important not to fall out into another extreme – deglobalization with edification of new "Berlin walls" of protectionism, which would separate the developed economies from the becoming ones.

No matter what the modifications that would interfere in accounting standards as a result of the financial crisis, IFRS must remain further on an accounting language at the basis of which there are some principles of high quality, which support the prevention or attenuation of its effects, meant to sustain the difficult mission of accounting domain in the terms of which it is considered the principal culprit in cause.

Nobody knows for sure what will happen in the future, as nobody knows exactly in what stage of the crisis we are or how long will it last and it's enough to look at the past to find the answer. The only certain thing is that recession gives rise to opportunities.

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