Fair Value versus Historical Cost: Which is actually more "Fair"?[*]

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ABSTRACT

Fair Value Accounting has been regarded by significant portion of academics and practitioners as a revolutionary approach to aid investors' decision making abilities since it presents the current value of financial assets. Though proponents have long praised for the relevance strength, opponents of fair value have underlined the significant lack of reliability; therefore praised for historical cost accounting as a sound system constructed on robust pillars of prudence. With the more balanced structure of the Financial Accounting Standards Board on conservative versus fair value accounting issues, especially with the developments under FAS 155, FAS, and 157 to promote the use of mark-to-market, the financial world has shifted towards a more 'subjective' accounting. Even with the Enron case, having applied fair value has been linked with fraud. This paper discusses the ambiguous nature of fair value accounting and stresses the importance of historical cost accounting to avoid any potential future crisis.

Keywords: *Fair Value Accounting, Mark-To-Market, Historical Cost.*

Jel Classification: *M41, M49.*

Gerçeğe Uygun Muhasebe ile Maliyet Esaslı Muhasebe Karşılaştırılması: Hangisi Daha "Gerçek"?

ÖZET

Gerçeğe uygun muhasebe, finansal varlıkların güncel değerini yansıtması açısından akademisyen ve pratisyenler tarafından yatırımcıların karar verme süreçlerine verdiği destek ile devrim niteliği taşıyan bir yaklaşım olarak görülmekte. Savunucuları sağladığı alakalı bilgilerin önemini vurgularken, bilgilerin ihtiyatlı ve tam güvenilir olmamasından dolayı eleştirilere de maruz kalarak maliyet esaslı muhasebenin daha güvenli bir sistem olduğu öne çıkmaktadır. Finansal Muhasebe Standartları Kurulu'nun yayınlamış olduğu FMS 155, 156 ve 157 ile birlikte ihtiyatlılık ile gerçeğe uygunluk noktasında biraz daha dengelenen finansal sistem, piyasaya göre ayarlamanın daha yaygın kullanılmasıyla birlikte eskiye göre daha "öznel" bir karakter edinmiştir. Enron vakasında bile gerçeğe uygun muhasebe uygulamaları ile hile bağlantısına rastlanmıştır. Bu çalışmanın amacı gerçeğe uygun muhasebenin belirsiz yapısını eleştirerek, ileride doğabilecek başka finansal krizleri önlemek adına maliyet esaslı muhasebenin önemini vurgulamaktır.

Anahtar Kelimeler: Gerçeğe Uygun Muhasebe, Piyasaya Göre Ayarlama, Maliyet Esaslı Muhasebe.

JEL Sınıflandırması: *M41, M49.*

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1. GİRİŞ

Having recently witnessed to see some of world's leading banks and remarkably large financial institutions collapse and some even been acquired; stock markets drastically weaken, economically sound nations bail out their financial systems through rescue packages have generated a significant question mark: Are these events a strange coincidence or in some ways can they be attributed to the application of a series of reasonably more fair accounting approaches; one of which is mark-to-market (MTM)? Steve Forbes, chairman of Forbes Media and sometime political candidate, views mark-to-market accounting was "the principal reason" that the U.S. financial system melted down in 2008 (Pozen, 2009a). The crisis led to swift and unprecedented actions from the Treasury Department, the Federal Reserve, and Congress, including the $700 billion Troubled Assets Relief Program (TARP) to help financial institutions (Arya and Reinstein, 2010). In the name of seeking plausible answers to the posed question, we should go deeper in the historical evolution of the issue and investigate the reasons to why accounting standard setting bodies such as the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have made a shift from the prudent nature of accounting to a fair approach.

For decades, the United States Generally Accepted Accounting Principles (GAAP) ruled that business entities should anticipate all probable losses, but never anticipate any probable gains. Though this may actually sound like a one-way street, the idea of realization kicks in and finalizes the discussion as to the general fact that revenues should be recorded at the time goods are sold or services are rendered – in this case, securities. Since the ultimate value of goods or services sold can only be *estimated* prior to the sale, the only possible technique to account for an increase or decrease in value prior to sale is to account for an unrealized (holding) gain or loss (Williams *et al.*, 2003). One way companies were able to apply historical cost but at the same time update investors were done by disclosing supplementary information on the current market price of the traded securities so that all interest groups could see the *real* economic picture of the business (King, 2009).

Historical cost principle has been regarded as the unquestionable orthodox approach of financial accounting in the U. S. as well as in many other parts of the world until the 2000s. Increasing economic instability during the early 1970s put the historical cost in a position to take the blame for the changing financial environment, creating a doubt on the perennial fidelity on the principle by both the standard setters and the markets; resulting in FASB to intervene and finally take revolutionary action to modify the conservative nature of accounting and introduce fair value reporting in financial statements. Over the accounting course of events, the FASB has returned to the topic of asset valuation many times, specifically in Financial Accounting Standards 87, 105, 107, 115, 119, 121, 123, 123R, 133, 157, and 159. These statements of financial standards have incrementally and systematically advanced the use of valuation methods that provide a more relevant measure of value than that provided by historical cost. These changes have not occurred in a vacuum, and the board

has been subjected to much criticism as the issues have been debated and implemented (Emerson *et al*., 2010). As for the non-U.S. arena, IASB officially introduced fair value reporting around mid-1970s as well, to act as an alternative approach to historical cost (Shanklin *et al*., 2011). The accounting world is going through a convergence as we are speaking. The shift from rules-based U.S. GAAP to principles-based IFRS is intended to improve transparency and comparability in global markets. In addition, some say, the principles-based approach is supposed to deliver higher quality reporting (Heffes, 2009). One of the founding grounds for such a shift in the accounting world is the issue on relevance versus reliability. The debate over the two principles has been going on for a very long time and the significant disagreement between two principles is sufficient enough to have many followers on both approaches of historical versus fair approach. The level of transition from historical to fair accounting is not limited to – as an example on the elementary level of transition - elimination of last-in-first-out within the scope of US GAAP. There are much more complex issues which draw criticisms. On an objective and unbiased stand, since it is common sense that investing means market value, relevant information is crucial. Yes, historical cost accounting may lack some relevance, as during periods of heavy inflation, and it sure does require improvements in some certain areas; but the optimum level of consensus is imperative. On the other hand, even proponents of fair value agree that historical cost accounting outperforms fair value on matters of understandability and verifiability. According to Hanselman (2009) the understandability advantage is obtained simply by the longstanding common practice and use of historic cost accounting. The verifiability advantage is earned by historic cost accounting since the information is certain to be confirmed by several independent evaluators since the purchase price is fixed and easily determined and any subsequent adjustments likely conform to standard depreciation schedules. It is crucial because it plays a vital role in influencing a decision. By the same token, unless reliable, what good is relevant information to investors? Historical cost financial information produces earnings numbers that are not based on appraisals or other valuation techniques. Therefore, the income statement is less likely to be subject to manipulation by management (Shortridge *et al*., 2006). Proponents of fair value disapprove of historical cost mainly on the fact that historical costs of assets on a company's balance sheet often bear little relation to their current value. To be more specific, a fixed asset on the books of a company is likely to appear on the books at a much lower value than it would actually command in today's market. Then again, historical cost is not entirely absent on the subject matter that the accounting treatment on such issue is to adjust the current market value on the financial statements of the company and even write necessary assets down to its current market value on the balance sheet if the impairment is not temporary, offsetting by incurring a loss on the income statement (Pozen, 2009b). The fact that relevant information timely and has predictive and/or feedback value strengthens its decision-making power over reliability principle (Philips *et al*., 2008).

Reliability principle revolves around the idea that accounting records and statements are to be based on the most reliable data available so that they will be *accurate* and only then has usefulness. Accounting profession has had strong reservations about the reliability of fair value accounting applications due to, among other things, difficulty and subjectivity of future cash flows estimation. Historical cost of an asset in an arm's length transaction is arguably the most reliable measure of fair value at the transaction date (Cortese-Danile *et al.*, 2010). One thing should be noted and underlined that reliable data are accurate, unbiased, and therefore verifiable (Horngren, et al. 2002). Is fair value considered to be reliable? According to Allatt (2001), "fair" and "value" are terms that both depend on the perspective of the valuer and the recipient of the information. In the search for an optimum balance between historical cost and fair value accounting, one thing is obvious that this transition requires an enormous effort. Since valuing assets in the absence of active markets can be very subjective, which put financial statements in a less reliable spot; Madray (2008) argues that disputes can arise over the very definition of certain assets and liabilities.

2. HOW POLITICAL, PRACTICAL, AND PROFICIENT IS FAIR VALUE?

FAS 155 permits fair value re-measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. FAS 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract. Finally FAS 157, the major focus of this paper, defines fair value and constructs a framework for measurement purposes under US GAAP (Sinnett, 2007). FAS 157 defines fair value as the price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability (FASB, 2007). The definition of fair value focuses on the price that would be received to sell the asset or paid to transfer the liability (the exit price), and not the price that would be paid to acquire the asset or received to assume the liability (the entry price). The fact that the statement emphasizes on the *assumptions* applied by the market participants to price the asset for determining fair value – though set forth by fair value hierarchy- has attracted numerous criticisms. While a significant portion of academics and practitioners raised noteworthy questions about this issue, on the other hand, Securities and Exchange Commission (SEC) Chairman Christopher Cox stated in his closing speech in the round-table meeting held in 2008 that investors seemed to view fair valuation as extremely useful, while financial institutions felt that fair valuation was worth the challenges involved because it was better than the alternatives (Friedmann, et al. 2008). There have been harsh objections to fair value application prior to the round-table meeting by some of the practitioners. Though the scope of this work aims to focus on the nature of accounting aspect of fair value, the political aspect of the FASB deserves some

attention. Financial accounting standards in the U.S. are set by the FASB. The board as a private sector organization is empowered by the SEC through a delegation of its authority created under the amended Securities Act of 1934 and is charged with specifying the content of GAAP (Fogarty *et al*., 1994). Accounting rules and changes in them are shaped by political processes (like any other regulation). The role of the political forces further complicates the analysis (Laux and Leuz, 2009). (Bonaci and Strouhal, 2011) emphasizes an unbiased accounting framework to the extent that political implications which inevitably arise in the international accounting arena, should also be considered and dealt with, so that they do not interfere with designing and implementing an adequate conceptual framework and accounting standards that aim for the quality of financial reports.

According to Freeman (2003), fair valuations do not represent actual market prices simply because of the fact that they are not real prices. Because of the weight fair value places on exit prices, that is, what an asset *would* be sold for – rather hypothetical and subjective - it is overly rigorous to verify them or find errors. This is open ground for mischief. There have been many problems with use of fair valuation in recent years, resulting in SEC enforcement actions and shareholder litigation. Finally at one point, The U.S. government felt the urge to intervene and decided SEC enforcements were not sufficient enough. In October 2008, George W. Bush signed into law the bailout bill which granted the SEC the authority to suspend the use of fair value accounting under FAS 157 (Trussel & Rose, 2009). According to Deaconu and Nistor (2009), fair value applications, or in other words, fair value measurement methods, are not clear.

3. HAS SARBANES-OXLEY HELPED?

Initially Sarbanes-Oxley (SOX) was expected to restore public confidence in the financial markets by improving the quality and quantity of information provided to the public. It actually was a direct response to the corporate scandals of Enron and WorldCom—immediately followed by Adelphia and Tyco, the collapse of the once-venerated accounting firm of Arthur Andersen, and the mistreatment of employees and investors by flagrantly unethical business practices (Orin, 2008). The Act prohibits auditors from providing certain types of non-audit services in order to enhance the perception of impartiality. SOX ensures that both management and auditors take a stringent look at the internal controls of the firm. The penalties for corporate fraud have been increased, and the Act requires more detailed and timely information to be released to the public. All of these actions in aggregate will work to increase both the quality and the quantity of information available to the public and enhance the transparency of corporate financial reporting (Chang *et al*., 2009). SOX is crucially important for the accounting profession that any attempts by business lobbies to reduce the requirements of SOX may have the potential to weaken the protection of the public interest which is a cornerstone of the accounting profession (Cohen *et al*., 2010). Since the passage of SOX into law in 2002, more accounting scandals surfaced. The real question is whether SOX

is acting as a measure of deterrence. Caixing and David (2011) argue that SOX would not only deter or prevent the extreme cases of earnings management i.e., fraudulent financial reporting, but also mitigate within-GAAP aggressive accounting practices in which managers may not violate, but aggressively apply GAAP. Therefore, the degree of earnings management (the deviation from normative accounting practices and in some cases leading to manipulations) would be expected to decrease after the passage of SOX. Lobo and Zhou (2010) examined whether or not firms (which are listed both on Canadian and U.S. exchanges, therefore subject to SOX) that were more aggressive before SOX (that is, firms with positive discretionary accruals) have a lower signed value of discretionary accruals following SOX. Their findings assert that firms with positive discretionary accruals have significantly altered their aggressive behavior and have reported negative discretionary accruals in the post-SOX period. Moreover, their findings show that the pre-SOX to post-SOX period change in discretionary accruals for these firms is significantly more negative than the corresponding change for firms that had negative discretionary accruals before SOX. The most striking finding is on the comparison of change from aggressive to moderately more conservative between Canadian firms which are subject to SOX and the ones that are not gather. Their findings show that there is no significant difference in discretionary accruals in the post-SOX and pre-SOX years fort the firms that are not subject to SOX (firms that are only listed on Canadian exchanges).

According to King (2008), in many instances, fair value reporting does *not* provide transparency; in practice it may in fact promote bad and even misleading financial disclosure. In addition to the criticisms on the general nature of fair value accounting regarding financial markets, as for the real estate sector, a new set of criticisms emerged. For the case of the real estate sector, mark-to-market based level one and level two of this hierarchy play a minor role in the real estate sector. The fact about the character of real estate markets is that they are somewhat less active markets and there is a general lack of transparency for achieved transaction prices. Since the current prices for similar or comparable properties are not readily available in such sector, and since the quality of fair values derived using the mark-to-model approach heavily depends on the data used in the model, by the same token on the concern we have shown earlier in the study on the subjectivity matter, as a result of the fact that, usually, the values are based on the work of individual experts who have to estimate the marketability, or predict the cash flows and discount rates, for assets with very different characteristics (Dietrich et al., 2001). As for business combinations, reservations about the reliability of fair value remain. Benefits from extended use of fair value in business combination reporting are not yet evident, yet decision makers of combining entities should concede that fair value will produce relevant information. Dorata and Zaldivar pose a question: Are measurements within the scope of business combination reporting through fair value reliable? They point out that "*recent criticisms of fair value measurements and subsequent guidance revisions in the securitization markets should provide a history lesson to*

learn from" (2010, p. 31). Furthermore, Whitehouse (2010) compares fair value on the grounds of level of usefulness by investors and the financial sector. She states that, because of its relevant nature, investors promote the use of even more fair value with improved disclosures and reporting so that financial information will make sense for the investors for their decision-making capacities. As for the financial sector, however, things are looking astray. She argues that the financial sector believes more fair value would lead to more controversy, more volatility, and more pro-cyclicality. The way out on this issue seems to be a mixed-approach where there is not *one* right model. Pozen (2009a) suggests that, to end the debate on whether historical cost or fair value is a superior method over the other, in the name of implementing the needed reforms, politicians and business executives must recognize that there is no single best way to value the assets of financial institutions. He emphasizes that assets may be more accurately measured under fair value accounting, while others may be better measured under the historical cost approach. Deans (2007) states that investors want earnings to mean something for them. As for the mixed model - particularly with any extension of the use of fair values, she believes, is of problem. She points out the fact that findings of a study conducted by PricewaterhouseCoopers pervasive concerns [among investment professionals] about the adoption of any form of current value measurement for illiquid assets and many liabilities. Finally, and disappointingly, the most recent guidance from the FASB leaves a gap in reporting Level 3 fair values. The absence of detailed specified tests will only serve to keep the door to manipulation wide open. There must be structural changes in ethics education and corporate culture to help mitigate the temptation to manipulate fair values so that confidence in financial reporting is restored (Cortese-Danile *et al*., 2010).

4. CONCLUSION

Accounting scandals buried the energy giant Enron down, and taking Arthur Andersen with it. This has triggered many market participants to question the precision of fair value accounting. The recent crisis resulting in a series of bank failures and meltdown of stock markets reawakened the concern, this time with even more severe criticisms.

There are valid oppositions towards fair value from many parts of the business society, including the author, based on the following areas.

In addition to deficiencies embedded in fair value accounting standards, what is more alarming is the lack of adequate control over the application of these standards, especially within levels 2 and definitely 3. The hierarchy of the inputs is of question. The ambiguous nature of unobservable inputs during times of illiquidity in the markets, particularly under level 3 regarding valuation assets or liabilities which are solely based on the firm's *own assumptions* disregards the very nature of accounting through the involvement of hypothetical estimations. Such condition tears down the very objective and reliability being of accounting.

One of the infamous concepts of accounting is realization. Without an exchange, any gain or loss will be considered as *probable*. By recognizing gains and losses without actually realizing them, in the format of an unrealized gain or loss, the financial books, especially the owner's equity will be distorted. The above mentioned recognition of unrealized transactions breeds into imprecision.

Even more, the ethical foundation of the accounting environment has been shaken due to questionable executive compensation, inappropriate incentives, which in the end, led to agency problems that contradict with the overall organizational objectives. Granting managers with the incentive to involve personal postulation over issues –as it is in valuation – which may turn out to be of some variance than expected when the actual transaction date arrives, is risky business. These kinds of subjective applications have created moral hazard. Within this context, the integrity of credit rating agencies is also under the spotlight, as it is partly responsible for the present crisis in particular with the ratings they have assigned to many of these institutions just days before the financial crush.

FASB and IASB are eradicating their differences and their priority is establishing stronger transparency. While doing this, sufficient attention should be given to issues surrounding fair value. Historical cost is an alternative. Opponents disapprove of historical cost on many grounds, some of which are valid. As for today, as the financial world has suffered a great deal of wrongdoings, sensible attempts should be made to systematize an unambiguous future for all actors of the financial world from standard setters to banks, firms, all the way down, especially, to simple investors.

The nature of reporting should put more emphasis on disclosures. SOX should increase penalties for corporate fraud and as it already is mandated by FASB, the board should urge companies to execute further disclosures on fair value transactions or on transactions that may actually take place in the future and SEC should also back up this FASB decree and make it clear that firms are to only disclose probable transactions and omit ones which do not seem expected.

Increasing economic instability during the early 1970s put the historical cost in a position of a scapegoat to take the blame for the changing financial environment, and for some, including the author; it is the fair value accounting for this era. In the light of the author's proposals, the financial system may avoid to debate over a new scapegoat in the future.

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