FAIR VALUE AS THE DIRECTION FOR VALUATION IN ACCOUNTING

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Abstract

The valuation of corporate resources, in particular the measurement of the financial result, is one of the key tasks of the accounting system. It is also one of the most difficult and controversial issues. Investors expect a different method of valuation, creditors expect another method and managers yet another.

Currently, there is a noticeable tendency to move away from the commonly used valuation based on historical cost towards valuation based on fair value of assets.

This study has been devoted to the presentation of the essence of valuation based on historical cost and fair value, with a particular emphasis on the advantages and disadvantages of each of the presented methods of valuation.

Keywords: valuation, accounting, fair value, current cost, historical cost.

1. INTRODUCTION

There is an expectation that accounting, as the primary information system of a company, presents a true and clear picture of the condition of assets and capital and the effects of business activity, which is closely related to an appropriate valuation of assets and a correct measurement of the financial result. The valuation of resources of an enterprise should therefore be the most important task of the accounting system. It is its immanent goal. It is also one of the most difficult and controversial issues in accounting as valuation expectations vary. Investors expect a valuation different than creditors, and managers yet another [Kędzior 2013, p. 82].

Investors are mainly interested in valuation based on the market value in order to know the current situation of a company and be able to take economic decisions on an ongoing basis, primarily investments. In turn, creditors prefer a conservative valuation based on historical values. This conservative valuation ought to protect their capital lent a company. Managers, who favor the use of both historical values and market values for the valuation of selected groups of company resources, expect another valuation. They are guided by simplicity and labor-intensity of valuation methods, but also by the possibility of impact on the financial results of a company.

There is currently a tendency to move away from the commonly used valuation based on historical cost in towards valuation based on the fair value of the assets. Increasingly, opinions arise that modern accounting should strive for a situation where the book value of net assets would be equal to the market value of net assets, which is possible only when all the resources of a company- the assets and liabilities- are measured based on the market value (the fair value) [Kędzior 2013, p. 82].

The aim of this study is to show the essence of valuation based on historical cost and fair value, with a particular emphasis on the advantages and disadvantages of each of the presented concepts of valuation.

The study used research methods such as literature analysis, analysis of legal acts, deductive method, comparative method and descriptive method based on analysis and logic.

2. THE ESSENCE OF VALUATION IN ACCOUNTING AND ITS BASIC CONCEPTS

It is often emphasized, both in literature and business practice, that the primary purpose of accounting is to provide information about the activities of economic entities, seeing accounting as only the information system of a company. By doing this, a very important attribute which is to measure (the valuation) of economic phenomena is ignored. The valuation of a variety of enterprise resources and the measurement of the effects of business activities is possible thanks to the accounting system. Accounting continually evaluates various assets and their sources, that is the capital, as the effects of processes (operations) of purchase, production and sales taking place in the enterprise [Stępień 2013a, p. 66].

One of the many definitions of accounting defines accounting as "the art of measurement, description and interpretation of economic activity" [Meigs, Meigs 1986, p. 4]. This definition emphasizes the most important qualities of the accounting system, which in addition to providing information about the condition of economic entities, are also the valuation of economic occurrences and their interpretation [Stępień 2013b, p. 807].

The concept of valuation is presented in various ways in the literature. From the of perspective of accounting, "valuation" is based on assigning size to various economic activities expressed in monetary measures, to individual economic categories (assets and capital), as well as any other information included in accounting books and financial statements [Stępień 2013a, p. 67].

The concept of valuation is also defined in the International Financial Reporting Standards, where in the Framework of financial reporting, valuation has been defined as a process to determine the monetary terms, amounts in which the components of the financial statements are to be expressed and reported in the balance sheet and the income statement [*Międzynarodowe Standardy*… 2011, §§ 4, 54]. It is worth noting that the use of a monetary measure for valuation enables the comparison of information of different economic categories, in other words, it allows to bring these values to a common denominator.

In general, valuation carried out in accounting may refer to the resources acquired (manufactured) or subject to sale [Hendriksen, van Breda 2002, pp. 488-490]. The valuation of acquired or produced economic resources, meaning the so-called input values, expresses the amount of monetary resources or other remuneration given for a specific element of assets or service. The value of investment may be determined based on past, current or expected prices in the future, which are, respectively: historical prices (costs), prices (costs) of reconstruction, expected prices (costs) [Babuśka 2013, pp. 48-49]. As an example of methods of valuation of acquired economic resources, the purchase price or the price of acquiring assets may be used.

On the other hand, the valuation of resources for sale, meaning the so-called exit value, is the amount of cash or other value received when a given component leaves a company through sale or exchange. The exit values are expressed by past and current sales price and the expected value of transaction (sales price). The sale price, the net sale price, liquidation value or discounted cash income can be used as examples of resource measurement methods [Babuśka 2013, p. 49]. There is another valuation method which has a long history: the valuation at the lower purchase price (production cost) or market price, which can be applied to both purchased and sold assets [Hendriksen, van Breda 2002, pp. 491-506].

Valuation is a process, which is systematic, repeatable and continuous. It includes a variety of bases and methods of evaluation of economic occurrences. Due to the moment at which resource values are measured in accounting, generally speaking, two moments of valuation can be observed. The first moment is related to the current valuation, and the second is related to the balance sheet valuation [Stępień 2014, p. 150].

Current valuation is the so-called original valuation of the asset or liability, carried out during the reporting year, when the resource enters the company's accounts. It usually takes place in connection with the acquisition of an asset element or its production by the entity. This valuation is made on the basis of purchase documents or production cost calculation [Stępień 2014, p. 150].

In turn, the balance sheet valuation is made on the date the financial statement is prepared, e.g. at the end of the reporting year [Stępień 2014, p. 150]. This valuation must take into account the change in value of the resource due to its technical and technological wear, changes in the market value, changes in exchange rates, consumer preferences and other factors. The balance sheet valuation affects the amounts of elements in the balance sheet and the size of revenues and costs, which in turn determines the value of assets, liabilities and financial results of entities. The manner and degree of correctness of such a valuation, determine the amount of profit a company, profit whose honest and reliable measurement is the primary goal of accounting.

It should also be noted that, in principle, each measurement of value is the result of a more or less precise estimate made during valuation. For this reason, taking into account the degree of accuracy of measurement, limitations and weaknesses specific to each method of valuation can be noticed, pointing to its bias. It should be noted that, an accurate measurement of economic values is not always possible, purposeful and profitable, however it is the most anticipated [Babuśka 2013, p. 50]. Accounting as a practical science allows discrepancies between the results of valuation and the real (actual) value of the subject of valuation, which are mainly due to [Stępień 2013a, pp. 69-71]:

- the relativity of valuation resulting from: the properties of the subject of valuation, pricing imperfections, simplifications and solutions adopted in accounting, the use of estimates and room for error,

- inflation deformities, as well as
- system deformities.

Leaving aside the matter of restrictions of different valuation (measurement) methods, it is worth noting that in the theory and practice of accounting, there are two basic contrasting concepts (systems) of valuation based on [Sutton 2004, p. 173]:

- historical cost accounting,
- current cost accounting.

In light of current legal regulations, historical prices are typically used for the valuation of assets consumed during operational activities of an entity, i.e. fixed assets, inventories, trade receivables and services and obligations to suppliers, budget, banks. These are prices at which the purchase, production or sale of goods, rights and services were actually made or at which liabilities were contracted.

Current prices are applicable mainly to the valuation of investment activities, such as investment in real estate, securities, financial liabilities. These are the prices that are the current market prices, at which on the date of the balance sheet the purchase or sale of goods or rights takes place or will take place [Fedak 2011, p. 40]. Due to the inability to determine the market price in certain situations (e.g. the lack of an active market for certain goods), the present value can sometimes be substituted by an alleged, hypothetical value of the current price which is highly obtainable. Such market (real) and probable current prices reflect the so- called fair value of the subject of valuation [Babuśka 2013, p. 55].

2. VALUATION ON THE BASIS OF HISTORICAL COST

Valuation on the basis of historical cost is the basic and historically the oldest asset valuation model in accounting [Gmytrasiewicz 2011, p. 27]. This model is widely used and preferred in the accounting system of the mainland. It is based on the concept of monetary nominalism and assumes stable economic conditions, constant purchasing power, that is basically no inflation in the economy, or at least very low levels of it. These assumptions cause both assets and liabilities of a company to be valued at current prices that exist at the time of acquisition or production, so in the past time. In other words, the valuation of all accounting categories, facts, occurrences and capital takes place using the historical cost model at values current at the time of their introduction into data sets of an accounting system [Gmytrasiewicz 2011, p. 27]. It is therefore a primary valuation as it is made by taking into the account a new component of the assets which has just been included in the account books of a company.

The main measures (categories of pricing) used in a model based on historical cost to value company resources are: the purchase price, acquisition price, manufacturing cost and the nominal value.

Pricing model based on historical cost is associated with the so-called transactional approach that focuses on correctly determining the financial result of a company during a given reporting period. Therefore, the primary source of information about an entity considered in this approach, is the profit and loss account [Hejnar, Kulis 2005, p. 131].

The transactional approach focuses on conducted economic operations. The effects of these transactions are noted in the profit or loss account in accordance with the principle of implementation, according to which the financial result of a business entity should be determined only by acquired gains and losses. According to the rules for principles of implementation, profits are generated only at the time of sale or other sale related activities. So when, for example, at the date of the balance sheet market prices of stocks of goods previously priced at cost of acquisition rise, then the profit in this respect can be reported in account books and financial statements only at the time of their sale, because then it is considered to be made. The consequence of the transactional approach is the measurement of costs based on historical prices, and the settlement of costs which affect the financial result is subject to how much they match the revenues [Hejnar, Kulis 2005, p. 131].

The advantage of the valuation model based on historical cost is the ease of verification of its objectivity [Riahi-Belkaoui 2005, pp. 538-539]. The objectivity of the valuation in this case means, on a limited basis, the usage of accounting estimates, contributing to the ease of verification (evaluation) of the valuation. In addition, historical prices, which are the basis of this valuation method, have the advantage of being prices actually incurred, proved in accounting documents. Therefore, they add integrity to accounting and so are widely used in the accounting system.

Valuation of assets based on historical cost is also vital for the balance sheet valuation of assets. Historical prices as a result of changes in the value of money over time, are generally lower than the current prices at the date of the balance sheet. In addition, the historical value of a given component often means the minimum value possible to obtain in the case of a need for sale [Kędzior 2013, p. 83]. Adoption of historical prices (past prices) for balance sheet valuation must be considered with caution and is intended to protect the entity against reporting an exaggerated optimistic condition of the assets and financial situation of a company. The result of applying the precautionary principle in the valuation of assets is expressing in the financial result a lower utility and commercial value of assets due to depreciation and updates because of the loss of value, the creation of provisions for risks known just to a given entity, impending losses and effects of other events.

It is worth noting that the simultaneous use of a valuation model based on the historical cost which follows the principle of implementation and a caution valuation creates a kind of inequality and inconsistency in the valuation of company resources. For example, an increase in the market value of stock above their acquisition price cannot increase the financial result, but lowering this value triggers the need for revaluation and lowering the financial result of a given company [Fedak 2011, p. 41].

A company's loan holders, creditors and lenders are the ones who are the most interested in a cautious valuation of a company's elements. These entities, in order to protect their capital lent to a given company prefer to use a worldwide principle of a "precautions merchant", according to which, in fact, an entity cannot be in worse condition than is apparent from its financial statements; it can only be in a better condition [Olchowicz 2002, p. 32].

Valuation based on historical cost is not free of flaws. Basic drawbacks of this pricing model concern the inadequacy of historical cost to current prices and therefore distorting the current valuation, carried out on the date of the balance sheet date. Historical cost, based on the valuation from the past, does not provide relevant information on current and future financial situation of a given company, in particular concerning future cash flows, information which is of most interested to all investors [Kędzior 2013, p. 83]. Valuation model based on historical cost often does not reflect the essence of the principle of true and fair view and does not guarantee a picture of the current situation of a company

Valuation based on historical cost cannot also be regarded as a good instrument for the protection of an owner's capital, especially against the effects of inflation [Gmytrasiewicz 2011, p. 27]. In the case of a high inflation, the nominal profit which is disclosed in the financial statements cannot be considered a real increase in capital as partially or even entirely, it is a so-called inflation profit. The consequence of this state of affairs is that, in case of high inflation, profits which are only apparent (inflation) are shared, and which have not been actually generated. This in turn contributes to recapitalization of a company's resources and to the violation of owners' interests.

3. VALUATION BASED ON CURRENT COST (FAIR VALUE)

Due to reservations about the cognitive value and utility of valuation based on historical cost, valuation based on the current price (cost) is becoming increasingly important. As a basis for valuation in this concept, the price of exchange is used, which is the current price of a given component of the balance sheet. The exchange price is derived from a market that is efficient, sufficiently liquid and has a correspondingly large number of members on both the supply and demand side, so that prices reflect the actual market prices [Kędzior 2013, p. 84].

Currently in commerce, valuation based on the current cost is increasingly identified with the valuation at fair value [Sutton 2004, p. 173]. International Accounting Standards have a significant impact on the popularity and worldwide spread of valuation based on fair value.

Fair value has been created for the needs of company owners and investors, to increase their confidence in terms of relevance and profitability of investments undertaken in the changing environment [Micherda 2006, p. 53]. This is the optimal category for measuring the value of information provided to this particular group of users through the accounting system [Gmytrasiewicz 2009, p. 68]. Requirements placed by investors on financial reporting indicate that, the information derived from these reports should show true economic value of components, namely value possible to obtain at the time of valuation. Such expectations can be regarded as legitimate, unless the valuation at fair value differs significantly from the valuation at historical cost.

Valuation model based on fair value is derived from the Anglo-Saxon accounting system and is associated with an approach based on the measurement of the value of equity (net assets). This approach focuses on the presentation of a true and fair financial position of a given company measured in terms of its equity or otherwise - net assets (assets less liabilities), which correspond in value to its own capital. For this reason, the primary source of information about an entity, in this case, is considered to be the balance sheet [Hejnar, Kulis 2005, pp. 131-132].

It is worth noting that, the approach based on measurement of the value of equity, the balance sheet valuation is subjected to the rule of substance over form. The adoption of this superior accounting principles as a basis for valuation justifies the wide use of the fair value concept [Hejnar, Kulis 2005, p. 132].

Definitions of fair value used in developed accounting systems of the world are generally similar. Under Polish balance sheet law, fair value is the amount for which an asset could be exchanged or a liability settled at arm's length transaction between knowledgeable, willing, unrelated parties [art. 28 paragraph 6 of the Polish Accounting Act].

In the context of the presented definition, it should be stated that, fair value as a valuation category combines objectively listed market prices with attainable potential prices (presumed prices). Therefore, fair value is a broader concept than the market price (value). The definition of fair value clearly shows that this may be the market price (value) of an asset if it is traded on the market, but also the hypothetical price that could be obtained if a transaction was conducted. In case of necessity of valuation of assets that lack an active market, there is a need to determine fair value in other ways, e.g. based on the estimated value using mathematical models, or with the participation of independent experts who use specified valuation models.

Balance sheet valuation of resources of a company on the basis of fair value is based on the hypothetical valuation of transactions, which are possible but have not been conducted. This valuation takes into account the impact of changes in market conditions on the value of current resources (assets), and thus reduces the difference between equity value on the market and their adequate book value, which undoubtedly can be considered an advantage of this valuation concept [Hejnar, Kulis 2005, p. 133]. Valuation based on fair value favours the implementation of the principle of true and fair view.

Among other advantages of a valuation model based on fair value it should be emphasized that it transmits useful information to investors, in particular the actual financial results as measured by the increase in the value of wealth for shareholders (economic profit) [Kędzior 2013, p. 95]. In addition, fair value is a market amount, independent of factors specific to a particular entity, which constitutes an objective measurement of various entities from between specified periods.

Valuation based on fair value has many advantages but it also has disadvantages. It is worth emphasizing the large subjectivity of valuation, the possibility of manipulation of profits, especially when the valuation cannot be conducted using market prices but only using on estimates. In addition, when caring out valuation at fair value technical difficulties related to plus and minus adjustment to the value of the components arise. In this valuation model, determining the source of information about the fair value of the component is of foremost importance, and in turn this is associated with indicating whether or not an active market exists. It must be noted that valuation based on fair value is considered to be difficult and complicated for the average stock market investor. Most users believe that the current solutions should be clearer and precise [Baluch and other 2011, p. 23] .

The main measures (categories of pricing) used in the model based on fair value to put a value on company resources are: the market price, sales price and net sales price.

SUMMARY

The problem of measuring value in accounting is a difficult and an on-going issue. There is no perfect method of valuation of assets, which would satisfy all the stakeholders of a financial statement. All developed and used categories and valuation methods have both advantages and disadvantages.

The current valuation system proposed by the committee of International Accounting Standards can be characterized as a kind of mixture of historical cost model (pertaining to operations) and fair value (pertaining to investment activities). However, historical cost valuation, which has been used for centuries, gradually gives way to valuation based on the current value, synonymous with fair value. In the opinion of many scientists, the future of valuation involves fair value.

According to A. M. King [2008, pp. 301-311], for example, a revolution in financial reporting awaits the world economy, dropping historical cost valuation in accounting for fair value is currently propagated. The point of reference should not be the historical value of the balance sheet components, but their current value. The author notes that, in its current form, valuation based on fair value of has neither significance nor credibility. The valuation of financial instruments for which there is an active market may be justified, but for financial instruments without an active market business entities are forced to use the "best possible estimates".

D. Prochazka [2011, pp. 989-1001], on the other hand, believes that the valuation of balance sheet items based on fair value carries a significant decision-making value for users of financial statements. It makes it possible to present a true and accurate picture of economic reality, because only the current valuation based on market value has decision-making qualities, hence fair value has a definite advantage over other methods of valuation. According to the author using fair value of assets and liabilities you can predict future price fluctuations of shares.

In contrast, S. S. Seay and W. H. Ford [2010, pp. 53-66] believe that the fair value reflects the actual value of assets and liabilities. Not using fair value and returning to valuation based on historical cost will result in the loss of important information for investors, and a drop in their confidence in financial reporting. In addition, empirical data collected by the US Securities Exchange Commission (SEC) confirmed that the fair value is the most appropriate measure for the valuation of financial instruments.

Despite these positive opinions on the valuation of assets at fair value, it must be noted that its evaluation should be multifaceted and is not entirely clear. In the opinion of many representatives of the world of politics and business valuation based on fair value is one of the main sources of the current financial crisis [Laux, Leuz 2010, pp. 93-118]. The accusation against valuation at fair value is that it is some kind of an "illusion of profits" because it does not show actual (achieved) results, but only hypothetical results that could be achieved if the transaction was at the time of valuation. In addition, it has also been observed that some of the companies, which at an early stage introduced a valuation based on the fair value, are beginning to withdraw from it.

In conclusion, the valuation of business resources carried out by the accounting system will continue to move towards fair value despite its flaws. However, there should be a continuous strive to the improve its assumptions and to seek new techniques to conduct it, especially in situations where due to the lack of an active market, you cannot rely on the market price.

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