

# FAIR VALUE ACCOUNTING VERSUS HISTORICAL COST ACCOUNTING: A THEORETICAL FRAMEWORK FOR JUDGMENT IN FINANCIAL CRISIS

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## Abstract

Since the 2008 global economical and financial crisis, the fair value measurement has acquired a controversial position both within the accounting regulatory committees and the accounting theory. The literature generally examines two opposite central paradigms of evaluation, namely the Fair Value Accounting (FVA) and the Historical Cost Accounting (HCA). The paper, after a literature review through both these opposite sides, suggests a theoretical framework, using the basic concept of "accounting system", for the choice between the opposite paradigms, considered noteworthy in times of crisis as it should allow to conceptualize a 'mixed system', combining FVA and HCA in different ways according to the different contexts and entities reported by the financial statements.

**Keywords:** Accounting, Financial Crisis, Historical Cost, Fair Value Accounting

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## 1. Introduction

Since the 2008 global economical and financial crisis, the *fair value measurement* has acquired a controversial position both within the accounting regulatory committees and the accounting theory.

As it is common knowledge, the fair value measurement implies that financial assets and liabilities are measured at their 'market value'<sup>7</sup>, namely the value under the theoretical assumption of a perfect, efficient and complete market that should therefore imply that the financial statements meet the needs of investors and creditors. If the market is imperfect and incomplete, the solution proposed by IASB is to use a model for measuring the value of the flows generated by the assets.

The fair value debate is certainly previous to the recent financial crisis, but this one has further raised the stakes in this debate. In particular, the analysis of the studies on accounting for financial distress indicates the existence of a critical body of literature that examines the effectiveness of the fair value

measurement in time of crisis and the relationship between this paradigm of evaluation and the stability of the economic system. This literature examines two opposite central paradigms of evaluation, namely the *Fair Value Accounting* (FVA) and the *Historical Cost Accounting* (HCA).

By analysing the accounting literature, it seems that the primary criteria used to choice between FVA and HCA are the different typologies of economic contexts and markets and financial reporting information.

Indeed, from one side the followers of FVA, by assuming that the market is perfect and complete, focus on how also in times of crisis this measure can continue to provide relevant information for investors and creditors. According to these researchers, the adoption of HCA than FVA can not be fruitful in times of crisis and the critical issues on fair value measurement do not translate into issues in support of historical cost measurement (Laux and Leuz, 2009).

From the other side, the followers of HCA, by assuming that the market is imperfect and incomplete, focus on how in times of crisis the fair value measurement can provide little relevant information to the management and a misinterpretation of the items of the balance sheet.

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<sup>7</sup> According to the recently issued IFRS 13 fair value is «the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date» (paragraph 9).

The major critique related to using FVA is that it introduces higher volatility in the financial statement. Critics argue that FVA can contribute to a stronger cyclicity of accounting measures: in booms the fair value would allow revaluation of assets, while the historical cost would create "hidden" reserves (Laux and Leuz, 2009: 829); in times of crisis, wherein there are relevant decreases of market values, FVA contributes to contain the financial results of firms by triggering a vicious circle.

The exchange between followers of FVA and followers of HCA is fruitful: the study of the arguments *for* and *against* the use of either evaluation approach in financial reporting has led some authors to make the contributions for the development of new theoretical models and frameworks.

This paper is organized as follows. In the point 2, the Authors briefly analyse the recent debate on FVA vs. HCS, with emphasis on the accounting contributions that have proposed alternative theoretical approaches to the FVA. In the point 3, the Authors propose a theoretical framework for the choice between these opposite paradigms of evaluation, based on the concept of 'Accounting System'. Finally, in the point 4, the Authors conclude that the notion of Accounting System is particularly useful for Accounting in times of crisis as it allows to conceptualise a 'mixed' system combining in a proper way FVA and HCA.

## 2. Fair Value Accounting versus Historical Cost Accounting

Despite the almost universal adoption of International Financial Accounting Standards (IFRS) by accounting regulatory committees in many countries, the FVA continues to foster an intense debate about its impact on the recent global financial and economic crisis.

This debate is part of a broader one on the risks and opportunities that the financial and economic crisis has for accounting. Between 2008 and 2012, much current research has attempted to study how the recent crisis has affected theory and practice of accounting. For example, *Accounting, Organizations and Society* has published in 2009 a special issue consisting of a group of articles on the implications of the economic crisis for accounting, both for the theory and the practice. The aim of this issue is well described by Anthony Hopwood in his introduction to the articles: it is to provide «a range of interesting and challenging observations on the contemporary worlds of accounting practice and research» (Hopwood, 2009: 799); it is to constitute «the basis for a similar plea in the area of accounting research» (Hopwood, 2009: 802).

In this context, most of the controversy of accounting research focuses on the comparison between two alternative approaches to accounting: the approach based on the principle of *fair value* and the

approach based on the prudence and especially *historical cost* principles.

In front of the international business competition, the accounting jurisdiction change adopted by European Union has led to a standardization based on a different «philosophy» than traditional harmonization. Indeed, the standardization implies the adoption of a universal measurement method and the elimination of alternative methods in accounting, while the harmonization, practiced previously, permitted to use different accounting measures. More specifically, the introduction of the IFRS led to the change of accounting measurements, namely the FVA, while the European legislation had focused mainly on the Historical Cost Accounting (HCA) before IFRS adoption.

But, since the beginning of crisis, this move to FVA has been again discussed. Effectively even before the 2007/08 financial crisis there was a series of critical studies about the IFRS arising especially from the European continental doctrine. For example, the authors of *Les normes comptables internationales, instruments du capitalisme financier*, edited by Michel Capron, and published in 2005, warn against the dangers of the use of fair value measurements in financial reporting. Specifically, Capron argues that when the assets are accounted for at fair value, the values of financial statement of the firms are influenced by change of their market prices over time. He highlights that these measurements can lead to adulterate and to misinterpret the asset values (Capron *et al.*, 2005: 20-21).

The analysis of current accounting literature shows that the debate about FVA versus HCA mainly revolves around the traditional divergence between *relevance*, namely the utility of information accounting for the different users, and *reliability*, namely the accuracy of information. Indeed, altogether the literature on fair value indicates that it provides more relevant information to investors and creditors than historical cost, the latter is considered more objective and reliable than fair value (Rodríguez-Pérez *et al.*, 2011: 61-62).

In particular, the emergence and the persistence of recent financial crisis seems to further invalidate the typical 'capability' of market value and provides the occasion for criticism of FVA. Many researchers suggest therefore that FVA standards in the financial reporting may have rather played a role in exacerbating the effects of the crisis. Otherwise, the debate on fair value versus historical cost has also resurfaced within the context of the IASB.

In other words, the crisis even more shows the criticality of trade-off between relevance and reliability of accounting information in markets that are above all imperfect and incomplete. Indeed, one of the key lessons of the crisis is therefore the gap between market value and real value of assets and liabilities appearing on the financial statement of

firms. From this point of view, Bignon, Biondi and Ragot (Bignon *et al.*, 2009) argue that the usage of FVA is limited by asymmetries of information, complementarities and specificities. Indeed, in presence of these conditions, the evaluations based on fair value can compromise the reliability of accounts and introduce the risk of incorporating financial volatility into the accounts. Moreover, emphasizing financial criteria on the management evaluations, FVA may not guarantee a correct information to all the stakeholders. These Authors conclude that in presence of asymmetries of information, complementarities and specificities is preferable to opt for the historical cost (Bignon *et al.*, 2009).

Another contribution in support of revisiting the FVA as a general principle for a 'true' evaluation of asset combinations is provided by Ronen. By considering the fair value as a methodology that encompasses different approaches for the estimation of exit values, for example, the Author suggests to compare the fair value or the exit value of assets and liabilities with the use value of asset combinations. Ronen proposes a new accounting framework able to evaluate benefits and costs of operating the firm based respectively on use value and exit value of asset combinations. The first measure represents the expectations of cash flows when the firm's resources are used within the firm to produce goods and services. The second represents measures of opportunity costs and abandonment value if the assets would be sold (Ronen, 2008: 205-26)<sup>8</sup>.

The study of the key differences between FVA and HCA can provide a solid foundation for alternative models and frameworks based on the assumption of imperfect and incomplete markets.

Whittington's article, titled "Fair Value and the IAS/FASB Conceptual Framework Project: an Alternative View" (Whittington, 2008), provides an interesting analysis of the differences between the two competing world views on measurement issues: a "Fair Value View", implicit in the pronouncements of the IASB, and an "Alternative View", offered by the critics of these pronouncements.

In particular, according to the Author, the Fair Value View seems to underpin on logic and coherent theoretical foundations while the Alternative View arising from a pragmatic approach to specific issues seems to lack theoretical basis. Actually the Fair Value View cannot be a so attractive and good theory as not related to the real world. On the other hand the Alternative View, even if characterized by a high specificity, finds theoretical support in the works of Hicks, Edwards and Bell, Beaver and Demski. Hicks, writing of income, defined it as not a logical category, but as a rough approximation used by the business

man. Edwards and Bell, emphasizing income, suggested to use ex post accounting income to evaluate performance on the base of current cost measures instead of fair values. Beaver and Demski, starting from the statement that income is an ill-defined concept in an imperfect and incomplete economic environment, highlighted the importance for accounting of providing useful information rather than definitive measures. Starting from these theoretical foundations for the Alternative View, Whittington comes to the conclusion that it is more fruitful not to search for a theoretical and universally valid measurements method, but to define a clear objective and select the measurement method that best meets that objective with reference to specific problems.

After having provided a theoretical support for the Alternative View, coherently with this approach the Author proposes to use the deprival value concept – unfortunately missing in the current list IASB of evaluation criteria – based on the assumption that the value of an asset is equivalent to the loss that the firm would sustain if deprived of it.

In summary, the different contributions analysed highlight that fundamental argument against the fair value measurement in financial reporting is that it leads to make accounting information that does not indicate the real and useful 'value' of the items of the balance sheet for the firms.

### **3. A theoretical framework for the choice FVA vs. HCA: a true 'Accounting System' (two series of accounts)**

As the previous survey shows clearly, the alternative between HCA and FVA is not only a methodological question. It implies a basic judgment on the conceptual framework to adopt for the financial reporting evaluations.

In the International debate the need for a framework to justify the basic choices, in terms of evaluation methods, is quite recent. Notwithstanding that, the 'Frameworks' produced till now do not explain fully why the following standards should adopt one or another method of evaluation. This basic choice is only evoked, e.g., in the final part of the International 'Conceptual Framework', furthermore in the not revised part of the far 1989. There, we can find the distinction between two basic conceptions of capital maintenance. But the link from this conception and evaluation methods remains undetermined.

According to our interpretation the conception we adopt is instead relied with a peculiar 'Accounting System'. The chosen 'Accounting System', on its turn, implies the emergence of a particular principle of evaluation, mainly the *historical cost* or the *fair value*.

The concept of 'Accounting System' is not very spread in Accounting Science debate of nowadays. It comes essentially from the Italian doctrine, where,

<sup>8</sup> Our theoretical framework, proposed in next point, is rather similar to this position. Yet, the "use value" of the "combinations" will be there best approximated just by the HCA (eventually depreciated if the use value is probably lesser than the historical cost), see below.

already in 1880, the famous scholar Fabio Besta distinguished the simple 'method' of Double-Entry Accounting from a proper 'system' of Double-Entry Accounting; we can speak of a D.E. 'system' if, and only if, *not only* we find that the sum of credits balances the sum of debits, *but also* we find that accounts are shared into two sets or, namely, *series*: the first one (Assets and Liabilities), measures the original aspect of the entity's wealth, the second one (Net worth values and Income/Expenses) measures the derived or causal aspect of the position and performance of business wealth (Besta, 1922).

This *accounting system*, in Italy known as the "Sistema patrimoniale classico" [Classical Financial System], saw the only true values as the ones of Assets and Liabilities and corresponds, roughly, to the classical American school of 'Asset and Liabilities view' (Sprague, 1908). Net worth is *only* the difference between Assets and Liabilities and Income/Expenses are *only* the differences between the previous and the actual Net worth. They have *not* a true value in themselves. They are only derived values. This conception brings naturally to an additive conception of business capital. Every item of assets and liabilities has *its own* value and we have only to catch properly these separate values and after to sum up them together.

The emergence of the *accounting system* is very powerful for our goals, above all in a period of crisis, because it found a theoretical justification for an evaluation method that is the ancestor of modern fair value. In fact Besta, the father of the aforesaid "Classical Financial System", suggested to value separately the items with one value that nowadays (through the *lenses* of IFRS 13) we will call a 'cost based' fair value: in a world where the market values were rare and the income values too uncertain to calculate, the FVA degenerated in a Substitution-Cost Accounting, that belongs, however, to the main domain of FVA.

The following success of the Zappa's 'accounting system', namely the "Sistema del reddito" [Income System], shifting the emphasis from the 'Stock' (Net Worth) to the 'Flow' (Net Profit or Loss), restricted the *original series* of accounts to the only ones representing cash or cash temporary substitutes (like trade credits and debts) (Zappa, 1920-29). These accounts were called as "numeraire", and they enjoyed of a true value as well as was the case for the Besta's previous 'first series'. The others items of the balance sheet now belonged to the *derivative series*, like before was the case only for 'net worth' values, revenues and expenses. The non-financial assets and liabilities, not belonging to the original series, could not have but a derivative value. Thus, for example, property, plants, machinery, inventory, and other not financial items, like active or passive prepayments, were no longer 'assets or liabilities', but only 'revenues and expenses' temporarily placed in the balance sheet, but awaiting for entering the

income statement when allowed by the accrual principle. For example, a plant is now a multi-year expense, entering after the income statement, slice by slice, by means of the depreciation; likely, a prepayment for an anticipated receipt for a rent, shall enter the income statement of the next year among the other revenues.

Being these items 'only' revenues and expenses (even if "suspended" temporarily from the income statement) their natural evaluation method shall be the *historical cost* (or *historical income*) measured exactly with the cash or cash substitutes ("numeraire") needed for buying (selling) them and effectively exited (or received). In the 'first series' of accounts we record the cash inflows and outflows; in the 'second series' we record nothing but the same flows interpreted according to the nature of cost (or income) acquired (or sold). In this view (a far 'cousin' of the Anglo-Saxon 'Revenues and Expenses View', (Paton, 1922)), the HCA finds a strong ideological support. The basic criterion of evaluation of nearly all assets and liabilities (out of "numeraire" values, which enjoy of a their own value) is only one: the Historical Cost. The underlying ideological and economic assumption is that the value of business is *not* the simple sum of the single values of assets and liabilities but is a separate value, the value of the combination in itself, derived from the actualization of future net profits or losses (or, preferring a more financial approach, a true discounted cash flow over a future and defined interval of time), i.e., a sort of use value. In this sense assessment of separate values to the single items of the combination is a non-sense, because they have *not* their own function out of the combination where they work. The only sure value attributable to them with prudence is the cash spent for buying them (eventually even depreciated, but *never* appreciated).

Anglo-Saxon accounting does not know all this 'systematic approach' to the accounts. Then, in English or in American traditional accounting, accounts are not shared into two sets or series of accounts. Then, there is not an intrinsic reason for which an item of financial reports should be evaluated with one or another method. According to the quoted Italian classical approach, Anglo-Saxon accounting should be classified still as a D.E. 'method' *without* a proper D.E. 'system', just as in Italian Accounting was between Pacioli and Besta (1494-1890).

The evaluation methods, as a matter of fact, have never had a theoretical and analytical derivation from a general principle. They are derived from 'practice', even if the 'best practice'. But who decides which practice is the 'best'? Literature in Anglo-Saxon countries derived the evaluation methods more from the different concept of capital maintenance: at the end of a very long scientific debate we can roughly assert that when a 'physical' maintenance prevails, then HCA prevails; when, otherwise, a 'financial' maintenance prevails, then FVA prevails.

In US literature, in particular, even if the Italian 'systematic' approach is not known, we find somewhat similar to this one in the three great phases of Accounting thought. In the classical "Assets and Liabilities view", we observe a separate evaluation of the different items with different criteria: market, income or cost determination of what, decades after, will be named as the 'fair value'. In the following 'Revenues and Expenses view', we observe a prevailing of evaluation by means of the historical cost. In the last decades, finally, we observe to a coming back to the previous evaluation method, but with a stronger accent on the market, which, at the end, lead to the FVA and to its generalization for nearly all the evaluations. Are the times now up for a new change of perspective?

Of course modern IFRS are formally an autonomous system, not strictly derived from a specific national tradition, not even from the American one. But, if we only consider their brief history (since 1973), it is plain the considerable influence of English Accountancy before, in the first decades, and of American one, in the years nearer to us.

IFRS accounting language could be considered an Anglo-Saxon accounting system among the others that historically have been recorded until now and toward the English literature it has the evident major debts.

Thus, one hypothesis assumed by the authors of this paper is that accounting system have a syntactic structure of 'systematic type', both if the authors and operators of accountancy are aware of it, and if they are not. The 'first' and 'second' series (*original* and *derivative*) always exist, even when no one has still noticed them. The question, if anything, is if this approach could be useful for interpreting and deciding in the alternative HCA vs. FVA, or if this hypothesis is not useful for our goal.

A suggestive hypothesis could be that 'systematic approach' allows to reveal *why* for determined items a language prefers an evaluation criterion while for other items other criteria are preferred. IFRS 13 tells us *how* using the FVA when requested or permitted but does not tell *when* using FVA is preferable to HCA. The solution IFRSs give is now of a formal nature: "when is requested or permitted by *another* IFRS". Could then the systematic approach give a theoretical framework for this basic choice? If this would be the case we could finally understand why in financial 'held for trading' assets HCA has disappeared while in properties, even if permitted, FVA is not very popular. If this would be the case we could even suggest to the 'framework maker' to implement it with a rational device for deciding when it is better to consider one 'system' of accounting than another.

The discovering of an implicit 'systematic' character of the accounting language adopted by IFRSs could be very useful in times of financial crisis

like the ones we are experimenting now. In the 'accounting system' the standard maker could find its way to rationalize the processes of evaluation. Is there, then, if any, an implicit system in actual IFRS, where a first set of accounts constitute the *first* or *original* series and a second set (the remaining) constitute the counter-series, this time *derivative* or *causal*?

If such distinction is possible we will be able to distinguish items in Financial Reports, which have their own value from other items not endowed by this propriety and simply measured by the original value of accounts belonging to the first series spent for them. As a matter of fact, all the accounts referring to assets and liabilities evaluated by the FVA seem, and really are, first-series accounts: they are like cash substitutes, because for those (according to the IFRS 13) there is an *exit price*, i.e. a theoretical possibility to sell them in a market and to give them just this value of exit. If all assets and liabilities, at a limit point, would be recorded and evaluated according FVA, Net Worth would be simply the summary of all assets and liabilities and the value of business would be simply the algebraic sum of all assets and liabilities. In this conception business would be no longer a combination of factors of productions ruled by a holistic principle, but only a portfolio of investments.

Actual IFRSs are not so exposed to the FVA but we are now, notwithstanding the international financial crisis, very near to this limit situation. Only a little portion of assets and liabilities are still evaluated at their historical financial value (of exit, like in historical cost of inventory and fixed assets, or of entry, like in many debts not evaluated with fair value), assuming that they are *derived* from a principal receipt or expenditure, and that they assume value only in a business combination.

This survival of HCA in modern IFRSs allows us to classify the accounting system in word like a hybrid system, prevailing FVA and HCA only in a regressing way.

The implicit economic assumption that seems to emerge is that the wealth of an entity is the sum of two different businesses. The first one, growing day by day in relevance, is a *financial* business, where the capital is allocated in different investments and, for this business, the statement of financial position is only the summary of portfolio investments. The second one, diminishing day by day in relevance, is a *real economic* business. For this last one we record on the statement of financial position the only possible value we have, oriented to prudence, i.e. a minimum value for the assets and liabilities participating to the business, linked to the cost; but the true value is that one of the entire combination of assets and liabilities, while no one of single assets and liabilities has a *per se* value.

The boundary between these two world is openly conventional. Property may be instrumental to a real

production of goods and services or be an investment *per se*; a share in an investee may be functional to an industrial integration or be a financial investment.

In the first case we have derivative or second series values, just like the ones of net worth or income and expenses; in the second case we have original or first series values.

The distinction between two series of the accounts, then, allows to decide the method of evaluation. Where we have a combination of factors ordered to the production of real good and services (and indirectly to the production of income), we will have also a physical maintenance of capital, and then we have to consider as first series accounts only cash, cash equivalents and cash trade substitutes, measuring every other asset or liability belonging to this combination as a derived value, without a proper value and measured only by means of cash needed to buy it (or sell it). Where, otherwise, we have a pure investment (in financial assets, or liabilities, or in inventory, or in fixed assets, or in a combination of assets and liabilities) where we are interested only in enhancing the original value of investment, we will have also a financial maintenance of capital, and then we have to consider all assets and liabilities belonging to our portfolio as first series accounts and only the variations in value of these assets and liabilities will be the second series or derived valued (either they are generated in current management or are only market variations in value).

The final question, however, we have to ask is if this state of art represents an equilibrium for the years we are living or they are the right answers in wrong times. To this final question we will try to give an answer in next point.

#### 4. Conclusions

In this paper the authors attempted to find a link between the formal syntactic that rule the accounting system as well as the production of the financial reports, and the judgment in deciding which general criterion of evaluation to adopt. This choice becomes of particular relevance in a context of crisis where the same accounting regulation might be accused of some responsibility for not being able to stabilize the economic system.

Thus, they discerned the two central paradigms of evaluation, namely the FVA and the HCA, and compared them by a survey of the existing literature.

To this survey they added a formal interpretation based on the "theory of accounting system", that is the sharing of accounts into two main sets or series, the former called *original*, the latter called *derivative*.

The main conclusion is, then, that according to the nature or businesses, we can have basically two main kinds of combinations: real and financial. In *real* economy, the concept of physical maintenance of capital should prevail and, in it, the "original" series should be restricted to the "numeraire" values (cash

and cash substitutes). The other elements of financial reports should be considered as "derivative" value and then evaluated by means of the only reliable method, the HCA. This would ensure stability to the values and an anti-cyclical role of accounting regulation. Of course, in this case, the main emphasis is toward who looks at the entity as a firm, as a business able to product income over years and not toward who looks at the entity as a volatile investment. In *financial* economy, instead, should prevail the concept of financial maintenance of capital, and the "original" series should be enlarged to absorb potentially every asset or liability, everyone with its own 'fair value', while in "derivative" series should remain only the 'net worth' values. Of course such evaluations would be volatile and pro-cyclical, but, in this case, that would not be an undesirable thing, because the capital market is *effectively* ruled by speculation.

A possible further and interesting question is where to classify financial business like, e.g., banks. Are they real or financial according our proposal? If retail banks and investment banks would still be divided as they were until a recent past, then the difference between the two "accounting system" might be assessed accordingly: retail banks concern *real* economy, even in a second level, while investment banks concern *financial* economy, where they are the leading actors. But in the modern western economy these two functions of banks are mixed, and then the generalized FVA is, technically speaking, the best accounting solution for their financial reports. Probably, then, the destabilization of real economies by financial actors, is not primarily caused by 'accounting regulation', but by 'business regulation', too much unbalanced toward financial speculation against the reasons of real economy.

But, for what concerns however the accounting law maker, the perspective of the aforesaid "accounting system" could be very useful in any case for giving a more rational basis to the financial reports. This would allow to define, in the most complex generalization, a *mixed* "system", where every entity could assess which items are financial investments (then evaluated according to FVA) and then attributed to the first series, and which items belong to a 'physical combination ordered to the production of income' (then evaluated according to HCA) and then attributed to the second series.

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