

## THE MODEL OF HISTORICAL COST AND FAIR VALUE IN THE CONTEXT OF NATIONAL AND INTERNATIONAL REGULATIONS

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**Abstract.** The concept of a true and fair view is representative for the submission of the entities' financial statements, considering that all other principles are derived and shall be subject to it. Along with the entry into force of Directive IV of the EEC, the financial statements should give a true and fair view on enterprises, and historical cost has been officially considered the main basis of assessment in accounting, the other bases being considered derivative thereof. This step oriented and opened the process of accounting normalization to the capital market, giving priority to the accounting mechanisms based on common law, against the rigorous and exhaustive ones. Our research takes into consideration a quantitative research, by analyzing the reevaluation alternatives of the listed Romanian entities on the Bucharest Stock Exchange, components of the BET index.

**Keywords:** historical cost, fair value, tangible assets

### 1 Introduction

In the conceptual accounting framework IASB there are defined several bases of evaluation that can be used in the preparation of financial statements: historical cost, current cost, realizable value and accrual value. There is no indication of preference for one or other of these bases of evaluation, but the choice of one or more of these bases of evaluation must be coherent (consistent with) the concept of maintaining the capital (which represents investor wealth), depending on which the entity's performance (profit) is measured. In general, the IASB accounting enshrines the assessment of inputs (assets) and outputs (incomes) at their fair value, represented most often by market value. The fair value, is the amount that can be dealt an asset or a liability settled, voluntarily, between the parties in the knowledge of the facts, which are not under pressure, in a transaction in which the price is determined objectively. In the absence of a market price, fair value is represented by a subjective value, attributed in particular managers and experts on the usefulness of the property for business rated.

Further assessment, based on historical cost, of the assets in the long term given the requirements of IAS 16 "Tangible" and IAS 36 "Impairment of Assets" is achieved through two methods: the first will lead to changes in assets, and what was the the second to changes in equity. In the first case, the assessment is the historical cost, any negative differences that are found will find in the accruals adjustments for depreciation, affecting the accounting assets . In the second case, the assessment is the choice (current value, discounted value), and the differences in plus or minus will affect the accruals reserves, increase or decrease them.

As shown in the two approaches, the emergence of reserves and adjustments is closely linked to the subsequent asset, so we will continue to examine this issue.

National and international debates on the concepts of historical cost and fair value and the evolution of the way in which financial information is presented make this subject timely.

## **2 Research methodology**

Harmonization and convergence between international accounting standards IFRS and U.S. GAAP trigger the interest of all the professionals in the field. Regarding the assessment and revaluation of tangible assets, Romanian regulations comply rigorously with European standards, but in future they will have to comply with U.S. GAAP and specifications, in order to depth knowledge of the differences and similarities between the three systems, we considered an appropriate comparison of the main topics of revaluation.

In our applicative research we analyzed options concerning the election of the assessment, taking into account a sample format of the first 10 Romanian companies listed on the Bucharest Stock Exchange after BET index. The reason for the choice of these companies was related to the reliability, reputation and prosperity, to easy access to information, and to the representativeness for the Romanian economy. By processing the information provided by their financial statements, we extract the accounting policies covering the theme of our work and we prepared a summary of the topic treated in the light of these companies reference in the Romanian economy. Based on results we try to establish a trend in terms of the bases for the assessment of tangible assets and use the revaluation in Romania.

## **3 Literature review**

Studying the specialized literature, we have concluded that in time there were supporters of fair value, and critics of this, on the national and international plan. The arguments pro to achieve certain financial statements more reliable, improving the objectivity and neutrality of accounting, even a better comparability regarding the present and the future of the entities' financial performances. On the other side, the critics refer to the impossibility of fair value to always provide reliable information, the necessity of specialists in the field for determining fair value.

On the revaluation, some authors consider that is more relevant and meaningful to do the revaluation of fixed assets, in the detriment of the revaluation of land and buildings. After other authors, the reason that managers are not indifferent to how and when do the revaluation of assets is due the costs which affectes the company.

Among supporters of the fair value we mention Obert R. (2004) which brings the argument that fair value obtaining more reliable financial statements, Castle (2001) whose argument refers to improve objectivity and neutrality of accounting.

Feleagă (2006) believes that the existing literature on fair value deals, in particular, the weaknesses of systems and accounting practices, especially those traditional, based on historical cost. He also said that though, the literature does not set forth a convincing manner, a clear indication of what to annex assessments in fair value for the assets and liabilities of the company, not a sufficient source of information.

Whittred and Chan (1986) presented five possible reasons for which is used reevaluation into an entity:

- when provided a profit lower than current profit;
- to provide information in the balance sheet;
- to create reserves for revaluation value resulting from the revaluation;
- to improve the financial coverage of shares and increase the price of the shares;
- when the report is to improve the debt / asset.

Scott Henderson and Jenny Goodwin (1992) consider that revaluation plus is not treated as income, and the new book value of the asset is amortized starting point for calculating depreciation in subsequent years. Following a positive review (increase value) of an asset amortized in the financial statements are the following effects:

- a greater expense to depreciation resulting profit lower. This does not refer to a movement of profits from one period to another. The expenses are high, profits are lost in the current year and are no longer recover in subsequent periods;
- earnings from eventual sale of an asset is less reassessed, since the value of accounts is higher;

Brown, Ivan and Loh (1992) argues that the revaluation affects the cost of an entity, which is why the managers are not indifferent to how and when do the revaluation of the assets of the company. According to their views, revaluation of assets could help to solve problems caused by information asymmetry, and managers could reveal important information that they have linked the revaluation of assets they control. Revaluation is treated and from the perspective of cost-benefit analysis. Thus, in 1977 Watts said that revaluation would be made when the effect of revaluation would exceed its costs (costs related to fees charged by those who do revaluation, costs related to the accounting records, costs related to the auditors). Weston and Solomons (1971) believes that the annual revaluation is inadequate for assessing the financial performance of entities as most investment decisions which have the tangible assets are made on a much larger horizon of time (more than a year).

Buchman (2001) he argues its view on that is more relevant and meaningful to the revaluation of fixed assets, to the detriment of the revaluation of land and buildings, the reason that fixed assets are used, more than the required land or a building whose value remains constant or any small oscillations from one period to another. Jaggi and Tsui (2001) and Gaeremynck and Vangelers (1993) have done empirical studies on the motivation of entities managers to revaluation of assets.

Empirical literature has provided a number of factors to explain the decision of the revaluation in different contexts and environments. Among these reasons is remember:

- if a value resulting from a reassessment of the entities could obtain larger loans or new loans because the entity would report a rate of indebtedness, less due to increases in asset values, argued the reason Brown and all, in 1992, and Cotter Zimmer, 1995, and all Black, 1998; Cotter, 1999, Lin and Peasnell, 2000, Jaggi and Tsui, 2001.
- revaluation allows the entity to make the historic level of market value, a phenomenon resulting in decreased profitability of a public offer subevaluate (Brown et all, in 1992, Easton all et, 1993).

In his study Missionier Franck (2004) deals with five main factors that determine the conduct reassessment, like:

- the legal status of the property;
- existence of foreign shareholders;
- the investment opportunities;
- the company size;

- degree of indebtedness of the company (multiplier effect).

D. Stokes and T. Leong (1988), in their articles, defining the revaluation as a way of correcting the accounting value of assets from another point of view than that of impairment, after each reassessment resulting either win or a loss of depreciation.

#### 4 The empirical study regarding tangible assets

We have consulted the website of the Bucharest Stock Exchange to identify the entities that have a major role in the national economy. To form a representative sample we have chosen the top 10 companies listed after BET index because we believe that they are able to establish a trend in terms of reevaluation in Romania. In addition, each of them is relevant and representative for the sector in which they are operating, and financial data is available to the general public as proof that we were able to achieve their financial situations by accessing their websites .

After analyzing the balance sheet and explanatory notes for the year 2008 we using codifications as P1-P4, respectively G1-G4 to determinated the exactly classes of fixed assets revalued in the years mentioned in relation to the activity of the entities. Based on the schedule below, notice that in the three consecutive years trend, mainly majority of entities applied global revaluation, meaning the entire class of tangible fixed assets that the company has (assets, land, buildings) for various reasons that we planing to analyze in detail in our future researchs and developments.

**Figure 1** The trend entities in the last three years

Companies	Passing form historical cost to fair value		
	2006	2007	2008
<b>Petrom</b>	-	P1	P1
<b>Banca Transilvania</b>	G1	G1	G1
<b>BRD Societe Generale</b>	G1	G1	G1
<b>Rompetro Rafinare</b>	-	-	G2
<b>Transgaz</b>	-	-	-
<b>Transelectrica</b>	G1	G1	G1
<b>S.S.I.F Broker</b>	-	G3	-
<b>Antibiotice</b>	P2	G1	G1
<b>Impact Developer&amp;Contractor</b>	P1	P1	P1
<b>Biofarm</b>	G4	P3	P4
<b>The trend</b>	<b>G1</b>	<b>G1</b>	<b>G1</b>
<b>Codifications</b>			
<i>P/G = partially/totally revaluation of tangible assets</i>			
P1 = buildings		G1 = assets, lands, buildings	
P2 = lands and fixed assets		G2 = buildings, technical equipment	
P3 = technical installations and transport means		G3 = buildings and lands	
P4 = lands		G4 = lands, transport means, technical equipment	

Some companies have worked in previous periods in an economy characterized as hyperinflationary. One of the main effects of the hyperinflation lead to loss of comparability of information contained in the financial statements. Thus, the expression of non-cash items in historical values leads to underestimation of the net assets of companies. Revaluations performed by some of these companies, in previous periods are likely to mitigate the effects mentioned above.

## **5 Conclusions**

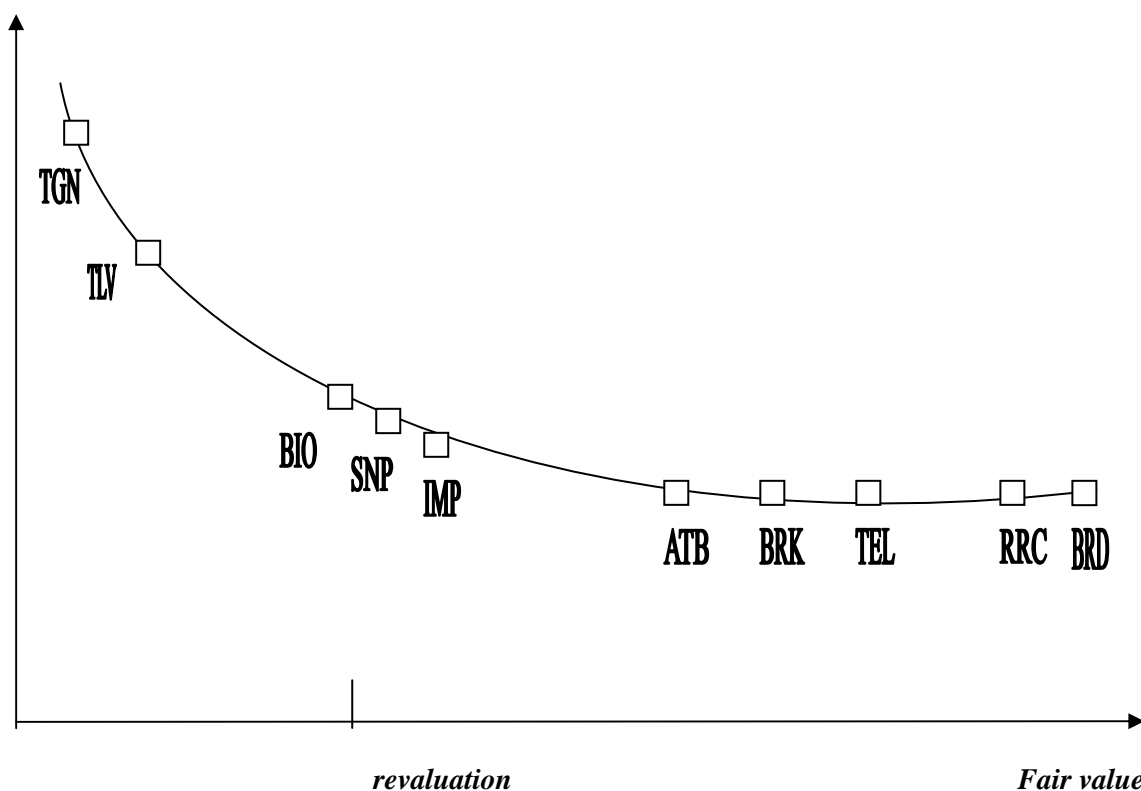
Following this study, analyzing the first 10 companies listed on the BSE after BET index, we reached conclusive results from the perspective of historical cost and fair value. In our analysis we had emphasized the link between the market value of (the harmonization of standards) and historical cost (precautionary principle). Due to the advantage of easy access to information, these companies having large size, we analyzed each entity in part regarding the accounting policies of tangible assets for 2008 year, intending to highlight the differences that occur between these large companies fair value perspective, the historical cost, the method of revaluation of depreciation and policies of the revaluation.

Thus, analyzing the first company listed on BSE after BET namely PETROM SA we concluded that it applies the partially revaluation: the buildings are presented at fair value and fixed assets are recorded at historical cost. The second company, TRANSILVANIA BANK, has reassessed tangible assets in 2007, and in the financial statements of 2008 have been reflected in the value of the previous year, to comply with such precautionary principle. Such Transilvania Bank, BRD-Groupe Societe Generale apply totally revaluation from which it will use the fair value and ROMPETROL S.A. reassess its wholly tangible assets.

Since 2006 TRANSGAZ S.A. has not made any revaluation, so tangible assets are recorded at historical cost. Instead, TRANSELECTRICA S.A. applied totally revaluation, registering such tangible assets at market value. Another big company, namely SSIF BROKER apply partially revaluation, on land and buildings, which were presented at their market value (the trend is to harmonize standards). Unlike some companies listed above, the company ANTIBIOTICE SA apply totally revaluation of all tangible assets belonging to the company as recorded at their market value. IMPACT DEVELOPER & CONTRACTOR reassess their buildings just by signing them at fair value in accounting, and the rest of tangible assets are reflected at historical cost. And the tenth company, BIOFARM S.A. revalued fixed assets only, presenting them at fair value, applying gross method. The building and lands held under lease is recorded at historical cost.

So from the perspective of historical cost and fair value applied by the companies mentioned above, we got the results shown in the diagram below:

**Historical cost**



**Figure 2 Historical cost versus Fair value**

For example, according to the graph, the company TRANSGAZ SA used mainly historical cost, which is due to the fact that it did not made revaluation in 2008, only in 2006. This may be the result of the election of a certain length of time between revaluation, or that it believes the reassessment advantage of the moment (current relationship historic cost-respecting fair value such precautionary principle). On the opposite side, however, BRD apply totally revaluation to market value, thus having a tendency to harmonize standards. Between these two extremes are three major record companies in the accounting part of tangible assets at historical cost and a part in market value, established after the revaluation.

Viewed from another point of view, we analyzed the companies chosen by specific indicators such as the revaluation policy, historical cost, fair value, revaluations' methods and depreciation methods and we concluded that only 3 of 10 companies apply partially revaluation, only for a specific class of tangible assets, and 7 companies revaluated all classes of tangible assets. Some classes of fixed assets are recorded at historical cost, some at fair value, or the entire class of tangible assets is recorded either on historical cost or at market value. Taking into account this aspect we concluded that 2 companies on their way to prudence, respecting this principle, 5 companies tend to harmonize standards and 3 of them were trends both toward prudence and to harmonize standards. This breakdown of companies according to previous state indicators are published in the diagram below:

<b>Codifications</b>	<b>Policy revaluation</b>	<b>Fair value</b>	<b>Historical cost</b>
<b>0</b>	0	5	2
<b>1</b>	3	3	3
<b>2</b>	7	2	5
0 = does not apply the indicator in question; 1 = apply partially the indicator; 2 = apply totally the indicator; 2-5=number of the entities which apply an indicator.			

**Figure 3 Companies repartition**

Limits quantitative research would be this small sample of entities analyzed.

In the future, we would like to engage in further research regarding:

- Increasing the sample with 100 companies listed on BSE
- Analysing of certain selected companies considered representative along several financial years.

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