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FAIR VALUE IMPLICATIONS ON ROMANIAN CAPITAL MARKET

Theoretical article

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Abstract

Fair value generated intense debate during the last years, as the financial turmoil influenced many economies and capital markets, including the Romanian ones, too. Some researchers and professionals consider fair value in charge with the financial crisis and they ask for historical cost accounting basis for financial reporting. Fair value has its supporters, too. They consider that fair value reflects the effects of changes in market conditions when they take place, and accounting information is more reliable in this framework. Following recent regulations, Romanian entities activating on capital market as investors in capital market instruments, or whose shares are traded on a regulated market, must prepare their individual financial statements in accordance with the International Financial Reporting Standards. The study provides some conclusions that could enlarge the utility of fair value related to entities that activate on Romanian capital market.

Introduction

In the late years, the financial crisis affected most of the countries and many companies and its presence in our day to day reality determined policy makers, researchers, business people and managers to discuss more and more intensively about the causes that determined the evolution on the international scale in such a way as it happened. Entities activating on capital markets were in the center of this turmoil, because many voices considered this kind of companies responsible for generating the financial crisis worldwide.

Romanian economy, as being connected to the international one, had to face too, this crisis. And Romanian companies that activate on capital markets had to face similar problems with counterparties from biggest western economies.

During this tumultus period, different opinion makers pointed several factors that generated the slipping of international economy, many debates being around the idea that western economies have a non-adecvate accounting system, they are very de-reglementated, that capital markets allowed the increase of the thirst for profit and this all generated new toxic products that helped managers to report growing assets and profits.

Fair value debate

From the accounting and financial point of view, there were many voices that argued that the use of fair value is one of the main factor that allowed the financial crisis come to our lives. The temptation, due to the fact that we passed a crisis is to blame fair value, but, essentially this is just a messenger, and some governments and some regulators preferred to believe the numbers were wrong rather than the investment decisions (Andre et al., 2009). And this is a messager connected to market and transparent transactions.

But what is fair value? Under the provisions of International Financial Reportings Standards and of the Financial Accounting Standards Board, fair value is defined as 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 (Financial Accounting Standard 157 - Fair Value Measurement, International Financial Reporting Standard 13 - Fair Value Measurement, 2014).

First thing that we can find out of this definition is that fair value is a market-based measurement. The price is determined at measurement date under current market condition. In such hypothesis we can notice that the Adam Smith’s invisible hand is coming back to its rigts when we assume the definition of fair value. The market has a central role and position in fair value based accounting. But this makes fair value vulnerable too, because fair value accounting could be associated with market bubbles.

Second of all, we notice that fair value is rather an exit price, or the price to sell an asset rather than the price to buy that asset. An exit price embodies expectations about the future cash inflows and cash outflows associated with an asset or liability from the perspective of a market participant, based on buyers and sellers who have certain characteristics, such as being independent and knowledgable about the asset or liability(KPMG – US GAAP and IFRS, Fair Value Measurement, Questions and answers, November 2013).

Another important assumption of the fair value is that the participants to the market would use their best own economic interest when acting there from a position of seller or buyier.

Fair value is measured assuming:

a) a transaction in the principal market for the asset or liability. We understand by principal market the market with the highest volume and level of activity

b) a transaction in the most advantageous market, in the absence of a principal market, and we understand with this advantageous market, the market that would maximize the amount that would be received to sell an asset or minimize the amount that would be paid to transfer a liability.

The principal market and thus, market participants should be considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities. This is an important figure to be taken into consideration in understanding the fair value concept because it is based on a market measurement, not an entity-specific measurement. In the case that there is a a principal market for a specific asset or liability, the fair value measurement shall represent the price in that market. This means that using fair value makes our accounting to be called basely marked-to-market accounting. This are also the so called level 1 inputs. (Laux & Leuz, 2010).

Then if this level 1 inputs are not available, then we have to go to use models in order to determine fair value. This so called level 2 of fair value is also known as marking-to-model, and it is required that these models to use observable inputs such as quoted prices for similar assets, relevant market data, interest rate evolutions, different spreads between related interest rates, etc.. Then there come the so called level 3 inputs that are unobservable inputs, typically model assumptions, and can be used if observable inputs are not available. We have to notice that with level 3 inputs, management has considerable discretion (Laux & Leuz, 2010).

Under a fair value accounting model, the incentive to preempt sales by other firms is greater during periods of market illiquidity because sales have a greater impact on short-run price when markets are illiquid. Thus, strategic concerns which can lead to procyclical trades and an increase in overall risk in the financial system are heightened during periods of market illiquidity. They also conclude through the model they use that a full implementation of a mark-to-market regime may need considerable investigation and care. Anyway, the historical cost regime - because it ignores price signals - is inefficient. But our world is covered by imperfections and in this circumstances, precise nature and consequences of the imperfections ought to be the first step in any debate in accounting, especially when we argue for fair value accounting against historical cost based accounting (Plantin, Sapra & Shin, 2008).

But the advantages of more timely and relevant information under a fair value-oriented accounting regime may overwhelm those of a historical cost-based regime if markets are liquid and competitive. Under a fair value oriented reporting regime, managers have considerable discretion and judgment in ascertaining whether impairment is other than temporary under a historical cost accounting regime (Khan, 2014).

We have to emphasize also that hat managers are more likely to adopt fair value when it facilitates performance measurement :

(1) value changes in investment property are informative of operating performance when capital gains are part of the business model;

(2) fair value adversely affects key performance measures if the management chooses to hold unproductive assets (assets with high value in alternative use) and thus can benefit in governing firms lacking investment opportunities (Christensen & Nikolaev, 2013).

In case that we assume free market discipline, the management can have choices to use reportings built under historical costs or fair value accounting. The setters gave the opportunity through International Financial Reporting Standards to allow companies to choose between historical cost and fair value accounting for certain and specific balance sheet positions such as for example, the non-financial assets, but requires pre-commitment to either practice, that must be defined through the accounting policies they choose, and strengthened by declaration in the financial statements.

Managers are very interested to provide good information to the users of financial statements. But fair value is considered a factor that can introduce volatility in financial statement. There are three points to happen in such a manner (Barth, 2004):

a) the volatility associated with changes in the underlying economic parameters.

b) the volatility produced by measurement errors or changing views regarding economic prospects throughout the business cycle.

c) the volatility may be introduced by relying on the "mixed attributes" model that applies fair value accounting to certain instruments and amortized cost to others, reducing the netting effect that full fair valuation of assets and liabilities would produce.

Mark to market is a measure of the fair value of accounts that can change over time, such as assets and liabilities. For example, financial instruments traded on a futures exchange, such as commodity contracts, are marked to market on a daily basis at the market close (Metzger, 2010).

The opposite to fair values accounting model is the historic cost based accounting. Historical cost is based on the stable measuring unit assumption. In some circumstances, assets and liabilities may be shown at their historical cost, as if there had been no change in value since the date of acquisition. In fact, the hystoric cost is the original monetary value of an economic item.

We can define historical cost as an aggregate price paid by the firm to aquire ownership and use of an asset, including all payments necessary to obtain it (Hendriksen & Breda, 1992).

Those who sustain historic cost consider that it has some characteristics that fits to the changes in time and for determining the market evolutions. Some opinions consider that historical cost is based on actual, not merely possible, transactions. It is the acquisition price of the assets.

In such circumstances, the entities have only to record all the assets and liabilities at their acquisition price. Hence they are measured and reported objectively. Historical cost is therefore basically verifiable. Thus some sustainers of historical-cost based accounting consider that this minimises the risk of manipulation of figures by the managers (Bakar & Said, 2007).

There are also historical cost accounting fans who argue that historical cost affects the evaluation and selection of decision rules. To determine which decision rules to use, managers need information about the quality of their past decisions. Historical cost is indirectly related to past decisions. Also, in the decision-making process, a forecast of future prices must be made, and past prices (historical cost) serve as the basis for such a forecast. Historical cost is used because it is imposed on the decision maker by his environment. (Yuji Ijiri, Theory of Accounting Measurement, 1975). He also argues that in order to increase comparability of information, using the same measurement basis at different points in time strenghtens the comparability and timeliness of information. This happens because quantities for transactions can be recorded at the time of transactions, and in a future moment, when financial statements are being prepared, prices based on different measurement bases (historical cost or fair value) can be multiplied by quantities to create financial information under different valuation methods.

Fair value in Romania

In Romania, historic cost based accounting is still the base pillar in the judgement of accountants and managers. Since 1994, the Romanian accounting standard setters have introduced the principle of historical cost accounting rules. The assets, liabilities and equities are valued at historical cost when they enter into the unit and remain at this value called the input value until the exit from the enterprise, being deduced after the output at the same historical cost level. Starting with the addoption of European Union Directives and the implementation of International Accounting Standards, fair value started to make its presence in the life of Romanian economy, and today most important companies, and especially those that are listed at stock exchanges, that activate on banking system and those that are part of international groups, apply fair value, especially for the financial assets. But fair value is not a concept used to be applied to all the assets and liabilities and capital structures of a company. For entities activating on capital markets, romanian setters provided the Regulation No. 4/2011, regarding the accounting regulations in accordance with Directive IV of the European Economic Communities, applicable to entities authorized, regulated and supervised by National Securities Commission (actually called The Financial Supervisory Authority).

Markets are not static, they are dinamic, and this determines a change of the conditions for transactions on markets, with implications on prices and liquidity. Prices change over time as a result of the diversity of economic and social factors specific and general. Specific factors such as changes in supply and demand or technology can generate significant price increases or decreases. General factors in turn can have the effect of modifying the general level of prices and therefore in the general purchasing power of money. On capital markets changes are even more visible. We can assume that we have hour to hour or minute to minute changes. And there are used daily, weekly and monthly information to make reports and complete in a transparent manner the financial reports and internal analysis.

Given that most of the information provided by accounting includes in Romania, especially for small and medium companies, financial statements based on historical cost, which does not take into account changes in the price level for assets, liabilities and equity, the users of the accounting information need to know the effects of price changes to the financial position and financial performance of their companies. In this regard companies must disclose information in response to the effects of price movements. And fair value, as an exit price and a market-based measure is the response for all the answeres regarding transparent, efficient and proffesional information. Using fair value accounting means assigning a value to a position held in a financial instrument based on the current fair market price, rather than its original cost or book value, for the instrument or similar instruments. On international capital markets, investors demand the use of fair value when estimating the value of assets and liabilities. This has been influenced by the desire of the investors for a more realistic appraisal of an institution's or a company's current financial position (Chea, 2011).

In order to provide a more relevant information to financial statement users, fair value information should be reported for all financial assets and liabilities. But today in Romania we still have some important conceptual and practical debates relating the reliable determination of fair value. We have to pass through this debates and the first step for full fair value accounting principles for entities activating on capital markets, could be full fair value disclosures before contemplating a shift to full fair value recognition in financial statements. Another important fact is that financial reportings are aimed to provide to the users of financial information the best possible characteristics of the assets, liabilities and debts that are reported through the positions and components of the financial statements. Disclosures can add extra information that helps the users of financial information to better understand the environment the company they are interested in is acting in, as well as the position and performance of that entity. Fair value, connecting to market the reported information represents a better option in our days, as the economy, the informations and decisions are on a ground that is changing and moving very quickly, and capital markets need investors and managers that can connect the information they have to decision-making process in a very efficient mood. Capital markets are also connected to risk, and in such circumstances, fair value brings the reported information closer to the characterictics of the risks and this makes the financial environment easier to be understood by invetors, managers and the other users of reported information. Of course, reporting based on fair value accounting, in comparison with historical cost accounting based principles, requires a more detailed analysis of the methods and assumptions used to determine values recognized in the financial statements or other public or in-house information, but this, in turn, will require market participants to educate themselves in the application of fair value principles.

Today, in Romania, fair value is applied mainy to instruments that are:

a) recognized when entering in the assets, capital or debts structure

b) profiled to a change of their structure in the next period of time (for example, are held for trade shares).

For assets held to maturity, the international dominant opinion is that a financial asset shall be measured at amortised cost if both of the following conditions are met (IFRS 9 – Financial Instruments):

(a) The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.

(b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

A financial asset is any asset that is (Romanian Financial Supervosory Authority, KPMG, 2013):

- cash;
- equity instruments issued by another entity;
- contractual right to receive cash or another financial asset or to exchange assets or financial liabilities under conditions that are potentially favorable to the entity;
- certain contracts settled in the entity's own equity instruments.

Going on from this definition, the classification of financial assets in Romania runs as follows:

a) Financial assets at fair value through profit or loss (FVTPL). This category includes:

- financial assets held for trading
- derivatives, if not applicable hedge accounting
- Any financial asset designated in this category to initial recognition

b) Loans granted and receivebles: Non-derivative financial assets with fixed payments or determinable payments that are not quoted in an active market

c) Investments held to maturity (HTM): Non-derivative financial assets with fixed payments or determinable payments and fixed maturity that an entity has positive intention and ability to hold to maturity

d) financial assets available for sale (AFS) include:

- All financial assets that are not classified in another category are classified as available for sale
- Any financial asset designated in this category to initial recognition.

Now, we have to make some clarifications starting from this classification: a financial asset can be classified at fair value through profit or loss only if meets one of the following two conditions:

1. is classified as held for trading ("held-for-trading"). A financial asset is classified as held for trading if:

- acquired or incurred principally for the purpose of selling or repurchasing in the near future;
- included on initial recognition as part of a portfolio of financial instruments identified that are managed together and for which there is evidence of a recent pattern of tracking short-term profit; and
- a derivative, except for a derivative that is a collateral financial or derivative designated as a relationship of the effective coverage risk.

2. the initial recognition is designated by the entity as at fair value through profit or loss. Designated at fair value option is allowed only if:

- instrument proposed to be designated at fair value through profit or loss is a contract hybrid that includes one or more embedded derivatives;
- the designation eliminates or significantly reduces a measurement inconsistency or recognition (sometimes called accounting mismatch - 'accounting mismatch') that would otherwise would arise from measuring assets or liabilities or recognizing the gains and losses assigned to them on different bases;
- a group of financial assets and / or financial liabilities is managed and its performance is evaluated based on fair value in accordance with a documented management strategy investment risks or entity, and information are provided to key driving the base station.

Investments in equity instruments that do not have a quoted market price in an active market and whose fair value can not be measured reliably should not be designated at fair value through profit or loss.

Fair value measurement does not apply in Romania to:

a) non-derivative financial instruments held to maturity;

b) loans and receivables originated by the entity and not held for trading; and

c) interests in subsidiaries, associates and joint ventures, capital tools issued by the entity, contracts for contingent consideration in a business combination and other financial instruments with such special characteristics that the consistent with what is generally accepted, are accounted for differently from other instruments financial.

It is very important to notice that the actual international standardization organizations consider that a financial asset shall be measured at fair value unless it is measured at amortised cost (IFRS 9 – Financial Instruments).

Of course, not only assets are presented in financial statements. Liabilities have also a very important role in the determination of financial position of companies through their financial reportings.

Here we have the classification of financial liabilities in Romania, for entities activating on capital markets and financial investment businesses:

a) Financial liabilities at fair value through profit or loss:

- Financial liabilities held for trading
- Derivatives, if applicable accounting coating
- Any financial liability designated in this category upon initial recognition

b) Other financial liabilities at amortized cost: we include here all financial liabilities that are not classified at fair value through profit or loss.

Conclusions:

- historical cost accounting is still present in Romanian and international accounting practices
- fair value accounting is a market-connected base for financial reporting
- using fair value makes financial information more (a) relevant (predictive value, feedback value, timeliness), (b) reliable (verifiable, neutral, representational faithfulness), (c) comparable
- should be used in Romania for all financial assets

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