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Fair Value or Market Value?

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Abstract
When taking into consideration the issue of defining the "fair value" concept, those less experimented in the area often fall in the "price trap", which is considered as an equivalent of the fair value of financial structures. This valuation basis appears as a consequence of the trial to provide an "accurate image" by the financial statements and, also, as an opportunity for the premises offered by the activity continuing principle. The specialized literature generates ample controversies regarding the "fair value" concept and the "market value" concept. The paper aims to debate this issue, taking into account various opinions.
Keywords: accurate image, financial structures, valuation, fair value, market value

Introduction

Both terms are defined by IAS 32 „Financial instruments: presentation and description. This IAS sustains that „fair value represents the value for which an asset can be traded or a debt can be paid, voluntarily by both of the partners involved in a situation of a normal competition transaction".

However, the same standard defines the market value as „the value obtained from selling or paid for buying a financial instrument, on an active market".

Fair value vs. Market value

According to the above definitions, the fundamental difference between the two types of value could be easily noticed. On one hand, the market value comes out implicitly from the voluntarily negotiated transactions in a well determined context.

On the other hand, the fair value involves a choice, having a high degree of subjectivism. Moreover, the market value in the moment of financial reporting does not take into consideration the asset's residual value and this fact generates a net difference[1] from the fair value, especially in extraordinary economic situations.

In the same time, using a market value in the accounting process, as a main goal for valuators, is not considered efficient as long as compulsory financial statements are prepared with a periodicity of a year. This thing comes out from the utility of market value itself in the context of informing the investors.

Thus, the accounting information reliability would be much higher by using the market value only if the reporting period was much shorter than a year.

A middle solution, comfortable both for investors and internal information users would be the fair value, agreed by both compared accounting systems.

Numerous specialists consider that „the fair value includes the market value and tends to cover all the values revealed by the estimations based on economic calculations" (Breban, 2008). We can notice that the strongest argument against the fair value is generated by its estimated character, based on a large values scale, being taken into consideration different subjective adjustments.

Indeed, the used fair value represents a market value, established by valuation expertises if an active valuated market exists. Otherwise,

[1] The net difference is given by a part of the goodwill involved by the valuated asset.

the measure of fair value is replaced by the present value of the future economic flows[2].

Also, a fair value is determinable as long as there is an active market for the valuated financial structure.

Moreover, the existence of such a market is not enough; it must be efficient, also.

In the same time, the fair value supports the forecast analysis of the future cash flows, being thoroughly based on market indexes, accessible to all the users.

Professor Niculae Feleagă notes several disadvantages involved by a financial reporting based on fair value (Feleagă, 2010):

- ✓ Fair value in neither reliable, nor free of elements leading to wrong interpretations, as a consequence of internal methods of perception of the value used in case of unrated assets;
- ✓ Fair value is not free of its determining methods permanence, taking into consideration the fact that fair value is an estimation obtained by using different methods dictated by external market factors[3];
- ✓ The cost of fair value determining has a significant amount.

Nevertheless, the market value represents a nowadays internationally recommended valuation basis thanks to some grounded arguments (Georgescu, 2010):

- ✓ In contrast to the historical cost, the fair value allows a real comparison of the entity’s performances, being a daily value, observed on market;
- ✓ The investors, as main accounting information users need to know about the fair value in order to decide, because fair value expresses most accurately the present value of future cash flows;
- ✓ The active administration or the more and more often placing on market of financial instruments before the term justify the valuation at a value reflecting the best, the economic reality;

[2] It is important to notice that in the USA accounting system the value of future benefits is not submitted to the update process. This could be a consequence of the USA economic stability.

[3] The discount ratios would be an example.

- ✓ The market value is more neutral than other values because it is established independent of the entity's or managers' intentions, of the used instruments type or of the operations date.

Thus, using the fair value in the financial reporting offers to the investors, to the creditors and to all the other users an accounting information characterized by predictability, comparability, coherence, integrality, pertinence, simplicity in applying, flexibility and neutrality.

The fair value is not well defined in the context imposed by the European Directives, excepting the 7th one regarding the group society's consolidation (Foster and Hall, 1996).

Also, the Romanian legislation and namely OMFP 3055/2009 is much different from the international accounting referential, concerning the fair value. For example, even if the fair value is mentioned as a valuation basis, its using in valuating financial instruments is possible only in the case of consolidated accounts.

This version of using the fair value represents, in fact, a combined mode of valuation which offers comparable pieces of information, which represents accurately the results' obtaining and the management vision on the entity and, finally, which reduces the involved subjectivity level of the value loss estimations.

Such a strategy of financial reporting could lead to a redefinition of the accounting result by a global result defined by the Americans as „an extensive measure of transactions and other entities' events effects, including all the variations of net assets, excepting those coming out from the owners' contributions or the distributions to them" (Foster and Hall, 1996).

Such an approach, taking into consideration the latent profit or loss possible during the financial exercise, would somehow bring together the accounting and the valuation vision on the entity performance concept significance.

Moreover, an accounting expressed in present values ensures an orientation towards financial capital's maintenance.

In order to simplify the things, we won't take into consideration the capitalized costs adjoining the purchase price, such as irrecoverable taxes, transport expenses and other necessary expenses for acquisition or releasing the purchased asset.

Beyond the basic treatment, through which these costs are reported as current expenses and beyond the option for an alternative treatment, through which the companies were allowed to consider these expenses as part of the asset's input value, there are many critic opinions regarding their negative impact on the financial statements.

Basically, the option for the alternative treatment could be justifiable only if these expenses have very high amounts, which should be phased during several years in virtue of the exercise independence accounting principle. A similar treatment could be applied for an asset obtained from own production.

Considering the purchasing, the problem of the chosen valuation basis should be raised, taking into consideration the way in which that purchase is financed.

Two directions can be noticed and namely: the purchase by leasing and the purchase by paying within a year. The two ways of financing the asset involve different modifications in the balance sheet, in the profit and loss account or in the cash flow statement. While the first way of financing modifies the long term debts, the second way affects the amount of the short term debts.

The time impact on the valuation of assets represents an important pawn in settling the chosen valuation basis. IAS 16 defines the cost as "the amount paid in cash or cash equivalents or the fair value of other counter performances made in order to purchase an asset, at the date of its purchasing or construction".

This definition involves a temporal residual variable to the current input price, represented by the seller interests earning, determined by updating the future payments.

But what happens when we desire to know the entity's real value? How are we supposed to proceed when we desire to make comparative analysis either within the entity or between distinct entities, in time? The deficiency of the historical cost is obvious from the temporal prospective of the inevitable money devaluation and so from the economic and financial analysis methods lacks' point of view.

Therefore, similarly to the investment projects valuation methodology[4], especially focused on a solid set of dynamic indicators, the update method used in the financial reporting process represents a

[4] We could take as an example the BIRD methodology for evaluating the projects.

step forward to the improvement of destructive effects of the myth of "historical cost monetary nominal's".

Conclusions

The choosing of the valuation basis obliges the specialists to be rational because no valuation basis could be generally satisfactory. Therefore, specialists must identify a balance point meant to settle the conflict relationship between prudence and fidelity, as a main feature of the accounting profession. Such an approach is obviously agreed also by the international accounting referential which, even if prefers a historical costs based accounting, takes into consideration the combined alternative methods.

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