

THE FAITHFUL IMAGE AND FAIR VALUE- MAIN OBJECTIVES IN INSSURING TRANSPARENCY OF THE FINANCIAL AND ACCOUNTING INFORMATION

MARILENA-ROXANA ZUCA¹

ABSTRACT:

The main concern of IASB and FASB is to create a modern system that informs quickly and honestly the users of financial and accounting information, as well as an active concept in order to give an objective image on an economic entity as a whole.

*The Romanian economy needs a similar image, a real and an objective one that supplies honest information, the basis for decisions leading to adopting a strategy according to the economic truth at all its levels. An important position in making financial statements is the concept of **faithful image** that supplies the necessary security and prestige. The faithful image concept is tightly linked to the concept of **fair value**, both being in continuous movement and influencing each other.*

KEYWORDS: IASB, FASB, accounting system, faithful image, fair value, financial statements.

Code JEL: M41

1. Introduction

The transition to fair value from historical cost it represents a choice with major implications in accounting, thus being a difficult process that must be redefined according to current national and global economic tendencies. The current economic competitive environment needs numerous changes in evaluating economic entities, thus following the fact that all economic entities move in an unstable environment, with rapid, many and unpredictable evolutions that make information to be inaccurate, uncertain and untimely. The context of globalization and the spreading of policies oriented towards market economy have led to a radical change in economic and commercial policies that ruled certain countries at the beginning of the 80's and 90's. In 1990, Romania started the transition process from a centralized economy to a market economy, implementing an extended program as reform focused on economic restructuring, fiscal and monetary discipline.

The **fair value** concept, that is no longer news, is a step forward towards accounting history and can bring advantages for financial reporting and all the users of financial statements. The concept isn't wrong, even though at this time is not perfect and can be improved. The problem is how do we measure fair value, what elements can be evaluated at fair value, how do we recognize or not the differences owed to fair value, and most of all *who is making the evaluation and who confirms it* (reporting entity and auditor).

^{1*} Corresponding author. Senior lecturer, Ph.D., Romanian-American University, Bd. Expoziției 1B, Sector 1, Bucharest, Romania

The lack of fair value from the accounting landscape is unthinkable.

There is need for an evaluation basis that can be used to evaluate (important in recognizing an element of a financial statement) financial statements either modern (financial instruments or human resources) or have important variations in time, as value (like fair value).

The purpose of financial statements is to provide valid information to help users make a financial decision. The financial position and the performances of the entity depend on the values and scale of values used to quantify them.

The validity of exposing a business to a market (evaluating at fair value doesn't mean that we determine the value according to market prices and performances based on variations of fair value), is not a bad idea, but considering the existence of a liquid market and a process that measures a credible and fair fair value then users are given real guaranties regarding the real value of the business.

2. Faithful image- the objective and fundamental principle of financial statements

The concept of faithful image is found in Anglo-Saxon doctrine and it is based on the 1974 Law of Societies through section 149 under the syntax "true and fair view", *a true and correct image that states that each balance sheet must give a true and correct image of the financial and patrimonial situation of a company at the end of the exercise and each result account must give a true and correct image of profit and loss*.¹

Because the concept of faithful image is based a hundred percent on Great Britain's accounting and later adopted by European Economic Community in the 4th Directive, is *an objective to be achieved and not a principle that seeks the truth of accounting*.²

G.A. Lee, in 1982 states that: *"Today faithful image has become an expression of art. It assumes presenting multiple accounts made according to accounting principles generally accepted, using exact numbers, making reasonable estimations, and presenting them as truthful as possible as to embody an objective image, without errors, distortions, manipulations or significant omissions. In other words we must consider the spirit and letter of the law"*.³

In European accounting, this concept is an objective of financial statements, while in Anglo-Saxon accounting is a fundamental principle that attracts all other principles.

According to International Accounting Standards and the 4th European Directive, the object of accounting is to supply synthetic documents that provide a faithful image of patrimony, financial statements and result, in order to give useful information to users when they make economic decisions.

IASC, the international organism for normalizing accounting, has an appropriate wording for the financial accounting objective that joins together faithful image with the faithful presentation of financial statements without referring to the concept of faithful image.

The paragraph 46 of IASC General Framework states *that financial statements are described as faithful image of the financial position, performance and changes in financial position of an enterprise*. Although this framework doesn't approach directly

¹ Finance, banks, insurance magazine, no.35/2008, p.20

² M.Ristea, Accounting between tax and management, Ed.Tribuna Economică, Bucharest, 1998, p.19

³ G.A Lee, Modern financial accounting, Walton on Thames, Survey, 1981, p.270

these kinds of concepts, applying the main quality characteristics and the adequate accounting standards has, as a result *“making financial statements that reflect in general a faithful image of the enterprise situation”*¹. The French doctrine (l’image fidele= faithful image) and Anglo-Saxon doctrine (true and fair view) have different interpretations for this concept.

The French doctrine states that the principle of faithful image would be useful in three essential fields:

- *“it would force the enterprise to present useful information attached to the balance sheet and Profit and loss account;*
- *It would allow the enterprise to make a rational choice between multiple applicable rules;*
- *It would be the last resort if the matters couldn’t be solved one way or the.*

In return, the meaning of faithful image in Anglo-Saxon doctrine has three essential characteristics: it translates an idea of life and judgment; it assumes the obligation to inform its users; it is a communication mark”.

Romanian researchers are of the opinion that applying the Anglo-Saxon concept that gives another meaning to the faithful image by allowing annual accounts to be in accordance with the reality, obtaining an accounting real and loyal information, based on sincerity and faithfulness. Approaching the faithful image as an objective to be achieved, the accounting truth perceived following accounting principles or conventions must focus on the possibility that synthetic documents reflect true information on the patrimony, financial situation and on the result of a company.

3. Fair value - valued and disputed criterion

The concept of faithful image is tied to the one of **fair value**, both concepts being in continuous movement, influencing each other. The American origin of this concept is explained by the fact that futures appeared in the USA, where they rapidly evolved. Although, references to fair value have been made since 1984 when FAS 80 *“Accounting for futures contract”* was issued, the American standard that has seen its valuation at fair value as a new accounting Convention for evaluating the majority of financial instruments was FAS 133 *„Accounting for derivative instruments and hedging activities”* (Accounting for Derivative Instruments and Hedging Activities”), issued in 1998.

The American framework launched a standard named *“Evaluations at fair value”* (F.A.S 157 *“Fair Value Measurements”*)² that establishes a conceptual frame for evaluations required by existent rules and details the explanations in it.

Fair value has been the concept that confused evaluation as well as financial analysis, the one *decoding and making sense of the numbers, to accounting language*. Despite these waves, we believe that because evaluating at fair value focuses on a large number of financial and non-financial assets and liabilities, that it can be the basis for a new model of accounting representation for an economic entity, which will help follow unstable

¹ International Financial Reporting Standards, Ed, CECCAR, Bucharest, 2013.

² FAS 157 *“Fair Value Measurements”*, <http://www.fasb.org>, accessed, November 9th, 2013,

financial situations affecting the forecasts of financial flows and short or long term investments.

International Accounting Standards / International Financial Reporting Standards retain the following definition of fair value (IAS 16-6, IAS 21-7, IAS 32-5, IAS 38-7, IAS 39-8, IAS 40-4, IAS 41-8, and IAS 148-7): *the amount for which an asset could be exchanged between parties voluntarily, knowingly, in a transaction in which the price is determined objectively.*

Alternative valuation models provided by IAS 40 "Investment Property" and IAS 39 "Financial Instruments: Recognition and Measurement" raise the issue of fair value based on fair value being located on the same level with other conceptual bases of assessment under the Framework. An opinion in this respect makes M.Ristea Professor and PhD, characterizing such fair value: [...] hope, if not a panacea to exceed other measurement bases used for the financial statements.

Specialists say that *"the origin of introducing fair value to international accounting standards is based on creating value for the stockholders"*¹. French researchers² consider that fair value does not designate a fair value or a true one but the idea of prudence. The term "fair value" from English was not translated in French by "valeur juste" but "juste valeur".

Considering fair value as an evaluation criterion is justified by the effective market theory that states that the course of an action reflects all the information available that led to its formation, or that the price of stocks doesn't necessarily show how much they are worth but what stakeholders should expect from it.

Efficient market theory, which is also known as the theory of Brownian motion or gait random or Wiener process, formulated in 1900 by the French mathematician Louis Bachelier³ (*in chronological order a major contribution to the use of this model in capital markets- Louis Bachelier (1900) who first proposed continuous-time formulation, formulation now called Brownian motion or Wiener process*), but has become controversial, especially after detecting certain abnormalities of the capital market, such as the effect class, one of the oldest and most important anomalies, since Banz R. (1981)⁴ reported that small entities have higher yields than larger companies, PER effect when Sanjoy Basu (1977)⁵ noted that entities small capitalization or value of PER (characterizes the efficiency of placement of shares) decreased get higher returns, or January effect (seasonal effect), first studied by Wachtel, S.B. (1942)⁶, which demonstrated that returns listed shares in the US market are much higher in the first month compared with other months.

Fair value is one of the evaluation forms that appear more and more in accounting language as well as in accounting standards. Including this concept in Romanian

¹ Maria Niculescu, *Financialdiagnosis*, Ed.Economică, Bucharest, 2003, p.34

² Casta J.F., Colasse B. (coord), *Juste valeur- Enjeux Techniques et Politiques*, Ed.Economica,Paris, 2001, p.5

³ A..Todea., *Rational expectations theory and evolutionary processes of exchange rates*; http://www.kmarket.ro/documentare/arhiva/Studiu_actiuni.doc, accesat 21 decembrie 2013;

⁴ Banz, R., (1981), "The relationship between and market value of common stock", *Journal of Financial Economics*, vol.9.p.4

⁵ Basu, S., (1977), "Investment performance of common stocks in relation to their price earnings ratios:A test of the efficient market hypothesis", *Journal of Finance*, vol.32. p.665

⁶ Wachtel, S.B., (1942), "Certain Observations on Seasonal Movements in Stock Prices", *Journal of Business*, vol.15, p.188

accounting standards contributes to making accounting a bridge towards the future. The Romanian accounting environment manifested the interest of combining historical cost with fair value. This concept appears to try to replace the shortcomings of evaluating the rival of fair value, namely historical cost by *correcting acquisition costs of assets at market value [...] achieved by permanent reevaluation of balance sheet elements*¹.

Fair value accounting is the accounting system of the 21ST century's dominant, representing an approach to reporting accounting, whereby companies are required or allowed to measure or report on a progressive basis of assets and liabilities at estimated price to be received in case of sale of assets or in the event of being paid to the issue of liability.

Furthermore *financial globalization and the constraints imposed on international and national harmonization of accounting increases the importance of fair value and offer it an added*².

In our country using a concept of evaluation in practice is not easy to achieve because there are few rules that emphasize accounting in economy than in law; and we must add the powerful interference of fiscal law in accounting.

Fair value is a step forward in the history of accounting and can bring important advantages to financial reporting and the users of accounting and financial information. This basis for evaluation, even though is not stated by the General Framework, is often used by IFRS as basis for evaluating assets and liabilities.

The definition of fair value, provided by IASB is as follows: *'the value used to trade an asset or settle a debt between interested and knowing parties, in a transaction made in objective conditions'*³. It is about estimation and not observation, as in market value situation.

Fair value includes market value and tends to cover all values based on economic calculus. These expressions, market value and fair value, as defined in international accounting standards, are compatible most of the time even though they are not always equivalent. Fair value is used for financial reporting of market value as well as values that are not based on market evolution. When the market value of an asset is settled then this value will be equal to fair value.

Fair value appears more and more in the accounting language and accounting standards as one of the reevaluation forms used. Including fair value in accounting standards allows accounting to become a bridge to the future. Generally, the international and national accounting environment manifested an interest in combining historical cost with fair value as method of evaluation.

We consider that using fair value is not easy to achieve, because there are many rules emphasizing law in accounting over economy. The transition from historical cost to fair value was labeled as a conceptual revolution in accounting. The objective of accounting based on fair value is to reflect market values in financial statements and the changes made in the consolidated situation of results obtained by the entity. This role has already

¹ Ionascu I., *The dynamics of contemporary accounting doctrines. Studies on the contemporary paradigms and practices*, Ed.Economică, Bucharest, 2003, p.149

² Deaconu A., *Fair value: accounting concept*, Ed.Economică, Bucharest, 2009, p.339

³ *International Financial Reporting Standards IFRS: official rules issued at January 1st, 2013*, Ed.CECCAR 2013, IAS 39, 'Financial instruments: recognition and evaluation'.

made many practical problems because estimating fair value is still a subjective process, especially since it has to be done in the absence of a market which implies professional reasons and the possibility of manipulation from the one estimating. For our country, since 2001, the use of fair value along with other changes in the accounting system is new.

Fair value was mentioned for the first time in Romanian accounting within harmonization with international standards in 2001, and then in 2002 when it was chosen to align to international and European standards. Fair value allows an evaluation of the financial position as real as it gets.

OMFP No. 1802/2014 supports assessment at fair value only in certain situations, namely: for the purpose of reassessment amounted, with reassessment operation results coverage in individual financial statements, and financial instruments, the fair value assessment is only permitted in consolidated financial statements.

In practice, entities in Romania *'used to reflect the fair value of the goods obtained free of charge or for those held in inventory plus'*.¹

Also, the fair value measurement is provided in IAS 39 *'Financial Instruments: Recognition and Measurement'*, which states that the best evidence of fair value is quoted prices in an active market. In some fields, the absence of an active market is obvious and fair value cannot be determined only by using valuation techniques and estimation based on management estimates relating to future cash flows and discount rates adjusted for risk.

Use of fair value is likely to contribute significantly to the improvement of accounting information released by increasing their accounts usefulness for its users, but it can be extremely subjective by allowing the manipulation of the image by those estimating it and the emergence of distortions in the financial statements, when the use of fair value is not accompanied by an adequate presentation of this information in the notes is often more dangerous than historical costs.

In the communication process of the entity, there is the essential difference between loyalty and sincerity, honesty wants to prepare accounting information to be as close to reality, with no concern for her understanding, and fidelity assuming a complementary care to a good reception of the message by third party users. The use of fair value as an evaluation criterion is justified by the confidence in the efficiency of markets.

Still, applying fair value has its disadvantages:

- fair value leads to a high volatility of the result, because the valuation at fair value implies the inclusion as a result of some virtual items arising from market developments that are just earnings or potential losses ;
- fair value results in overvaluing suited values presented in the financial statements ;
- fair value does not take into account the principle of continuity as long as currently requires setting value (not during normal activity cycle);
- fair value would require banks to reduce the value of assets in the balance sheet at the lower values as reflected by the market;
- fair value is meaningless in liquid markets;
- estimating the fair value of the entity is the prerogative of an external evaluator, in the worst case of an internal evaluator person separate from professional accountant.

¹ OMFP 1802/2014,pct.99 alin(1) si alin (102), pct.117 alin (1), pct.75 lit.(d).

In our country fair value has a restricted use, limited by the economic and legislative environment, characterized by:¹ *the priority of certain rules that favor fiscal and law to economic; the mentality of the accountant who doesn't accept new concepts; the insufficient development of capital markets, the main source of obtaining information at fair value; and not knowing the standards.*

First, one should note the attention paid to the concept of fair value, both by accounting professionals and the accounting normalization bodies. Although the scope of the model based on the fair value accounting has been extended, the maximum interest is that of financial instruments.

The development of financial markets and the complexity of the financial instruments traded have imposed the use of this alternative model of assessment.

However, the debate about fair value puts face-to-face two categories of players: on the one hand, managers of economic entities, seeking the best possible estimate of the performance achieved and, on the other hand, creditors, seeking, first, to estimate the risks they take, the immediate solvency of the company in the event of liquidation of assets.

The fair value is supported mainly by lawyers, who are considering real bankruptcy of the entity in which case all assets are valuable, for that moment, for that market on which it works and sometimes for a specific use. Lawyers try to defend the interests of creditors and the public in the event of liquidation of the business. They are interested only in a very small measure by what managers pursue of companies with state or private capital.

The traditional model of assessment at historical cost, coupled with the principle of prudence is today severely criticized for its approximate estimates, therefore, subjective, especially when it comes to asset depreciation. Criticism is addressed to it for the dependence of estimates influenced by the level of interest of accounts managers. Authors of criticism maintain in counterweight the virtues of fair value that are:

- lead to more objectivity, to more neutrality, because an accounting valuation model would be protected from the influences and opportunism of an account manager;
- application of fair value in accounting appears to allow the development of third-party financial statements that give better information on the performance and future of the company therefore the possibility of substantiating their decisions;
- fair value financial statements facilitates better control of managers, guiding more effective decisions in the sense of the interests of investors;
- enterprise resource assessment at fair value by determining control indicators on managers, based on shareholder value as well as economic value added-EVA, or value added market-MVA.

We ask ourselves the following question: Fair value measurement can contribute to creating value for shareholders? Can it dominate at historical cost? We consider that the fair value measurement can not create value for shareholders and other stakeholders than in accordance with the historical cost principle.

Table 1 presents few of the advantages of fair value concept envisioned by some authors:

Table no.1 Advantages for using fair value in accounting

¹ Deaconu A., *From historical cost to fair value*, *Adevărul economic*, nr. 19/2003, p.23

Advantages of fair value	Lucrarea-an apariție	Author
<i>Consistency management of risk assets.</i>	Article: The intrinsic qualities of fair value under questioning.,Accounting,auditing and business expertise magazine, nr.6/2002,	Barbu E.M
<i>The consolidated financial statements will be prepared by resorting to a large extent, at fair value, because they need to provide useful information, particularly to investors.</i>	The dynamics of contemporary accounting doctrines. Studies on the contemporary paradigms and practices. Ed.Economică, Bucharest, 2003	Ionașcu I.
<i>Fair value resulting from the evaluation process for all actors.</i>	Reporting financier et gouvernance des entreprises:les sens des normes IFRS, Editions EMS, Paris, 2005, p.33	Pigé B., Paper X.,
<i>The application of fair value accounting has the potential to improve characteristics such as understandability, comparability and timeliness, but only in the context of using estimates of fair value measures.</i>	The Role of Fair Value Accounting in Promoting Government Accountability, Abacus, Online first, http://maaw.info/Abacus.htm , accesed, 9 noiembrie,2013	Bolivar M.P.R, Galera A.N,
<i>(...) greater objectivity in measuring, providing more relevant information on present and future performance, and better control of managers.</i>	Juste valeur:Enjeux techniques et politiques, Mazars, Economica, 2001;1	Casta J.F., Colasse B

Source: Own processing

As an exception to the principle of historical cost EU Member States may permit or require fair value measurement of fixed assets. Member States may permit or require undertakings, or any category of businesses, to evaluate financial instruments, including derivatives, at fair value or to evaluate certain categories of assets other than financial instruments at fair value. The option of Member States to allow fair value measurement or query at fair value can be used at the individual or consolidated accounts. Member States may permit or require the recognition, measurement and disclosure of financial instruments in accordance with international accounting standards.

The main concern of the European Union on the concept of fair value lies in making efforts to reach an international agreement on accounting standards that would not destabilize the economic entities by intensifying economic trends, while guaranteeing obtaining a clear picture of finances. This will ensure that accounting standards, whose main objective is to provide useful information to all users in decision-making, better reflects the core values of companies. This objective relates to the other strategic objectives, including the prudent and financial stability regulation.

4. Conclusions

Although slow, **the transition to fair value** seems to be an unstoppable trend, more and more specialists, **considering it the best method for valuing assets.**

¹ <http://hal.archives-ouvertes.fr/docs/00/58/44/48/PDF/CAPPELLETTI>, accesat 5 noiembrie 2013;

This situation is fueled by pressures of accounting normalization bodies that promote it extensively through standards they develop. Discussions on the controversial subject of the use of fair value are far from being concluded and will continue for a long time, the concept of fair value is closely linked to that of faithful image, both in constant motion and influencing each other.

In order to present the financial statements truly and fairly regarding the situation and the operations of the undertaking, the accounts must satisfy, in compliance with the prudence rule, duties of regularity and sincerity.¹⁴ „ *Accounting information must give users a fair, clear, precise and complete adequate description of operations, events and situations* ”.¹

While the target of "faithful image" is not formulated as such, the works of professional American bodies emphasize that the information supplied by users in accounting is oriented towards credibility (reliability) and presenting a true and fair image of the company (present fairly).

Investors tend to sanction companies that do not provide transparent information and consider that fair value is the best method of evaluation.

5. Bibliography

1. Casta J.F., Colasse B. (coord), *Juste valeur- Enjeux Techniques et Politiques*, Ed.Economica,Paris, 2001.
2. Deaconu A., *Fair value: accounting concept*, Ed.Economică, Bucharest, 2009.
3. G.A Lee, *Modern financial accounting*, Walton on Thames, Survey, 1981.
4. Ionascu I., *The dynamics of contemporary accounting doctrines. Studies on the contemporary paradigms and practices.* , Ed.Economică, Bucharest, 2003.
5. V. Munteanu și colectiv, *Financial accounting of enterprise*, Ed. Universitară, Bucharest, 2012.
6. M.Ristea, *Accounting between tax and management*, Ed.Tribuna Economică, Bucharest, 1998.
7. *International Financial Reporting Standards IFRS: official rules issued at January 1st, 2013*, Ed.CECCAR 2013.
8. Toma C., *Annual accounts and faithful image in Romanian accounting*, Editura “Junimea”, Iași, 2001
9. Order of the Minister of public finance no. 1802/1986 approving the regulations concerning accounting annual financial statements and consolidated financial statements, Of. No. 963/30 dec 2014.
10. <http://www.fasb.org>.

¹ Toma C., *Annual accounts and faithful image in Romanian accounting*, Editura “Junimea”, Iași, 2001, pag. 86