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RECENT DEVELOPMENTS OF THE FINANCIAL REPORTING MODEL: THEORETICAL STUDIES IN REVIEW

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Our paper analyzes the manner in which the financial reporting model evolved towards fair value accounting. After a brief introduction into the context of financial reporting at international level, the analysis focuses on the accounting model of fair value. This is done by synthesizing main studies in accounting research literature that analyze fair value accounting through a theoretical approach. The analysis being developed relies on literature review methodology. The main purpose of the developed analysis is to synthesize main pros and cons as being documented through accounting research literature. Our findings underline both the advantages and shortcomings of fair value accounting and of the recent mixed attribute in nowadays financial reporting practices. The concluding remarks synthesize the obtained results and possible future developments of our analysis.

Keywords: fair value, accounting research literature, mixed attribute, pros, cons.

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1. Introduction and theoretical background

Questions regarding the identification of the most adequate values for assets and debts evaluation, and the manner in which changes that occurred in these values should be reported, are directly linked by other considerations connected to the nature and goal of the financial reporting (Gwilliam and Jackson, 2008). In the extreme case of economical models that target general equilibrium, when all information is embedded in the individual prices of assets, the fact that traditional financial reporting (in regard to the balance sheet and the profit and loss account) has a reduced, but not inexistent role is unanimous accepted (Barth and Landsman, 1995; Beaver and Demski, 1979; Walker, 1988).

In a real environment, one that assumes the imperfections of available information and a degree of uncertainty, financial reporting has the potential in playing a series of roles, both in retrospective - in terms linked to stewardship[††††], contract signing capacity, employee selection, resource consumption decisions, distribution, etc.; and in perspective - in terms referring to the anticipation capacity or to the, value, moment and probability of future cash-flows. In this context, the conceptual framework outlined by various accounting standard setting bodies such as the Financial Accounting Standards Board (US), the International Accounting Standards Board, and the Accounting Standards Board (UK), represents their attempt to offer, or at least to articulate, their own vision on a normative accounting foundation, and to identify a series of qualitative characteristics belonging to a "better" financial reporting in terms of relevance, credibility, etc. (Gwilliam şi Jackson, 2008). In the US, recognizing assets and debts at fair value

[††††]An additional role of accounting given that the market is not perfect and complete; a series of big entities entrust their assets and decisions to managers, having an informational advantage in terms of the degree of the decisions' adequacy; however it is difficult to conclude if a manger took some decisions that are inconsistent in relation to the shareholders goals; in other words, the shareholder cannot be certain if he "acquires" the decision he wants; accounting information can be useful in offering necessary incentives for diminishing the effects of the managers private information, and in supporting the company's' value growth

seems also to be favored by the Securities and Exchange Commission. In a report made for a Congress of the SEC (SEC, 2005), we can observe two major benefits of imposing fair value accounting for financial instruments. The first one would be the reduction in use of transactions structured in purely accounting ways by focusing on the exploitation of opportunities generated by managerial earnings created by the "mixed attribute" model - partially historical costs, partially fair values. The second one refers to fair value accounting of financial instruments which would lead to a reduction in the complexity of financial reporting, consequence of mixed attribute. Evidently, as the SEC report noted, there also are costs that are associated to the use of fair value.

A key aspect is the possibility to evaluate elements of financial statements at fair values, especially in the case of those financial instruments for which there aren't any active markets. Although market value is the recommended evaluation for fair value, the FASB adopted the term of "fair value" instead of market value, so that to underline the estimations of value necessary for financial instruments which are not traded on active markets. Both the FASB and IASB recommend, through the conceptual framework, the consideration of the cost/benefit report between relevance and credibility, when determining the optimum evaluation method for certain elements, analyzing if that evaluation has enough credibility to be recognized in financial situations. For investors, the assumed cost of fair value evaluations consists in the possibility, that one or more financial instruments might not be evaluated precisely enough to help them in their estimations regarding the financial position of the company and its potential to generate future benefits. This relevance cost is the consequence of the fact that in the absence of active markets for certain financial instruments, the management of the company must use fair value in its estimations, which leaves room for subjectivism and manipulation. Evaluating the costs and benefits of fair value accounting in the case of financial reporting, costs which affect investors and other users of accounting information in specific reporting systems is a difficult task (Matiş and Bonaci, 2008). The remainder of our paper is organized as follows: some research methodology aspects are discussed, the main part of the paper deals with analyzing theoretical studies in the area of fair value accounting in order to synthesize pros and cons being documented through accounting research literature, and finally we conclude upon the developed analysis by also formulating some future developments that might complement our study.

2. Research methodology

Our paper uses literature review methodology in order to develop a critical and evaluative account of what has been published within accounting research literature on fair value accounting by only considering studies that develop a theoretical approach. Therefore, the purpose of such an analysis in the area of literature review studies is to summarise, synthesise and analyse the arguments of studies being analyzed. Besides developing a summary of sources in the approached area, the employed research methodology imposes a certain organizational pattern that combines both summary and synthesis. More precisely, our analysis of each considered study covered the following aspects: question formation, identification of the relevance, assessment of quality, evidence summarization and interpretation of findings.

3. Developing the analysis and interpreting results

There is a myriad of arguments that can be invoked in the favor of implementing fair value, such as the comparability of market values, the credibility of the information provided by market prices, the conceptual benefits of market based evaluation of financial instruments, and the accounting of risk coverage managerial decisions. Information aggregation refers to fair value in the sense of correspondence between reported (supplied) and demanded information, in this case the aspect of credibility seeming to be the main argument with the potential to limit the

implementation of fair value evaluation in future projects of accounting regulatory bodies, especially in the case of balance sheet recognition. The accounting research literature documents the preference of investors for the use of fair value as standard for financial reporting, generating a superior level in information comparability. The level of relevance obtained through use of fair value is also superior to the one of the historical costs, due to the fact that management bases its decisions on fair values, as investors do, while in fact even the managements' evaluation should rely on the obtained results, but expressed at their fair value (White, 2008). Although these arguments are extremely powerful, a series of problems emerge when referring to accounting practices, especially in terms inked to evaluation credibility. This is also true when referring to theory related aspects, mainly in terms of changes taking place in fair values and their reporting. Therefore, starting from questions that regard the reporting method for gains and losses reflected in the profit and loss account, are induced by varieties of complex aspects, which derive from different conceptions regarding what in fact is the "result" and from various perspectives on the nature and goal of financial reporting. Even if we considered a perfect environment as Hicks (1946) did, starting from the premise that at any moment given in time all cash-flows and actualization rates are known (although in the case of a partial equilibrium model these certainties become variables), a variety of result ratings can be derived from the base distinction between the results calculated as difference between net assets in two different moments (this is the main approach in accounting referential), and the result representing a sustainable value in future time frames (Gwilliam and Jackson, 2008). A series of queries are linked to the manner in which information regarding these gains and losses should be presented, referring specifically to the necessity of separation - whenever possible - of temporary gains and losses, and to achieving a distinction between gains and losses generated by management and ones generated by other causes.

We could state that the role of financial reports is to offer users, i.e. stakeholders, the possibility to evaluate the success of a company or even its management. In this context, a question arises: How should the recent earnings generated by owning shares in international oil and gas companies be reflected in accounting? The high demand on the market was further accentuated by the Middle East crisis, fueling an increase in oil and natural gas prices during 2003-2006, the price of a crude oil barrel rising from 25$ (2003) to 70$ (2006) (NYMEX - New York Mercantile Exchange). Therefore, we face yet another important question: to what extent should these earnings be attributed to activities performed by the management of these companies? (Gwilliam and Jackson, 2008).

The main discontents regarding aspects that affect the credibility and comparability of information supplied by using fair value for financial instruments are comprised in opinions of practitioners. They express their concerns regarding the fact that estimations using fair value in the case of similar financial instruments can vary significantly in practice; that the management has an exaggerated power of decision and influence - by choosing entry market data that will be used in the evaluation, when the prices themselves are nor offered by the market; that certain shades of assumptions used in estimation models can have significant consequence; and that verifying the prices determined using unobservable data will be extremely difficult (Reinhart, 2008). One of the main adversaries of fair value is Alex J. Pollock (American Enterprise Institute), who considers that applying fair value accounting can create various excesses within the market, both pessimistic and optimistic, through the reported results and implicitly through the capital, which in the present state of the global economy does nothing but to fuel panic. From the point of view of the derivative, when these are not traded, Pollok considers that fair value evaluation creates an opportunity for a manipulation of the system. From his somewhat ironical perspective, fair value accounting represents "the last invention of metaphysical accountants in

their search for the only true way of bookkeeping". The arguments stated by Pollok address a series of problematic aspects that still require refining from the point of view of fair value.
For example, he mentions the situation in which the fair value of the debts of an entity decreases (which might happen due to the fact that the bonds market observes a worsening in the credit position of that entity), a case in which although the entity owes the same amount to its creditors - by the recognition of a smaller debt amount by its' creditors - fair value evaluation would assume recognizing in return the diminishing of the debt in correspondence to an income, thus generating a "profit".
Financial analysts also have their critics concerning the fair value concept, accentuating their role of functioning in a real world, where they have to offer decisional support to investors by operational systems and arbitrary rules of scientific models, and it is clear that the more instable entry data is, the more the analysts' role diminishes. A compromise is therefore needed, between the utopist goals of a perfectly-transparent and efficient market and the real world, based on human actions and inefficiencies. If the general public is unable to understand or face the torrent of short term oscillations of asset prices, the net effect of fair value accounting could generate nothing but fear, anxiety and systemic instability. On the other hand, we are aware that losses, gains and volatility result from market behavior and not from financial reporting. Using fair value is also not enough, because there is a need for additional information regarding risk exposure, models and assumptions used in estimations (especially in the case of less active markets), and also regarding the changes in factors that can induce the modification of fair value (White, 2008).
Radical attitudes are not useful to anyone. Instead, what would be of great use, is a collaboration based on individual experiences, so that the concept of fair value could be improved, thus becoming closer to the great goal of solving evaluation problems that have been troubling the accounting community for a few decades. Abacus published in 2008 a special issue dedicated to fair value, in which there are reproduced papers presented at the September Siena Forum in 2007 (the central theme of this forum was also fair value and conceptual framework). The respective papers cover a large number of matters concerning fair value evaluation, various initiatives of international organisms - especially IASB and FASB, etc. all of these needed for the development of a common conceptual framework. The majority of these papers resort to theoretical studies, meticulously processing the subtleties of the provisions of the regulations in cause. Following the Norwalk agreement from 2002 - through which IASB and FASB decided to strengthen their relations and to create a convergence plan for the standards they emitted - the events developed rapidly. Whittington (2008) evokes the strong affinities between the IASB and FASB conceptual framework, and the existence of important differences at the level of details. An important similar aspect between the two frameworks is the lack of an evaluation treatment, aspect which makes both frameworks incomplete (Whittington, 2008). We could say that there is still an "inheritance" of interests and some unsolved debates dating back from the 70's when the regulating organizations fought each other on the matter of inflation accounting, trying to come up with a solution that would satisfy both the users of accounting information and the persons responsible with the preparation of financial situations. Also, the pressures and controversies from that period are also responsible for the importance of decisional utility - especially in the case of investors from the capital markets - the center of the objective of financial statements. This was a major step at that time, making the transition from the traditional vision - which stated that accounting has legal goals, which are linked to the responsibility of managers towards the shareholders - to the decisional utility, as a possible extra benefice. Later, there were opinions that considered the focus reorientation as exaggerated, according to current revisions of conceptual frameworks. Whittington (2008) and Ronen (2008) include in their works various discussions regarding the current state of provisions regarding fair value and conceptual framework, and the measures that need to be taken in this matter. Bradbury (2008) and Turley (2008) comment on their opinions,

suggesting a series of amendments. Even after these debates, Wells' opinions (2003) conclude in a philosophical yet complete way the fact that:

The base of an adequate conceptual framework can only be found in the mechanisms of day-to-day commerce…where money represents the modality of exchange and the measurement unit of the characteristics of goods and services, obligations and benefits. As long as the function of accounting is to answer the needs of the ones who act in the market, the market is the place where we must find the base of a conceptual framework.

Hitz (2007) has a different perspective on the notion of decisional utility of reporting systems based on fair value evaluations, analyzing in detail the theoretical solidity of the arguments belonging to regulating organizations in favor of fair value evaluations, especially from the point of view of the relevance, which determined the adopting of standards focused on various financial instruments and some non-financial elements of the new evaluation paradigm. His analysis - having an a priori economical angle - approaches two aspects of decisional utility: the evaluation perspective and the informational one. The results he obtained indicate the fact that decisional relevance of fair value evaluation can be justified from both perspectives, but the conceptual framework of this type of evaluation is not fully congealed. Another important aspect was that the comparative analysis between fair value accounting and historical costs one generated mixed results. Thus, an immediate implication of this study is that it emphasizes the necessity of clarification from the point of view of the regulating organizations, the income notion and the ability of fair value to increase the level of decisional relevancy before continuing in widening the application sphere of fair value accounting.

4. Concluding remarks and future developments

When discussing financial reporting, there already exists the tradition of the contrast between evaluations based on historical costs, which are considered credible, but at the same time irrelevant, and evaluations based on current values or market based ones, which can be thought of as being more relevant and less credible. The opposing parties' arguments suggest the fact that investors would become refractory to base their decisions on subjective estimations of fair value (Barth, 1994, p. 3). We can therefore conclude that when markets related to assets and debts that are evaluated are sufficiently profound to permit their evaluation, a fair value evaluation is completely adequate. But while informational qualities of market supplied values are undeniable - in the context of complete and perfect markets - the use of fair value evaluation for purposes such as evaluation and contracting is still unclear in a real context (Beaver et al., 1989: 161). We could assert that accounting standard setting bodies in the US and other international ones have evolved in the same direction. The Joint Work Group (JWG) initiated by the International Accounting Standards Committee (IASC – the IASB's predecessor) was the one who identified the main advantages of a market value based accounting for financial instruments. These refer primarily at the use of more current and relevant evaluations in the balance sheet, and secondly to generating results reflected in the profit and loss account, results which were superior from the point of view of the stewardship relation, and of the forecasting value[‡‡‡‡]. Barth and Landsman (1995) also present a general analysis of arguments for and against the use of fair value and of market based accounting in financial reporting. Although not highlighted by the JWG, there is an aspect that can't be ignored (Gwilliam şi Jackson, 2008): accounting that is based on market provided values eliminates, at least from the theoretical point of view, the possibility for managers to chose the moment for profit and loss recognition.

[‡‡‡‡] The basis of the conclusions that the JWG reached regarding fair value use in the case of financial instruments can be accessed using the following link
: http://www.iasplus.com/agenda/jwg.htm.

The effects of this situation would be felt in multiple countries and regulations. For example, according to UK regulations, even though the reevaluation of long term debts was not allowed, it was always permitted for a company financed through bonds to refinance them in a manner that would allow any change in value reflecting interest rates changes to be incorporated within the profit and loss account once refinancing takes place, despite the fact that - ignoring transaction cost - the cash flow could not have been affected at all.
Creating a hybrid accounting system in which historical costs accounting is combined with the fair value one, or, in other words, a dual accounting system, is also analyzed by accounting research literature, which identifies a series of disadvantages generated by distortions of the reporting systems' coherence, thus facilitating the recognition of gaining resulted from managerial decision and embellishment of financial statements (Barlev and Haddad, 2004). Using market based evaluations can create problems for hedge operations regarding cash-flows, generating a context in which double attribute issues, therefore affecting the information provided by fair-value (Gigler et al., 2007; Shin, 2007). When assets are evaluated at values provided by the markets, and debts are not evaluated at fair value, the possibility of a significant distortion in the financial statements focused on equity is created. In this case, there are two possible outcomes: overrating or underrating that value (Wallace, 2008), depending on the interests of the distortion. Using the mixed attribute model leads to new information, this in turn can be misleading for its respective users, and reporting for hedge operations is difficult and opaque (White, 2008). Barlev and Haddad (2007: 495) succeed in underlining the connection between international accounting harmonization and the fair value accounting paradigm, by starting from the premises of the accounting comparability used in defining international accounting harmonization, the supporters of which consider necessary the elaboration of a unique set of Generally Accepted Accounting Principles – GAAP. These principles would lead, in their opinion to a complete "harmonization" at international level. They also bring to our attention the existence of a second requirement necessary for reaching a "complete harmonization", i.e. a common denominator in the evaluation, recoding and reporting of transactions, assets, debts and equity, thus considering feasible the option of fair value paradigm, unlike the historical cost one. The concept of fair value has the capacity to offer that needed common denominator, which is necessary for the comparability of accounting information. This denominator acts like a catalyst during a harmonization cycle: fair value spreads international accounting harmonization, which in turn generates more useful information that could be beneficial for the efficiency of global markets, the final consequence of these results being increases in the quality of fair value that was evaluated in this manner (Barlev and Haddad, 2007: 498).
We conclude our analysis by stating that our findings could be completed by developing a similar analysis on studies in accounting research literature that have an empirical approach to fair value accounting and its implications.

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