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TOWARDS A CRITICISM OF FAIR VALUE ACCOUNTING

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Abstract. *Fair value accounting has been subject to serious although not numerous criticisms throughout all development stages. The lack of convincing empirical evidence about its inherent weaknesses was a basic argument for rejecting and challenging these criticisms. The world financial crisis that began with the crash of financial markets in the US, in September 2008, provided numerous data that incited the examination of fair value accounting, among else. In the paper, the author contributes to the criticism of the fair value concept. The focus of the paper is on some serious shortcomings that are, in the author's opinion, taken less into consideration when treating this issue in Serbia and the world. Some of these shortcomings stem from wrong target orientation of annual financial statements based on fair value accounting. Others are the result of unavoidable conflict of the concept with the basic principles of accurate balancing. Finally, the author points out those weaknesses of fair value accounting that negatively reflect on basic characteristics of accounting information in a number of situations. Generally speaking, the paper deals with inherent conceptual limitations with numerous repercussions on the users of financial statements that cannot be removed through reforming. Thus, the author supports the planned and time-limited abolishment of fair value accounting as a measurement attribute in IAS/IFRS.*

Key Words: *fair value accounting, principle of accurate balancing, target orientation of financial statements, qualitative characteristics of information, financial crisis*

INTRODUCTION

Rapid development of new financial instruments in the last two decades of the 20th century in the US resulted in the creation and development of fair value accounting. It has been imposed on many other countries through International Accounting Standards (IAS), i.e. International Financial Reporting Standards (IFRS). This kind of accounting was glorified as a new accounting for a new millennium. Truly, there were serious and argumentative criticisms of this accounting model by certain respectable Nobel Prize holders, renowned professors in the area of accounting, some banking and regulatory accounting

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bodies as well as respectable politicians. However, their warnings could not stop the euphoria. The euphoria was based on the growth of real estate market and financial markets in the US, especially at the turn of the century. Namely, under such business conditions, fair value accounting produces greater financial results, i.e. results increased for unrealized gain, which "dresses up" the image of business successfulness of corporations and the economy as a whole.

The painful sobering began on 12th September 2008. On that Black Tuesday, the market crash in the US pushed the whole world into an economic crisis of worldwide proportions. The crisis showed that modern financial instruments created through financial engineering are not sophisticated, that financial markets are not perfect and the neoliberal concept of American capitalism is not the end of history. The crash of financial markets revealed that fair value accounting was not an objective measurement attribute for the positions of financial statements. Moreover, the financial crisis was the occasion for examining fair value accounting. These examinations are still in progress because the number and complexity of causes of the crisis, their interrelatedness and multiple effects reduce the possibility for analyzing the contribution of such a reporting to the current crisis. However, many measures undertaken, immediately after the crisis and in the past two years, in the area of regulation of financial reporting according to fair value accounting, point out that there is a connection. Hence, the measures such as IAS 39 and IFRS 7 would not have been carried out at all and requests for its abolishment as a measurement attribute would not have been so numerous.

In professional literature and within regulatory bodies, the critics of fair value accounting pointed to serious shortcomings of the concept, controversial from the moment it has been created. The seriousness of their criticism was added by empirical foundation based on data from the financial markets and real estate markets in the US in the period of market growth, the period of the first serious warning signals as well as in the period after the crash of the stock market.

In this article, I have the intention to give a contribution to the criticism of fair value accounting through considering its serious shortcomings that are not or are rarely considered in Serbia and elsewhere in the world. In my opinion, this concept is not scientifically grounded, but forcefully imposed on the accounting profession through lobbing of certain powerful financial investors. In order to prove this starting hypothesis, the paper has been conceived so as to include the following sections:

- Target orientation of annual account and fair value accounting,
- Propositions of accurate balancing (Die Grundsätze ordnungsmässiger Bilanzierung)[1] and fair value accounting, and
- Quality of financial statements and fair value accounting.

1. TARGET ORIENTATION OF ANNUAL ACCOUNT AND FAIR VALUE ACCOUNTING

Basic financial statements (balance sheet and profit and loss statement) are the result of annul balancing of business books that are managed in financial accounting. In profes-

[1] Although there are some similarities, it would be incorrect to identify the phrase accurate balancing principles (Die Grundsatze ordnungsmassiger Bilanzierung) with the phrase "generally accepted accounting principles"

sional literature, the dynamic theory of balance sheet, i.e. dynamic understanding of the main purpose of balance sheet dominated until the 1990s of the prior century. It concerns financial reporting oriented on gain with the annual account's main aim of establishing comparable financial results. According to this standpoint, profit and loss statement has a priority in contrast to balance sheet. Namely, the financial result is established by confronting all income and expenditures made throughout the year, i.e. from January 1 to December 31. Balance sheet has a supporting instrument role in the procedure. It undertakes all the positions that have not yet come for profit and loss statement. "The opinion that the main aim of balance sheet is the participation in computing the business results can be understood as a prerequisite for balancing annul income and expenditures in the amount suited to a related accounting period. Income and expenditures related to the current accounting period are taken over by balance sheet and stored as future unconverted potential."[2]

The target orientation of annual account is a theoretical basis out of which rules are drawn for assessing balance position, whereby other numerous tasks of financial statements are placed in the background. Namely, aside from primordial aim, financial statements have other numerous aims and tasks that are conditioned by requests of numerous internal and external users of balance information. Their realization is allowed under the condition that does not seriously jeopardize the realization of the primary aim-business successfulness measurement, i.e. realized gain measurement. The mentioned aim is in compliance with the basic postulates of market-oriented economy based on shareholding. "E. Edwards and P. Bell emphasize that gain represents one of the key elements of information according to which private free economy functions. Adjustable gain measurement is of essential importance for sound business management, for internal (not less important M.S.) assessment of business decisions made in the past in order to make better decision in the future".[3]

These few introductory statements about the primary target orientation of basic financial statements and their mutual relation in the annual account, has been necessary to consider in order to remind readers that the dynamic theory of balance sheet, under the dynamic and contemporary conditions, has survived throughout the century. Also, it is known that the theoretical basis for gain-oriented financial reporting is connected tight to the assessment of the balance positions according to the purchase price principle, i.e. purchase value as well as the conservatism principle. It is most important that carefully measured gain is not only in the interest of the ownership equity but other interested stakeholders.

Since the 1980s of the prior century there have been numerous changes in the functioning of corporations and economy of the US. Liberal fundamentalism has gained its full theoretical accountability (Chicago school of economics, with the Nobel Prize winner Friedman as a lead) and economic practice produced new financial and economic transactions and categories. In the myriad of theoretical attempts to explain rationally, within the leading paradigm, the aims and postulates of global corporations, many theories emerged in the U.S.

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[2] Jovan Ranković: "Teorija bilansa", Ekonomski fakultet Beograd, Beograd, 2008, p. 62.
[3] Dejan Malinić: "Politika dobiti korporativnog preduzeća", Ekonomski fakultet Beograd, Beograd, 1999, p. 19

The theory according to which maximizing the wealth of owners is proclaimed the fundamental aim of enterprises has become the dominant theory in the professional literature. "Recently, there have been many arguments about creating value for owners, i.e. shareholders as a primary aim of modern corporate enterprises' success. In that context, it is emphasized that created value in the commercial market must be valorized in the capital market, thus increasing the wealth of shareholders".[4] It is easily understood that this entirely new approach in defining the primary aim of entities has numerous important repercussions on business, financial and other activities of American corporations and the economy as a whole. The fact that is of interest for the subject of the article is that this theory laid the foundations for fair value accounting, with the aim of replacing, at the final development stage, the dynamic theory of balance sheet as a theory not suitable for contemporary conditions of economic activity at the end of the second and the beginning of the third millennium.

"Wishing to implement changes in financial reporting, IASB concentrated on fair value accounting as a sole principle that could introduce positive changes all the way through."[5] In accordance with the proclaimed principle, i.e. when it is consistently applied, assets and liabilities in balance sheet are evaluated according to fair value. It is considered that in that case the difference between assets and liabilities represents the fair value of net assets, i.e. net worth. The change in value of such established net assets at the end of year in relation to the start of the year actually represents financial result-gain or loss. This practically means that balance sheet has a priority in the annual account and that profit and loss statement is a supporting financial statement. To simplify, starting with the principle for estimating some specific securities in financial statements, interesting for some institutions and some securities, FASB and IASB have, by spanning its application to all assets and liabilities positions, defined a new target orientation of annual account. That way, the primary aim of annual and periodical reporting has been radically applied. In other words, the modern version of financial reporting oriented on assets has been created.

"Fair value accounting has for its aim disclosure of fair value of net assets on the day of reporting and disclosure of results that reflect the change in fair value of net assets."[6] The validity of this fundamental assumption of fair value accounting i.e. the standpoint that the target orientation of annual balancing of business books is the establishment of financial results through establishment of the difference between fair value of net assets at the end of the year and net assets in the beginning of the year can be refuted through many arguments.

The following can be pointed out:

1) Disclosure of unrealized gain can jeopardize capital retention,
2) The disclosure power of profit and loss statement is degraded,
3) The disclosure power of balance sheet is derogated,
4) Fair value is a hypothetical measurement attribute because of which there are serious practical difficulties for its reliable measurement.

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[4] Vlade Milićević: "Upravljačko računovodstvo i kreiranje vrednosti za vlasnike – savremeni pristup rentabilnosti preduzeća", Zbornik radova sa XXXII simpozijuma SRRS, SRRS, Zlatibor, 2001, p. 75

[5] Mirko M. Milojević: "Fer vrednost – privlačna i problematična", "Revizor" br 49/2010, Institut za ekonomiku i finansije, Beograd, p. 13

[6] Kata Škarić-Jovanović: "Finansijska kriza – povod za preispitivanje osnova vrednovanja u finansijskim izveštajima", Zbornik radova sa XL simpozijuma SRRS, SRRS, Zlatibor, 2009, p. 414

1) Financial result established in compliance with the premises of fair value accounting contains unrealized gain. It is a great danger to a corporation and all other stakeholders because the distribution of unrealized gain jeopardizes the substance, i.e. enterprise capital and can endanger the survival of the enterprise. In the professional literature in this area there is no established approach that can rationally defend the disclosure of unrealized gain. By contrast, from the 17th century to the present day, the professional literature has documented in detail the negative consequences of disclosure of unrealized gain. Economic practice, numerous past crises across the world and the current crisis testified to the danger of disclosing, distributing and making decision on the basis of the result plus unrealized gain. Considering this, it should be pointed out that there is a group of critics of fair value accounting that "do not accept the application of fair value since they consider the disclosure of unrealized gain unacceptable in itself"[7]. Since I analyze fair value in the paper, it is fair to say that the author belongs to the mentioned group of critics, which can be seen in the fact that the treatment of unrealized gain has been given a priority in the series of arguments to challenge the scientific foundation of this concept. Namely, I consider accounting and financial reporting to be in the function of capital maintenance.

2) Assigning balance sheet a role of the main instrument for periodicity of financial results degrades the role and importance that profit and loss statement has. It loses its function of an instrument for establishing financial results according to the type, amount and sources. This has been recognized and clearly emphasized in the professional literature: "Disclosure power of profit and loss statement is strictly limited".[8] This erroneous approach favoring balance sheet diminishes the organic relation to profit and loss statement and derogates the role and place of profit and loss statements in financial reporting so that it is not suitable for most of the users of balance information. Namely, profit and loss statement has taken a new role of informing on business risks. It is clear that this is an impossible mission because it is not possible to assess risks in the unpredictable financial markets on the basis of information from profit and loss statements. Even under assumption that this is possible, the investors would be unjustifiably favored as the financially and lobbystically strongest group. Prior experience reveals that gain-oriented financial reporting pays attention to information needs of all stakeholders.

3) Supporters of fair value accounting think that information in balance sheet totally meet information needs of investors since the assets, liabilities and net assets are estimated according to fair value on the balance day. However, financial result formed as a difference between fair value of net assets at the end of the period and fair value of net assets at the beginning of the period does not have satisfactory disclosure power to account for the derogation of financial results in profit and loss statement. Namely, "Market value is unpredictable and prone to changes depending on future information that are not still available and whose movement cannot be predicted. On these grounds, it is acceptable to say that the value is random. If the value is random than the changes in it (fair value of gain/loss) are random as well."[9]

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[7] Vladan Pavlović, Isidora Ljumović: "Finansijska regulativa u SAD kao pokretač aktulne svetske krize", "Računovodstvo 5-6/2009, SRRS, Beograd, p. 87

[8] Kata Škarić Jovanović: "Finansijska kriza – povod za preispitivanje osnova vrednovanja u finansijskim izveštajima", op.cit. p. 427

[9] Mirko. M. Milojević: "Fer vrednost – privlačna i problematična", op.cit, p. 14

The above citation points to a logical conclusion that it is not possible to project neither the amount of future results nor fair value of net assets on the basis of thus determined result. This is an argument that seriously questions the very fair value accounting as an acceptable alternative for accounting of historical costs because, aside from disclosure power of profit and loss statement, it derogates the information power of balance sheet. These are serious shortcomings inherent to the concept that cannot be dealt with through reforming the concept.

4) Finally, the question of defining and practically determining fair value is raised. According to US GAAP and IAS 39, a fair value is the amount for which an asset can be exchanged or liability settled between informed, willing parties within an independent transaction. Careful reading and correct interpretation point to the conclusion that this is a hypothetical assessment. The guidelines for its establishment reveal that it is possible to quantify this hypothetical category in three ways; first, as an output market price in the active and liquid assets market, i.e. liability on the balance day. For assets and liabilities that there are no such markets, fair value is established by means of some assessment methods based on certain assessment and current prices from the liquid market. The third way of quantification is reserved for specific assets and liabilities and encompasses the application of internal quantitative statistical-financial models that the management chooses itself because in this case market information are useless for determining fair value. Economic realty in over hundred countries in the world in which the IFRS and fair value accounting are applied reveals that liquid active markets for a large number of assets and liabilities is a distant future. Even in the U.S., where the concept was created, the banking sector used unexpectedly the third way of establishing fair value that was highly subjective one. "The principle of fair value is contradictory when evaluating illiquid assets because the subjective and fair are opposing concepts and the subjectivity is evident in evaluating illiquid assets."[10] Aside from that, the practice has shown that in the case of market bubbles (booms), the value of some assets in financial statements is overestimated, while in the case of market failure is underestimated. In such cases, the question is raised concerning the objectivity of fair value established in market-market model, i.e. the first hierarchical quantifying level. This practically means that fair value accounting is target-oriented on disclosure of fair value of net assets in balance sheet based on measurement attribute prone to subjectivism and/or important market oscillations (market bubble, market failure, market speculations, and as such does not provide any valid guarantees for true and fair insight into financial and rentability position of corporations.

On the basis of what has been said, a conclusion can be drawn that fair value accounting has a target orientation not suitable for the 21st century (assets oriented financial reporting), thus degrading the representation power of balance sheet and profit and loss statement. It is also based on the assessment principle that is prone to exchange cycles and speculations and internal subjective calculations of the enterprise's management. This is the basic reason why shareholders that lost thousands of billions in 2008 were not able to recognize risks the corporations had been exposed to and were not able to adequately control the management in the process of annual financial reporting. It was argued stubbornly that these were the fundamental benefits of the model.

[10] Mirko M. Milojević: "Fer vrednost-privlačna i problematična", op.cit, p. 17

2. THE PRINCIPLES OF ACCURATE BALANCING (GRUNDSÄTZE ORDNUNGSMÄSSIGER BILANZIERUNG) AND FAIR VALUE ACCOUNTING

The principles of accurate balancing are the rules whose application secures formal and material correct financial statements. Considering that the basic financial statements are the product of periodical balancing of business books, after the inventory has been taken, the principles of accurate balancing comprise a systematic whole including proper bookkeeping and principles of regular inventory taking. Their adequate application should enable the making of balance sheet that provides true and fair insight into property, liabilities, net worth, expenditures, profit and financial result. The importance of the principle of accurate balancing has been established through the Fourth Directive in the EU that is related to annual accounts of capital societies. Namely, one chapter of the Act is dedicated to this issue. It is interesting that in IFRS/IAS only some principles of accurate balancing randomly processed within the Framework for the Preparation and Presentation of Financial Statements. Qualitative characteristics of information are especially emphasized in financial statements as if it were possible to achieve the wanted quality without principles. Such an approach, drawing on US GAAP, enabled the violation of some basic principles of accurate balancing in some standards in which the estimation of property parts and liabilities according to fair value is regulated.

When I say that some basic principles of accurate balancing have been violated I point to the following principles:

1) conservatism principle,
2) objectivity principle,
3) accuracy principle,
4) consistency principle,
5) authenticity principle (principle of truth), and
6) matching principle.

1) The conservatism principle is the oldest and most important principle of accurate balancing. It was introduced to practice in the early development period of accounting. It was first examined in the professional literature at the end of 17th century in The Perfect Merchant by the French author Jacques Savary. The changed economic circumstances at the beginning of the 20th century created through the development of shareholding influenced a careful definition of the principle through four principles. These are the realization principle, imparity principle, lowest value principle and highest value principle. Fair value accounting is not in compliance with the conservatism principle. For example, "losses and gains in derivates (and other positions estimated according to fair value) are accepted by acknowledging ex ante approach and by leaving the realization as too strict a criterion that would impede the timely recognition, correct and fast reaction of investors and other users to information about losses and gains in such a derivate arrangement."[11] In other words, fair value accounting allows the representation of the unrealized gain. The danger carried by the disclosure and distribution of unrealized gain has been explained in detail and through arguments in the university textbooks and are generally known. The

[11] Goranka Knežević: "Izveštavanje o finansijskim derivatima u funkciji unapređenja kvaliteta finansijskog izveštavanja", Zbornik radova sa XXXVII simpozijuma SRRS, SRRS, Zlatibor, 2006, p. 219

above argumentation has been proven by the current crisis. "To what extent has book-keeping of unrealized gain influenced the crisis is not possible to express quantitatively. The phenomenon of recognizing unrealized gain that represents the basis for paying out enormous bonuses reflects the spirit of the time we live in: time in which financial elite allocates and spends something that was not earned, and the price is paid by the whole world."[12] The possibility of spending what has not been earned as a consequence of disclosing unrealized gain is an argument that discredits fair value accounting as a concept that is not scientifically based since this can lead to the capital erosion. For corporations, financial markets and economy as a whole, this is a concept whose application in interaction with other factors creates ungrounded optimism. "Critics that do not accept fair value consider that the representation of unrealized gain, under the conditions of unreal, i.e. inflated prices, creates a false picture of economic growth and incites consumption and think that the application of fair value contributed to the current crisis."[13]

2) The objectivity principle is a request that is reflected in the possibility of control (Nachprufbarkeit), which points to the connection with Schmalenbach's demand for excluding the self-will in fact-based assessment (the safety principle). This principle must be taken into consideration every time, when there is a choice between a number of value assessments"[14]. As it has been explained in the first section, there is a possibility, within fair value accounting, of choice between three models of its quantification on the balance day. This possibility is determined by the liquidity and activities in the assets market, i.e. liabilities that are evaluated on the balance day. Namely, it is considered that exchange prices in highly liquid markets with a continual trade of large scope is the best approximation of fair value on the balance day. Considering that this assumption about the existence of active markets for numerous property objects and liabilities is opposite to economic reality, it has resulted in two repercussions. Firstly, it is determined by using different assessment methods. The larger the share of property and obligations assessed according to various assessment techniques, the lower the reliability of balance information since this involves internal techniques chosen by the enterprise's management and that comprise the wide range of quantitative and statistical models. Secondly, this challenges the application of fair value as a round accounting concept since it greatly reduces the number of positions that can be assessed in compliance with it and the number of countries in which it can be applied.

The first repercussion has been evidenced in practice. According to data issued by the American Securities and Exchange Commission, most of financial institutions have over 50% of financial instruments in assets evaluated according to fair value on 31 July 2007. However, "in most of the mentioned institutions (Goldman Sachs, Deutsche Bank, Credit Suisse, UBS etc-M.S.) evaluation of financial instruments was undertaken not by applying Level 1 measurement inputs, that is quotation, but by applying Level 3 parameters that are to the greatest extent of subjective character. The evaluation used management defined parameters that are based on different assessment techniques and basic instruments for the

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[12] Vladan Pavlović, Isidora Ljumović: "Finansijska regulativa u SAD kao pokretač aktuelne svetske krize", "Računovodstvo br. 5-6/2009., SRRS, Beogra, p. 90

[13] Vladan Pavlović, Isidora Ljumović: "Finansijska regulativa u Sad kao pokretač aktuelne svetske krize", op.cit. p. 87

[14] Jovan Ranković: "Teorija bilasna", op. cit. p.164

same instruments."[15] The reliability of used assessment techniques of fair value in American financial institutions was reflected in 2008.

The other mentioned negative repercussion has been evidenced in practice. In numerous countries which apply IFRS/IAS, from different reasons, financial and other markets are not developed to fulfill the definition of active and liquid markets. This raises the issue of possible application of fair value accounting in these countries as well as issue of respecting the objectivity principle under such conditions.

3) The accuracy principle represents a set of demands that influence the material content of financial statements with the aim of real representation of business events and transactions in bookkeeping and financial statements. There is among them the demand for the basic financial statements to be composed on the basis of really made entry as well as demand that certain positions are accurate, i.e. correspond to facts. The completeness principle as a composite part of the accuracy principle implies the representation of the effects of all really created business events. The example of derivate financial instruments is sufficient enough to illustrate the argument that fair value accounting in some situations conflicts with the accuracy principle.

Derivative financial instruments are based on the so-called totally inactive agreements. This practically means that signatory parties have concluded an agreement and thus promised to act in a certain way, whereby it has not come to the realization of rights and obligations". Thus, the participants in the market make derivates by entering into contractual relations of buying and selling that will end in the future on a certain date, for example, in the next 24 hours or rarely in five years."[16] From the aspect of the accuracy principle, the issue of such a way of concluding financial transaction agreements is irrelevant until the moment the business event is created as a basis for accounting scope and consequently representation of financial statements.

Namely, the Framework for Composition and Presentation of Financial Statements unambiguously demands that assets, liabilities, expenditure and income should be the consequence of past business events and transactions (accrual basis of accounting). However, fair value accounting diverges from this stance by questioning the accuracy principle. "While until the past two decades of the prior century a past event implied the transaction in the execution of which the enterprise participated and whose immediate consequence is the creation of assets, income, liabilities and expenditures at the present moment, the past event, the consequences of which should be presented in financial statements, implies entering the contract that will be fulfilled on a future date under the conditions established at the present moment."[17]

In this regard, importance is assigned to "the fact that IAS 39 puts the contractual relation (contract basis) in the focus of recognizing derivate financial instruments not the past transaction of attaining/exchanging assets (exchange transaction basis), i.e. the prior

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[15] Goranka knežević: "Izazovi vrednovanja finansijskih instrumenata u uslovima krize", Zbornik radova sa XL simpozijuma SRRS, SRRS, Zlatibor, 2009, p. 447/448

[16] Željko Albaneze: "Zakonska i profesionalna regulativa o finansijskim derivatima", "Računovodstvo" br. 5-6/3003. SRRS, Beograd, p. 28

[17] Kata Škarić Jovanović: "Finansijska kriza – povod za preispitivanje osnova vrednovanje u finansijskim izveštajima", op. cit. p. 417

event as a basis for recognizing elements of balance sheet."[18] That way, it came to ex ante recognition and assessment of some positions of financial assets and liabilities. It is logical that what might happen cannot evaluate according to historical costs but according to fair value established in compliance with IAS 39, i.e. SFAS No. 1333. "The mentioned standards, although developed by different professional authorities, had the following mutual effects on the relevance of accounting information:

– Total balance presentation of derivate instruments and
– Domination of fair value over historical costs."[19]

The above effects show that in the process of building fair value accounting, the completeness principle as a composite part of the accuracy principle borders on the absurd. Namely, instead of being exhibited in off-balance sheet assets and liabilities and/or notes, financial derivates are exhibited in balance sheet before the contract on which they are based starts to produce real economic-financial effects for participants in the transaction.

4) The consistency principle comprising formal and material continuity has as an aim the comparison of information contained in balance sheet in a serious of consecutive accounting periods. Namely, only on the basis of comparable information the changes in financial and rentability position of enterprise in time succession can be really assessed. "Hence, the meaning of the consistency principle lies in the protection of requests for monitoring the development of enterprises in time, which can be endangered through reasons that make balance sheet incomparable."[20]

Formal consistency principle, among else, presumes unchanged content of certain group of assets, liabilities, expenditure and income. This implies that balance positions or groups cannot be willfully joined and separated, either be it the case of the whole or parts. This means that the definition of balance groups and balance positions and their content in the sense of items that they encompass must be clear and unchangeable in the long period of time. Material consistency principle is realized through consistent application of rules and methods in evaluating the successive annual financial statements.

Since the imposing of the revolutionary concept of fair value, as it was called, was done in the area of financial instruments, one can easily prove, on the example of their classification and assessment, that fair value accounting does not comply with the consistency principle. The professional literature testifies "to the creation of contemporary classification of financial instruments in the context of the globalization of financial markets. It is based on new demands and in the context of evaluation of financial instruments."[21] There is an agreement in the professional literature on the fact that the classification of financial instruments in US GAAP and IFRS/IAS is not based on theoretical grounds, but is the product of FASB and IASB.

This classification lacks the scientific grounds since the classification of financial assets into several categories is based not on objective criteria, but the intentions of the en-

[18] Goranka Knežević: "Izveštavanje o finansijskim derivatima u funkciji kvaliteta finansijskog izveštavanja", op. cit. p. 209.
[19] Goranka Knežević: "Izveštavanje o finansijskim instrumentima u funkciji kvaliteta finansijskog izveštavanja", op. cit. p. 230
[20] Jovan Ranković: op.cit. p. 167
[21] Goranka Knežević: "Izazovi vrednovanja finansijskih instrumenata u uslovima finansijske krize", op.cit. p. 441-

terprise's management. The intentions of the management are a totally subjective category that is difficult to document and that cannot be changed according to personal interests of the management. At the time of the inauguration of the contemporary classification through IFRS/IAS, i.e. US GAAP, no limitations in terms of changing the intentions of the management were laid. Since the classification was laid in the context of evaluating financial instruments, with the change in the intention the way of evaluating also changed. Therefore, the value of net assets in the balance sheet and the financial result in profit and loss statement are changed as well. Thus, the standards opened the possibility of opposing the principle of formal and material consistency and making financial statements in time series incomparable through reclassification and consequent change in the way of evaluation.

Paradoxically, IASB in October 2008 allowed, through amendments in IAS 39, the reclassification for some financial instruments with a retrospect application from 1 July 2008. "Through criticizing such revision of the demands of fair value accounting, the rating agency Moody sets forth the data that Deutsche bank will in financial statements for the third quarter of 2008 reclassify the assets valued at 32 million dollars through maneuvering, on the basis of reclassifying assets and choosing the best price and thus avoid the loss of 1 billion dollars."[22] By using this retroactive change in IAS 39, most of American and European banks and other financial institutions experienced better financial results in the third quarter of 2008 the described events enabled the comparison of financial statements in the quarters prior to crisis, the quarter of intense crisis and in the quarters to follow. Thus, the comparable information basis for analyzing the causes and consequences of the crisis in the financial sector was lost.

5) the authenticity principle (principle of truth) is defined differently in professional literature, because the truth is an ethical category as an notion. However, the practical problems in the application of the principle, regardless of lesser or greater differences in its starting definition, led to the agreement on the view that the realization of the truthfulness principle in composing financial statements presumes both the compliance with the accuracy principle and objectivity principle (the principle of excluding the self-will of the accountant). The accuracy principle is the starting point of the principle of forbidding the representation of erroneous and fictive positions in financial statements and the completeness principle. "Violation of the material accuracy regarding forbidding the representation of erroneous (false) or fictive positions implies not only inclusion into a balance of inexistent, but the inclusion of unjustifiably high amounts…" [23]

The growth of assets value in the US in the period before 1995 was important and lagging behind the inflation rate. It reflected on the increase in the value of investment real estates in balance sheet and unrealized gain in that regard in profit and loss statement. Among corporations that chose to value the real estates that are part of the position-real estates, plants and equipment according to alternative procedure, i.e. fair value, the value of real estates in assets increased as well as revalorization reserves, i.e. net worth in liabilities.

American experts that examined the growth of real estate price by means of data series for 50 (Dean Baker), i.e. 100 years (Robert Shiller) pointed to the bubble price of real

[22] Marija Pantelić, Miroslav Todorović: "Finansijsko izveštavanje banaka – može li biti uzročnik finansijske krize i kako ga urediti nakon nje", "Ekonomika preduzeća", mart-april 2010, Savez ekonomista Srbije, Beograd, p. 171
[23] Jovan Ranković: op. cit. p. 163

estates on time. "In August 2002 Dean Baker pointed out that the growth of real estate price in the US is the consequence of the creation of real estate bubble, thus forecasting the crisis."[24] Since the current crisis confirmed the forecasts and since the prices of real estates were high, it can be concluded that investment real estates and other real estates evaluated according to fair value were represented in financial statements in unjustifiably high amounts, which is opposite to the accuracy principle.

As it has been pointed out the fair value of financial assets can be established: on the basis of exchange price (mark-to-market model- Hierarchical Level 1 measurement) on the basis of the model that includes the price of active markets similar to assets or liabilities (mark-to-model Hierarchical Level 2 measurement) and on the basis of internal estimations of enterprise's management-(Hierarchical Level 3).

Unquestionably, there are many ways for evaluating some balance positions. In such cases, the intention of the regulator is to provide the accountant with the freedom of choosing, with the aim of possible using one option that under given circumstances most truthfully expresses the value of such positions.

The world economic crisis and crash of financial markets in September 2008 in the US showed that the mentioned freedom of choice, when it comes to financial instruments had been misused greatly, i.e. the evaluation through use of Level 3 parameters that are extremely subjective was spread widely in quarterly and annual financial statements of the largest banks and financial corporations. Thus, for example, the assets of financial institutions in the U.S. on 31 December 2007, "evaluated through use of Level 3 parameters reached the value of 160 billions of USD"[25]. These data confirm that the existence of three hierarchical levels was used to the great extent by the management for willful forming of assets value and amount of realized results. Practically, this means that the principle of excluding the self-will of the accountant is partly disturbed by imprecise definition of conditions under which certain models of establishing fair value are used.

6) The matching principle is a request for confronting all expenditures created for the purpose of creating the profit to profit of an accounting period in accordance with the realization principle. "Circumstance that between the creation of value (income) and value consumption (expenditures) there lies the connection makes the opinion that the main problem of periodization is assigning factor consumption through the realization principle to established income that is called subject classification logical."[26] Because of the importance that this principle has for accurate determination of financial results, it has been codified through the Fourth Directive. Also, in the European literature this principle is of a great importance. "Namely, under the assumption that the principles that underlie the concept of historical costs-the realization and matching principle have been consistently adhered to, the gain of the current period represented in the profit and loss statement is considered a reliable basis for forecasting future gain rates."[27]

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[24] Vladan Pavlović, Isidora Ljumović: "Finansijska regulativa u SAD kao pokretač aktuelne svetske krize", op. cit. p. 87

[25] Goranka Knežević: "Izazovi vrednovanja finansijskih instrumenata u uslovima finansijske krize", op.cit. p. 448-

[26] Jovan Ranković:"Teorija bilansa", op.cit. p.195

[27] Kata Škarić Jovanović: "Finansijska kriza – povod za preispitivanje osnova vrednovanja u finansijskim izveštajima", op.cit. p. 421

It is not difficult to explain the reasons why the concept of fair value inherently diverges from the matching principle. In quarterly and annual financial statements, the unrealized gain is represented. Some of them will in time become realized, although not in an initial amount. Others will in time transform from gains to losses because of the changes. For example, if the enterprise's management if the enterprise's management bought investment real estates at the time of a rising cycle at the real estate market, the unrealized gain related to balance position will appear. The passage of time makes possible the following situations. First, management has perceived that the cycle has picked and sold the real estates. In this situation, the unrealized gain represented in the previous accounting period has been proved in the market. Thus, it has come to movement of the financial result from period to period in the amount of unrealized gain. When the real estate bubble blows, the price of investment real estates will start to fall rapidly. According to the other possible scenario that is 180% in contrast to the previous, the management has not forecasted such a development of the situation in the market and has not responded on time, losing the opportunity to sell the investment real estates when it was possible, although at lower price from those bought at. In such a situation that many entities, real estates investors in the US have found themselves, the previously represented unrealized gain have been transformed into losses in this balance position.

The consistent application of the matching principle will not, in compliance with the economic essence of this transaction, cause the mentioned deformation of the financial result from quarter to quarter, from year to year, under the assumption that the real estates are bought when the prices rise, thus making profit at such difference. According to economic transaction logic, it would be evaluated according to purchase value during the purchase. During purchase, it would come to confrontation of sales revenues, and the difference would represent profit or loss that has been realized in the realization process that would be represented in profit and loss statement of the accounting period. Eventual remark, that the information on value of investment real estates would be old and past-oriented can be easily refuted. Namely, including information on fair value into notes accompanying profit and loss statements, investors and other stakeholders would have information about market price on the balance day.

To tell the truth, it should be emphasized that fair value accounting pays attention about matching principle. Namely, it concerns joining gains and losses created in the corresponding positions of assets and liabilities, which represents specific and very narrow understanding of the matching principle defined in such a manner in the context of fair value accounting.

3. The Quality of Financial Statements and Fair Value Accounting

Framework for Composition and Presentation of Financial Statements defines qualitative characteristics as those that make information presented in them useful for users. In addition, the following four basic characteristics are mentioned:

1) relevancy,
2) reliability,
3) comparability,
4) understandability.

Fair value accounting contains inherent limitations that prevent getting and presenting quality financial statements. I will explain theses serious arguments in the following section.

1) Relevance of information contained in financial statements, as a qualitative feature, connects the quality of information and decision-making on part of users based on this information. "The information is relevant when it affects economic decisions of users by helping them to valuate past, present and future events or by confirming or correcting previous users' valuations. Forecasting and verifying role of information are interconnected."[28] The problem of defining the rules and principles that should secure third very important qualitative feature of information has been created because of wrong understanding of forecasting role of balance information on part of creators of fair value accounting. Namely, it is understood for granted in terms of presenting future-oriented information in financial statements, i.e. an ex ante approach, which has already been mentioned in the previous sections of the paper.

More precisely, "Theoretically, the fair value principle in any moment reflects the already known information on future, so the current value of the firm is simply a difference between assets and liabilities"[29]. So, theoretically, the consistently applied fair value produces information relevant for users because it provides both forecasting and verifying role of information. However, the practical application of the concept in valuating financial assets, non-material investment, investment property, real property, plants and equipment as well as liabilities in the past two decades not only failed to confirm the mentioned theoretical decision of fair value accounting, but also refuted them. The practice of financial reporting revealed that it is not possible to valuate precisely future fair value of net assets on the basis of balance sheet as well as future financial results on the basis of profit and loss statement.

Fair value accounting does not offer information relevant to users neither under conditions of market expansion, nor under crisis conditions in the market and conditions of frequent short-term oscillations in the markets caused by speculating and other reasons. One should have in mind that the prior decades proved that the hypotheses on tamed economic cycles and efficient markets are far from the economic reality. Namely, "from 1970 to 2007 there had been 127 banking crisis, 208 currency crises, 63 debt crises, 42 double crises (banking + currency crisis) and 10 triple crises (banking+currency+debt crisis): IMF) across the world."[30] In the same period in some countries the real property bubbles and their bursting were evidenced. So, the view that " fair value accounting provides investors with relevant information for decision making..."[31] is not valid because practice shows no stable conditions in the environment ("the so-called normal business conditions") and efficient markets, i.e. the two primary conditions are not met for correct application of fair value accounting.

[28] "Medjunarodni standardi finansijskog izveštavanja (IFRS)", SRRS, Beograd, 2007, knjiga I, pp. 40-

[29] Mirko M. Milojević: "Fer vrednost – privlačna i problematična", op.cit. p. 14

[30] Ljubo Jurčić: "Finansijske krize", "Acta Economica", br. 10/2009., Ekonomski fakultet Banja Luka, Banja Luka, p. 60

[31] Marija Pantelić, Miroslav Todorović: "Finansijsko izveštavanje banaka – može li biti uzročnik finansijske krize i kako ga urediti nakon nje", op. cit. str. 170.

2) The next qualitative characteristic of information presented in financial statements that must be respected in order that information could be useful for users is reliability. In order that the information in financial statements could be reliable, the conservatism principle must be used in composing financial statements. According to the Framework for Preparation and Presentation of Financial Statements: "Conservatism implies the inclusion of certain degree of conservatism in making judgments necessary for valuating required by uncertainty conditions, so that property or revenues are not exaggerated, and liabilities or costs not reduced."[32] The realization of this correct and precise determination of the conservatism principle, implicitly implies the application of certain principles which secure that assets are not exaggerated (the lowest value principle), revenues are not exaggerated (the realization principle), liabilities are not reduced (the highest value principle) as well as that costs are not reduced (the imparity principle). It is evident that fair value accounting does not comply with the lowest value principle and highest value principle. Namely, the assets position that are valued according to fair value are always balanced according to hypothetical market price on the balance day, independent of being lower or higher in relation to the previous period. Analogically, the liabilities positions are valued according to the previous reporting period. Disregard of the lowest and highest value principle, among else, results in the disclosure of unrealized gain. Thus, the realization principle as a composite part of the conservatism principle is rejected.

So, fair value accounting is conceptually in conflict with the conservatism principle because it excludes the lowest value principle, the highest value principle and the realization principle. Considering that the Framework for Preparation and Presentation of Financial Statements considers only those information established through inclusion of the conservatism principle as reliable, it is clear that information represented according to fair value do not meet the reliability criterion, which is the unavoidable qualitative characteristic of financial statements.

3) Users of financial statements should be able to compare financial statements of an entity in a series of successive accounting periods in order to establish the succession. Also, they should have the opportunity to compare financial statements of various entities for comparative analysis of financial position and business successfulness. "Hence, the measurement and disclosure of financial effects of similar transactions and other events must be conducted consistently in the whole entity and during the time for that entity and consistently for different entities."[33] In other words, the realization of comparability as an important qualitative feature of accounting information implies the consistent compliance with the principle of formal and material consistency.

The application of fair value accounting in valuating non-material investments, investment real estates, real estates, plant and equipment, long-term and short-term financial marketing and long-term and short-term liabilities does not provide the comparability of financial and rentability position throughout time and between entities. Under the influence of market oscillations, from quartet to quarter, year to year, it comes to changes-increase or decrease of value position of assets and liabilities. Fair value of net worth also changes as well of financial result that is determined on the difference of fair value of net

[32] "Medjunarodni standardi finansijskog izveštavanja (IFRS)", op. cit. p. 42

[33] "Medjunarodni standardi finansijskog izveštavanja (IFRS)", op. cit. p. 43

assets. The changes in the amount and structure of assets as well as amount and structure of liabilities, the relation between certain parts of assets and sources of assets and financial result, as an unavoidable basis for comparing financial position and successfulness throughout time, are the result of changes in numerous oscillations in different markets (money market, capital market, investment real estates market, real estate market, plans and equipment etc) Thus, the financial position and successfulness of entities represented in successive time periods is incomparable.

When it comes to the comparability between different entities the existence of different models for establishing fair value (mark-to-market model, mark-to-model) prevents the comparison in numerous situations. In that regards "it is important to emphasize that model need not reflect all the factors relevant for the value of an asset and that this way of establishing value is related to the problems of spatial and time comparability."[34] There are in economic practice numerous examples showing that two corporations whose financial statements are subject to comparison, evaluate the same assets according to different values depending on the model for establishing fair value. Thus, the assumed quality of fair value comparability, i.e. theoretical standpoint that its application secures the comparability of entities viewed by FASB in terms of "using fair value for the purposes of comparison because the value of the same assets or liabilities is identical regardless of the entity it belongs to,"[35] has not been verified by practice. By contrast, in many cases there were numerous and serious problems of spatial and time comparability.

4) The Framework for Preparation and Presentation of Financial Statements points out that the understandability is the most important information presented in financial statements of general purpose. The comprehensibility of accounting information depends, among else, on the level stakeholders' knowledge of accounting and their knowledge of business, financial and other economic transactions and events. Considering that the educational level and profile of numerous concrete external users are individually conditioned, it is necessary to present the principal view within the Framework that the relevant information about complex economic categories must be disclosed in financial statements, although they might not be understandable for some users. If we have in mind this correct principal stance, this practically means that no objections to fair value accounting should be made in regard to the understandability of produced information.

CONCLUSION

On the basis of the aforementioned the following conclusions can be made:

1) Fair value accounting created and developed in the last decade of the 20th century and first decade of the 21st century in the U.S. and imposed through US GAAP and IAS/IFRS on many other countries across the world represents an unsuccessful attempt for creating a new system of financial reporting. This new concept should have replaced historical cost accounting. If you consider the guiding idea of fair value accounting i.e.

[34] Marija Pantelić, Miroslav Todorović: "Finansijsko izveštavanje banaka: može li biti uzročnik finansijske krize i kako ga urediti nakon nje", op.cit. p. 164

[35] Mirko M. Milojević: "Fer vrednost – privlačna i problematična", op. cit. p. 13

the valuation of assets and liabilities positions according to fair value and establishment of financial results on the basis of difference between the fair values of net assets disclosed in two successive balance sheets, then it can be concluded that this is a neo-static theory of balance sheet. Namely, consistently informing the complete accounting theory, fair value accounting represents the realization of classical static theory in the manner advocated by Herman Veit Simon in 1886.

2) According to its target orientation, fair value accounting represents assets-oriented financial reporting. The manner of realizing the aim has a number of negative consequences, of which the most important are the following:

– Disclosing and the possibility of distributing the unrealized gain is allowed, which can bring to the erosion of enterprises' capital,

– The disclosure power of profit and loss statement is degraded because it does not allow the analysis of financial results according to types, amount and sources. Namely, it gets the marginal role in contrast to balance sheet. This new role requires that the profit and loss statement serves primarily for informing on risk exposure in business,

– The information power of balance sheet is derogated because the changes in the fair value of assets and liabilities positions, from quarter to quarter, year to year, are the consequence of market oscillations. In concerns market booms, market failure, changes in the market caused by speculation that have as a consequence random measured fair value of net assets,

– Fair value is a hypothetical measurement attribute, quantification of which, in lack of liquid and active markets, results in wide scope of the subjectivity of accountants and management. In such cases, it is transformed from an objective to subjective measurement.

3) The application of fair value accounting in numerous situations leads to the disruption of the principle of accurate balancing. Theoretically, it can be proved and confirmed through numerous examples from the practice of financial reporting that the valuation according to fair value leads to the violation of the following principles: the conservatism principle, objectivity principle, accuracy principle, consistency principle, authenticity principle and matching principle. Materially-invalid financial statements are the consequence. More precisely, without complying with these principles, it is not possible to realize accurate and fair insight into assets, liabilities, capital, expenditures, income and financial result. The creators of fair value accounting tried to build the whole theoretical construction according to One-to-One Principle as a principle of the first rank and several principles of the second rank, whose only aim is to exclude the self-will in quantifying fair value. The financial crisis provided empirical evidence for arguing that the aim has not been realized to the greatest extent in financial statements of banks, other financial institutions and business entities quoted in the exchange markets in the US. This practically means that a careless rejection of fundamental principles of accurate balancing is not the result of their replacement by new efficient principles, but removal of impediments to valuation according to fair value.

4) Complying to the principle of accurate balancing through interrelatedness with the proper target orientation of financial statements and adequate standards is not the aim in itself. Their correct application should provide the high quality accounting information. According to the Framework for Preparation and Presentation of Financial Statements,

information are of quality if they are relevant, reliable, comparable and understandable. Fair value accounting, in many cases and in longer time periods, does not produce information relevant for decision making. The reason can be found in the fact that the "so-called normal business activities", efficient markets and lack of information asymmetry as prerequisites for the relevance of fair value, are the ideals to be obtained and not the economic reality of contemporary economies. The reliability as a qualitative characteristic of information presented in financial statements is inseparable from careful evaluation in valuating assts, liabilities, expenditure, income and result. Fair value accounting does not conceptually acknowledge the realization principle, lowest value principle and highest value principle as well as the conservatism principle as a one of the pillars of reliability. Comparability of financial statements in time and between entities is realized through the application of fair value because of the possibility of arbitrary way of determining the same.

5) There are numerous suggestions related to the future of fair value accounting that have been put forward in the period from the beginning of the crisis to the present day. They range from requests for prompt abolition of fair value valuation to suggestions of new ways for quantification of a "new fair value" that would be "more fair". The attained conclusions demand an opinion on the issue. In my opinion, fair value accounting should be rejected step by step in a reasonable short period, starting with the positions it was first applied from. The only reason against its prompt abolition as a whole is the consciousness about numerous negative consequences for the credibility of financial reporting and the accounting profession that such act would cause. Also, the confusion that would be created in the minds of the users of financial statements must not be left out.

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PRILOG KRITICI RAČUNOVODSTVA FER VREDNOSTI

Milorad Stojilković

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