Aspects Concerning Financial Debts and Assets' Evaluation at Fair Value

Andreea Elena Dreghiciu
"1 December 1918" University, Alba Iulia, Romania
deea_dreghi@yahoo.com

Abstract

In the actual context of the process of globalization and accounting normalization, within which the decisional process must be based on information which fulfill the quality characteristics required by the existing norms referring to a clear image, the notion of fair value is pointed out as a main coordinate.

Assets and financial debts, as well as all the patrimonial elements, are subjected to the process of evaluation, respectively reevaluation. Further evaluation of these elements may be realized at fair value a fact which leads to an improvement of the information which are furnished in financial situations, these becoming more reliable, and they have a smaller difference between accounting value and stock value for the rated entities.

The benefits of using the concept of fair value have made it presently extending upon all balance sheet items.

Key words: fair value, financial debts, evaluation
J.E.L. classification: M40, M41

1. Introduction

Even though not every informational necessity of users may be covered by given references in the published financial standing, there is a series of necessities which is common for every user. These necessities are satisfied by the objective of financial standing, namely the one of delivering information concerning financial position, performance and the evolution of financial position associated with an entity. (Feleagă, Malciu, 2002, p.27)

In order to present actual information, necessary for all categories of users, the entities must appeal to the instrument of evaluation, respectively reevaluation. This thing is due to the fact that there is a series of elements whose action leads to the burst of some distortions. The following factors may be included: open price, the national currency exchange rate, trader's internal managing. (Păvăloaia, Păvăloaia, 2006, p.215)

The economical evaluation, respectively reevaluation is made for determining the market value of an accounting element, thus giving current information. Concerning reevaluation, this means to evaluate again, usually for updating a preexistent value. (Todea, 2004, p.112)

The main concepts used in the evaluation process refer to types and categories of values, having different meanings when used in the evaluation activity. Among these, fair value is remarked, representing the amount for which an asset may be willingly exchanged between two interested parts which are witting, in a transaction in which the price is objectively determined. (Anghel et al., 2010, p.63). Though initially, the concept of fair value was associated only with financial assets, presently it has extended upon all balance sheet items.

Concieved and structured on a complex matter, the paper considers the presentation of some financial accounting elements, as well as a study case which basically reflects the implications of evaluating at fair value the assets and financial liabilities upon accounting recording of these elements.

2. Methodology

Any research which is supposed to be a scientific one should have a purpose. The purpose of this paper is that of presenting theoretical and practical aspects concerning subsequent assets and financial liabilities evaluation to a fair value.

The methodology comprises both theoretical research concerning the concepts and regulation in the domain, and also an empirical research. I proceeded to studying The International Evaluation Standards, papers concerning financial accounting, to analyzing regulations in the domain, thus being an explorative qualitative paper, and also I proceeded to studying practical aspects which are specific to assets and financial liabilities used when establishing their fair value, thus being a descriptive quantitative paper.

3. Fair value – basic concept in evaluation

Internationally, there still are questions about what exactly is the fair value, but also about its advantages and disadvantages.

According to IFRS 13 „Evaluation at fair value", fair value is the amount for which an asset can be traded or a discounted debt between parts being fully informed, in a transaction in which the price is objectively determined. (IFRS 13, 2008)

IFRS 13 specifies the factors which entities must take into consideration when evaluating fair value. These are: evaluated asset or liability, the market, market party / attendant, price.

Fair value is the price in the main market, and if there is no main market, this represents the price on the most advantageous market. It is the market price with the greatest volume and level of activity such as asset or liability, namely the market in which the value to which the asset is sold is maximized, or the market in which the value paid for transferring the liability is most reduced after being taken into consideration the transaction and transport costs.

Fair value upholders argument the utility of the evaluation system based on fair value by exposing the following advantages: allows getting a reliable financial standing, it offers a bigger accounting objectivity and neutrality, allows a better comparability between fungible assets, especially financial instruments, it allows a "more economical" vision of assets and equities which are drown by the entity, it offers a better informing and comparison concerning the entity's present and future performances, it reduces the difference between book / accounting value and stock value (for rated entities), it improves the managers' control on the entity's patrimony, it offers a active managing coherence for financial risks, it has a "more universal" character as opposed to historical cost. (Deaconu, 2009, p. 104)

The shortcomings that fair value has refer to: it does not always offer reliable information, being hard to be calculated by the entity's personnel without expert advice, it's actual determination implies technical and financial problems, it creates difficulties in determining the distributable result, it does not allow reflection of intangible assets value, it offers a short term financial standing of the entity, it influences the way of reporting and analyzing certain elements or operations which are subjects for evaluation at fair value, but it advantages one of the users of accounting information categories, namely the investors. (Deaconu, 2009, p. 106)

Concerning the concept of fair value we can say that it modifies the content of what accounting evaluation means. This change is connected to the term of "recognition". Firstly, recognition means acknowledgement of the existence of financial standing elements, and secondly, it implies a fair, rational, reliable evaluation of the financial standing elements using established methods and procedures. (Deaconu 2009, p.132)

4. Considerations regarding the fair value of the assets and financial liabilities

Subsequent evaluation of assets and liabilities represents a further measurement of their initial recognition and it tinges according to the regarded asset or liability. It is also a reporting value in financial standings and it represents an area of maximum interest in examining some patterns of evaluation which are different than the mixed model recommended by the General Framework of

IASB – restorable historical cost and maintaining the nominal financial capital. (Gușe, 2011, p.333).

Financial instruments are contracts which simultaneously generate a financial asset for an entity, respectively a financial liability for another entity. Financial asset is any asset which represents cash, a contractual right to receive cash or any other financial assets from another entity, a contractual right to exchange financial instruments with another entity in conditions which are potentially favorable or an instrument of personal capital / equity of an entity. (IAS 32). Financial liability is a contractual obligation to inflow cash or any other financial assets to an entity, or to exchange financial instruments with another entity in conditions which are potentially unfavorable. (IAS 32)

The entity must admit in the balance sheet a financial asset or a liability only when these become a part of the contractual terms of the instrument. The initial registration is made at cost, with the remark that this cost is measured at fair value of given counter performance. (Malciu, 2002, p.176).

Further evaluation of financial assets is mainly made at fair value without any cost deduction which might appear from trading or from any other outflow. There is a series of financial assets which are held until due date / or which are not held for trading / unlisted on an active market, which are subsequently evaluated to initial acknowledgement at redeemed historical cost. (Gușe, 2011, p.353)

Subsequent evaluation of financial liabilities is made at a redeemed cost, with the exception of financial liabilities and derived instruments held for trading, which are evaluated at fair value. (Gușe, 2011, p.353).

Gains and losses from the fair value evaluation of assets and financial liabilities are generally known in profit and lose costs. But there is an exception of this rule: gains and losses generated by an asset which is available for trading may be directly acknowledged in the direct own capital until the moment of trade, when the cumulated amount is transferred to net profit or to the period lost. (Cernușca, 2004, p.276).

5. Study case concerning subsequent evaluation at fair value of assets and financial

I. Entity S.C. Example S.A. invests 125400 lei in a portfolio of fixed income securities, having a 6% annually interest. After 12 months, the entity collected the first interest of 7524 lei. The securities' / titles' market value increased with 3800 lei. One must remember that the securities / titles haven't suffered any depreciation and no part of the principal has been reattributed.

Further the 3 possible cases referring to reevaluation of these securities will be presented:

Case 1: The titles / securities are retained for trading

In this case, titles subsequent evaluation is made at fair value and any gain resulted from their evaluation will be recorded in the profit and loss account.

1. Recording of interest collecting after one year.

6% x 125400 = 7524

Bank accounts in lei	=	Interest incomes	7524

2. Recording profit of 3800 lei gotten from market value variation, after reevaluation:

Financial assets	=	Unrealized gains (Profit and loss account)	3800

Case 2: Securities are kept as securities available for trading

In this case, subsequent securities evaluation is made at fair value and any gain resulted from reevaluation will be recorded directly in personal capitals, and at the date of titles' trading, cashing or redundancy in any other method, the gain will be transferred in the profit and loss account.

1. Recording of interest cashing after an year:

6% x 125400 = 7524

Bank accounts in lei	=	Interest incomes	7524

2. Once with reevaluation, the income of 3800 lei made from the market value variation, will be recorded in personal capitals

Financial assets = Unrealized gains in reevaluation (personal capitals) 3800

Case 3: The tiles / securities are kept till due date

In this case, the subsequent evaluation of these securities is made at amortized cost, and unrealized incomes as a result of market value variation (fair) are not established.

1. Registration of income cashing after one year:

6% x 125400 = 7524

Bank accounts in lei = Interest income 7524

2. Registration of titles' subsequent evaluation in amortized cost

Titles are evaluated at the amount of 125400 lei because this is the value at which they were initially registered and because there were no principal reimburse.

II. Entity S.C. Example S.A. has contracted a loan of 140000 lei with an income rate of 12% per year, for a four years period.

Case 1: Effective interest rate is equal to nominal interest rate

In this case the loan's fair value in calculated by updating future cash flows associated with effective rate, which is equal to nominal rate namely of 12%

Table no.1 Calculation of loan fair value

Year	**Cash flows**	**Updating factor $1/(1+12\%)^n$**	**Updated cash flow**
1	12% x 140000 = 16800	0,8929	15001
2	16800	0,7972	13393
3	16800	0,7118	11959
4	16800 + 140000 = 156800	0,6355	99647
Total	207100	-	140000

Source: own creation

As a result of this presentation it is clear that the loan's fair value and respectively its historical value are equal (140000). The loan (financial liability) will be established at its fair 140000 value without a necessary registration of unrealized gains or losses.

Case 2: Effective income rate is different than the interest nominal rate

In this case there is a difference between the nominal 12% rate and the effective 15% rate.

Table no.2 Calculation of loan fair value

Year	**Cash flow**	**Updating factor n 1/(1+15%)**	**Updated cash flow**
1	12% x 140000 = 16800	0,8696	14610
2	16800	0,7562	12705
3	16800	0,6576	11048
4	16800 + 140000 = 156800	0,5718	89659
Total	207100	-	128022

Source: own creation

As a result of this presentation it is clear that the loan's fair value (financial liability) of 128022 is different from the nominal one (historical cost) of 140000 lei. Provided the fact that the fair value is lower than the historical cost, the entity must register an unrealized cost associated with financial liability, and its creditor will register a loss associated with an asset.

Calculation of unrealized income as a result of financial liability reevaluation:

Historic cost – fair value = 140000 – 128022 = 11978 lei

In order for the debt to be presented at its fair value, the unrealized income will be established in the profit and loss account:

Financial liabilities = Unrealized incomes resulted from financial liabilities reevaluation 11978

6. Conclusions

In the process of evaluation of an entity, the assets and financial liabilities represent a distinct interest because for most of the entities, these elements are not part of their normal exploitation activity and as a result of that, they require a special alternative treatment. The alternative accounting treatments referring to subsequent evaluation use a fair value model of evaluation. Although initially the concept of fair value was associated only with financial assets, presently it has enlarged upon all balance sheet items.

As a result of fair value evaluation of balance sheet items, one may obtain more reliable financial statements, a better comparability of these elements, but also an abatement of the difference between accounting value and stock value for the rated entities.

7. References

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