CONTROVERSY REGARDING ITEMS EVALUATED IN FINANCIAL STATEMENTS

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ABSTRACT: *The study follows the evaluation process of patrimony through different accounting referential. It was analyzed the basis for evaluation provided, how credible and believable are to the extent of their advantages and limitations. The differences highlighted here come to support today's concerns of accounting organisms in setting and developing elements and content for a Conceptual common framework.*

KEY WORDS: *historical cost, current cost, achievable value, actual value, true value.*

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One of the most complicated problems in accounting is choosing those bases for evaluation in order to measure the items in the financial statements so that it provides relevance and an accurate representation of the firm's activity.

Both **IASB and American Framework** propose the following basis for evaluation of *items in financial statements* (IASB and FASB conceptual Framework, section SFAC 5):

- **Historic cost means** the amount paid in cash, or its true value from the moment of acquiring the assets, the equivalent value obtained in change of the obligation, or in certain circumstances the value waited to be paid to settle the debts according to the normal activity of the firm. A specific trade *is that this cost is the original cost associated with the initial recognition and it reflects the true value of the item in the original moment of recognition.* So, this evaluation is objective because its value reflects faithfully the real conditions on the market at the time of acquiring the goods.

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- **Current cost** means the value to be paid if the same asset or a similar one would be purchased at a current time that is the non-actual value needed to settle an obligation at a current time. The cost is calculated as follows, we search for the value of an equivalent asset from which we subtract the amortization corresponding to a useful life consumed, associated with the good held that needs to be replaced.
- **Achievable value means** the value to be obtained in the present through normal selling of assets, the value that needs to be paid to settle debts according to a normal course of business.
- **Actual value** of future net cash inputs that will be generated in the activity of the firm, actual value of future net cash outputs that are expected to be necessary to settle debts. A practical settlement of this value implies professional reason that takes into consideration multiple variables generated by an uncertain environment.

FASB framework proposes a different base of evaluation: **current market value,** still IASB framework includes it but in a general way as **achievable value.**

Section *SFAC 5 "Recognizing and evaluating financial statements of commercial firms"* of the *American conceptual framework* defines the current market value as the value to be obtained from selling assets according to liquidity, used for evaluating financial investments that are easy to trade (negotiable titles), for financial transactions traded on a market etc. (Section 5 of SFAC).

Both international and American regulators allow the use of these evaluation bases presented above in financial statements, in different combinations and with different levels of use. To offer concrete evaluation solutions, they come to aid practitioners with information included in several standards.

No matter what accounting framework we use, choosing *evaluation bases* depends on the *nature of the elements*, in order to obtain accurate and relevant information.

The **historic cost** is used especially to *evaluate intangible assets* , to *most stocks categories, debts*, **the actual cost** is applicable only to some stocks categories, **net achievable value** is applied to stocks and *receivables on short term*, **the actual value** *of future treasury flow* is applied to *receivables on long term.*

An important factor that *supports diversity in evaluation*, recognizing the limitations of historical cost, is *the time factor*, because from several choses is picked the one that reflects most recent market values, as the relevant ones in making future decisions. This way of thinking led to accepting values for the present time as current cost, data important even for *achievable value*.

The actual trend of financial reporting is characterized through *presenting information in perspective,* information needed to estimate future cash flow*,* reflected best in the *actual value of future cash flow.*

So, *section 7 of SFAC "Using information regarding cash flow and present value in accounting measurement",* defines a framework for the future cash flow as basis for accounting measures or in the initial recognition or future measurement.

This section specifies that only using the present value in accounting measurement we achieve the true value considered as being objective for most

measures in the context of initial recognition or future measures. It hasn't reached a consensus for using a certain evaluation basis that supports the existence of all bases presented above, but we still have to consider that these are *characterized by different levels of credibility and reliability*.

Below are synthetized the *advantages and limitations of these evaluation bases*:

- **Historical cost**

Advantages in report to other evaluation bases:

- results from real transactions;
- it is verifiable insuring objectivity for evaluation documents;
- it reflects the *correct value* of the items at the *time of initial recognition*.

Limitations:

- considering the economic parameters evolution in time (spending power, debt rate, firm profitability) the historical cost taken as an accounting input value for an item cannot paint a faithful picture in time of the value that should be reflected;
- considering an inflation situation, the data provided according to historical cost paint a distorted picture of reality: intangible assets are under evaluated; performance isn't correctly evaluated because the profit is over evaluated, and so the entity pays taxes for inflation and distributes fictional dividends.

- **Current cost** (value to be replaced)

Advantages:

- value with high relevance, used in evaluating provisions, on a national and international level (IAS 37 Provisions, debts and contingent assets);
- is used in evaluating different assets (like those obtained by the entity from its own production, the assets acquired, for tangible assets with life duration consumed).

- **Achievable value**

Advantages:

- *opportunity cost*;
- reflects the entity's capacity to liquidate assets;
- eliminates the need to assign accounting input value to tangible assets depreciated on useful life duration (amortization can be determined by calculating the difference between achievable value at the beginning and at the end of the period);
- this must be used with attention because it becomes relevant for those assets that are to be sold (it is easily determined for assets that have an outlet, thus a market value).

Limitation:

- it becomes irrelevant for those assets that are not to be sold.

- **Present value**

Advantages:

- it is a future oriented value calculated based on net cash flows associated with the specific interval (present, future);

- is representative for tangible assets used in the process of production because these are the ones who create value for the entity and generate future cash flows;

Limitation:

- is given by the complexity of calculating this value.

It has to be determined for every asset in order for the value to be relevant; it has to have a predictable duration, a present rate, and also an increase of price.

O problem in using the evaluation bases analyzed above is the relationship between *costs and benefits* applied.

The costs of applying certain evaluation bases (present value) are superior to the benefits obtained by using them, so it is possible that we could give them up even though they contribute to reflecting a faithful image of the entity's activity.

So, using the historic cost we cannot point out a faithful economic reality for the entity, according to future changes in evaluating initial recognition.

Nowadays, accounting is going through a process of "evaluation" talking about a "future accounting" and not about an accounting reflected in historical costs (Tournier, 2002). In this context, in order to insure a faithful image in financial reports, regulators have used over time several means of correcting historical costs, a process that continues at present day.

Thus the idea of evaluating is an important part of the normalizing process.

We must state *that no conceptual framework includes as a basis* for evaluation *true value,* but different forms of manifestation like: current cost, achievable value, or present value. In return we see more and more accounting standards using the true value defined as the sum to which an asset can be traded or a debt settled willingly between two parts during a transaction that has an objective price[1].

We must differentiate between *true value and market value* because we don't always find an active market for all kinds of goods, *true value being a wider concept than market value.* If there is an active market for the goods needed to be estimated at a true value, then the market value can substitute the true value, contrary the last one will be determined considering present value of future cash flow, estimated with the help of the present rate (Mitu & Mitu, 2007).

Requirements regarding *the evaluation of the items from financial statements according to International Standards of Financial Reporting are*:

IAS 16 Tangible assets and IAS 38 Intangible assets

- the evaluation of intangible or tangible assets in the *initial moment* of recognition is made at a *historical cost*;
- after *initial recognition* they can be evaluated at *a historical cost decreased by depreciation and loss of accumulated*; or
- another alternative would be accounting them at a reevaluated value (*true value at a reevaluated date decreased by depreciation and loss of accumulated value*).

IAS 2 Stock

- *initial evaluation is made at a historical cost*;

[1] Is the definition of true value from International Standards of Financial Reporting, American and national accounting regulations.

- after we must evaluate the lowest value between input cost and net achievable value[2];
- output evaluation (for *fungible assets* that have different input value) by: FIFO (first out) or CMP (weighted average cost)[3].

IAS 40 Real Estate investments

- *initial investment at historical cost*;
- after initial recognition *2 models are allowed*:
  - ✓ at input cost minus depreciation and provisions (according to IAS 16)
  - ✓ at true value.

Passing through model to model is allowed in order to obtain a faithful presentation, passing from cost evaluation to true value.

We notice that **true value** basis for evaluation suggested by IAS 40 is a value referring to prices on the active market undiminished with other expenses.

IFRS 5 Tangible assets held for sell and interrupted activities

- *initial evaluation at historical cost*;
- after *initial recognition*: the evaluation is made at the *lowest value between net accounting value and true value* diminished with estimated expenses from.

IFRS 6 Exploiting and evaluating mineral resources

- initial *evaluation at a historical cost*;
- after *initial recognition*: we use the cost method diminished with depreciation and loss of accumulated value; or reevaluation method (true value diminished with depreciation and loss accumulated);

IAS 41 Agriculture

- initial evaluation: *true value diminished* with estimated costs from selling;
- *post evaluations*: we maintain initial evaluation basis.

IAS 39 Financial instruments

- *initial evaluation*: at true value undiminished for assets and financial debts; *other financial instruments* evaluated at true value diminished with transactions costs;
- *post evaluations*: at **true value undiminished** for *assets and financial debts* evaluated at true value through Profit and Loss; the other *assets and financial debts* are evaluated at *depreciated cost (*example: assets owned until maturity, receivables, provided loans).

Based on information provided by International Standards of Financial Reporting presented above we can **conclude** the following:

- **Historical cost:**

We notice *that historical cost is used more carefully*. We only find it at the evaluation made in the initial recognition moment but not for all financial statements items;

- **Ulterior evaluation to initial recognition:**

[2] Achievable net value is the estimated selling price that could be obtained during normal activity, minus estimated costs for finalizing a good and selling it.

[3] Compared to IAS 2 "Stocks", national regulations provide as well LIFO method (last in first out).

It is recommended to evaluate through several evaluation methods like *corrections of historic* cost to insure a faithful image of the entity through financial statements:

- historical cost diminished with depreciation and losses of value accumulated;
- reevaluation model (true value at the moment of reevaluation diminished with depreciation and losses of value accumulated);
- the lowest value between input and net achievable value;
- true value undiminished;
- the lowest value between the net accounting value and the true value diminished;
- true value diminished with estimated selling costs.

- We must make the difference between evaluating at **true value***, IAS 40 Real Estate investments, and the evaluation at* ***true value diminished*** with depreciation and losses of value accumulated, *IAS 16 Tangible assets and IAS38 Intangible assets.*

Evaluation made based on true value must be basis of evaluation for presenting items in the balance sheet, otherwise we must evaluate at **a corrected true value**. *The model of true value* is different from reevaluation model allowed for some nonfinancial assets. So, according to the reevaluation model, pluses of value towards accounting value are recognized directly in *Equity at "Reserves from reevaluation*", while according to the model of evaluation at true value are recognized in the *Profit and Loss account.*

The question that arises is: is it better to recognize differences from reevaluation directly in Profit and Loss account? I think not, because recognizing gain and losses unachieved in Profit and Loss account increases the volatility and doesn't insure transparency, changes made from reevaluation obstructing the evaluation of the exploitation performance.

When talking about the evaluation of stocks *can the net achievable value mean the same thing as net true value?* From *IAS 2Stocks net* achievable values definition, this is a value specific to the entity, while net true value is the sum interchangeable between parties, minus the selling costs, thus being a value that doesn't take into consideration the environment of the entity. So the two values are different. At the national accounting standards level we notice a series of bases, most of all for ulterior evaluation to initial recognition, amongst them true value. **True value** is the result of theoretical and practical researches of different specialists to express as accurate as possible the value of an item from the financial statements, at a certain point in time, ulterior to initial recognition. Specialists say that true value was introduced as a concept under the pressure made by creating value for the stakeholders (Niculescu, 2003).

From literature and studies made by different specialists, appear pro and con arguments regarding true value as a basis for accounting evaluation:

Pro arguments for using true value:

- it induces market value, it is defined by offer and demand; in case there is no market place this value may be extended to the actual value of future cash flows (Capron, et al., 2005);

- it makes treasury flow prediction possible, the worth of the entity reflected by financial statements being closer to the market value;
- it takes into consideration profit and loss resulted from differences in price changes;
- it is a simple method of evaluation for instruments directly negotiable on an active market;
- it limits possibilities for managers to adjust results using historical costs, that allows them to make provisions and depreciation adjustments, influencing thus, the results in the wanted directions (Deaconu, 2003);
- it is the most efficient way to measure performance at a certain time towards the historical cost, because it allows recognition for differences of value between input and the value at an ulterior time, while the historic cost provides information about value differences only when the item evaluated is derecognized (Bunea, 2007);
- true value tends to depressurize the precautionary principle, because minus and plus value appear in the balance sheet improving predictions for flows generated by the entity's activities (Ioanăş & Manea, 2006);
- the use of this model allows financial statements to reflect in a more objective way the risks to which the entity is exposed to, this allows us to calculate the net asset as a sum of true values , excluding the subjectivity for management decisions (Tournier, 2002);
- it reduces the differences between accounting value and stock value.

Con arguments for true value:

- studies show that **a** true value determined by market mechanisms like offer and demand has a more credible value than based on estimative techniques (Castra & Colasse, 2001);
- the need to evaluate at true value comes from the investors, the other users of accounting information (suppliers, clients, State), they have other informational needs regarding the entity's accounting (Firescu, 2009);
- a form of value estimation that can lead to behavior like creative accounting;
- studies show that if banks would use it as an evaluation basis there might be the risk that the market will render incorrectly the increase of true value of equity, that is an increase of risks, anticipating a crisis, and on the other hand bank auditors may interpret in a wrong way a decrease of true value thus taking measures that can mislead the market and alert it (Lustman, 2002);
- studies show that evaluating at true value in insurance companies doesn't present guarantees regarding reliability and credibility, that is why it might appear the risk for major volatility in results, a situation that would create panic among employees;
- the costs determining a true value are not to be trifled with.

When there is no market place to allow setting a market value for a good, and if the entity can calculate the actual value of cash flow induced by using that good, this value may be recognized as true value, although the formula itself isn't easy.

Another time when it needs assessment is the evaluation of the risk capital market. Thus, *Value at risk* (VaR) is a summary statistic that quantifies the exposure of an asset or portofolio to the market risk. Now, value at risk is viewed by many as indispensable ammunition in any serious corporate risk manager's arsenal.VaR certainly is not the only way a firm can systematically measure its financial risk. But, its appeal is mainly its conceptual simplicity and its consistency across financial products and activities (Ungureanu, et al., 2010).

National accounting regulations, OMFP no. 3055/2009 regarding Accounting standards according to European directives, states that evaluating items from the financial statements is frowned upon for the following evaluation moments:

At the time of entering the entity (*initial recognition*), the goods are evaluated at the acquisition price for those goods acquired for remuneration ; at the production price for goods brought for registered capital; at worth input for goods brought for registered capitals at true value for goods brought with free title or as a plus for inventory.

The definition provided by the order is the same as the one in all accounting referential. The order gives the possibility of choosing a reevaluation of tangible assets at a reevaluated value (*true value at the time of reevaluation diminished with depreciation and losses of cumulated value*), adopting the same accounting treatment as *IAS 16 Tangible assets.*

Also*, financial instruments and derivatives* can be evaluated at true value adopting IAS 39 Financial instruments.

At the time of inventory, evaluating tangible and intangible assets is made at the inventory value set according *to the usefulness of* the good, its state and market price; stocks *are evaluated at accounting value minus adjustments for depreciation.* If accounting value of stocks is bigger than inventory value, their value is diminished until *net achievable value by* making an adjustment for depreciation.

The definition of net achievable value of stocks is the same as the one found in IAS2 Stocks *receivables and debts are evaluated at a probable cashing or paying value*.

When making the balance sheet (*evaluation made after initial recognition) the evaluation of tangible asset is made at accounting value minus depreciation and adjustments accumulated from depreciation or at reevaluated value.*

If we reevaluate tangible assets this aspect must be presented in the Explicatory notes together with the items subjected to reevaluation, the method of calculation and the item affected from the Profit and Loss account.

When goods exit the entity *(derecognition moment) they are evaluated and subtracted from inventory at input value* (for example: the value reevaluated for tangible reevaluated assets, true value for securities admitted for stock exchange market). Inventory is evaluated by applying one of the methods: FIFO, CMP or LIFO.

We notice that national standards choose to work with LIFO because its results are more credible, that is why IAS 2 Inventory has ruled it out.

CONCLUSIONS

The research gave me the possibility to notice that international regulators allow the use of the following bases for evaluation for the financial statements: historical cost, current cost, achievable value, actual value. These bases may be used in different combinations and levels of usefulness.

Choosing a basis for evaluation depends on the nature of items, because the information has to be relevant and trust worthy. So, the historical cost is used most of all in the evaluation of stocks and debts; actual cost is applicable to some stocks and short term claims/debts; actual value of future treasury flows is applicable to long term debts.

An important factor in evaluation, which supports the diversity of evaluation bases is time(because historical cost is limited), meaning that from multiple alternatives we have to choose the one that reflects the most recent market values as the most relevant for future decisions. This way of thinking led to accepting current cost and achievable value as values of the present time.

The actual trend of financial statement is characterized by presenting information in perspective, information needed to estimate future cash flows, reflected best by the actual value of future cash flows.

Researching on the matter of evaluating items in the financial statements entitles me to say that that this is circumscribed to developing financial statements that want to reflect a faithful image of the entity's activity.

I support this statement by the fact that historical cost is not used excessively but it's corrected using other bases of evaluation correlated with the specific of the item evaluated, both nationally and internationally.

The idea of evaluating at true value appears more and more in the process of normalization.

We must not forget that this comes from the support of investors not from other users of accounting information, the credibility of this value being specified especially where it is determined through market mechanisms, or supply and demand.

In conclusion, the aspects presented, confirm the option of most economic entities for a combo between the bases for evaluation in order to show a more faithful image of their activity.

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