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THE PHILOSOPHY OF ASSETS FAIR VALUE PRESENTATION IN FINANCIAL STATEMENTS

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Abstract: Publication of companies' financial statements is carried out in accordance with the requirements of International Accounting Standards, pursuit the aim of providing the reporting users with reliable decision-making information. The subject of research is scope of assets fair value philosophy, based on generally accepted principles in International Financial Reporting Standards (IFRS), in particular, on prudence approach. The purpose of article is to give suggestions for improvement of assets in financial statements of organizations, taking into account the interests of the users of the report, avoiding as much as possible the overestimation of the disposed assets or the underestimation of the assumed liabilities. In addition, financial reporting standards also require the presentation of assets at fair value, which is somewhat contrary to the principle of prudence. Philosophical issues of asset valuation are discussed in the article, analyzing the range of valuation approaches of assets at fair value in the financial statements published by organizations. The results of the research are proposals for new philosophical approaches to the fair value assessment of the organization's assets, according to which the current assets should be presented by market value, and the philosophy of valuation of non-current assets is to be based on the prudence concept.

Keywords: philisosphy of assets revaluation, IFRS, fair value, financial statements, prudence principle.

Introduction

The role of financial institutions in public life increased, especially sharply in the era of capitalism, when the public felt a need to be informed about the results of economic activities of organizations. Nowadays, this requirement has acquired new qualitative characteristics, and the process of published accounting reports has entered a new institutional phase, forming international accounting standards for the publication of financial statements, which still cause issues of philosophical interpretation.

International Financial Reporting Standards, which have been in place since the 1990s, were originally intended to provide users with realistic information that would enable them to make sound decisions. The principle of prudence considered one of the cornerstones of building standards (Siahaan et al., 2018). When applying it, overvalued assets or undervalued liabilities are not allowed. Prudence is the exercise of sufficient caution, so that assets income is not overstated and liabilities and expenses are underestimated, while not allowing intentional underestimation of assets, income and liabilities and intentional overstatement of liabilities (Sharma, 2017).

Consequently, when maintaining prudence consept, organizations present in their financial statements information that is not in "their best interest", as it presumably reduces the fair value of the assets. Reports, on the other hand, do not artificially present to users the portion of the fair value of the asset that is "hidden" in the reporting requirement.

The preparation and publication of financial statements is carried out in accordance with the requirements of International Accounting Standards, in order to provide users of the statements with reliable information for making decisions. International Financial Reporting Standards are based on universally recognized principles, one of which is conservatism (Capkun et al., 2016). It is important to take into account the interests of the users of the report, avoiding as much as possible the overestimation of the assets used or the underestimation of the assumed liabilities. In addition, financial reporting standards also require the presentation of assets at fair value, which is somewhat contrary to the principle of conservatism (Cheng & Kung, 2016).

The article discusses the range of issues of assessing assets at fair value in financial statements, published by organizations. In particular, it identifies methodological discrepancies between the valuation of long-term assets and the assessment of their utility, required by international accounting standards. Based on the research of methodological approaches to the valuation of assets, recommendations were made to limit the use of the principle of the market approach for assessing the fair value of long-term assets.

The Philosopy of Assets Measurement Prudence Concept

According to the professional literature, when preparing financial statements on an prudence basis, there is often a time gap between the "losses" of the recorded benefits. It is from this principle that the resulting loss should be directly recorded in the financial results of the organizations, even if the related transaction has not yet taken place, and in the case of a profit, there should be no urgency; it is necessary to wait until the transaction takes place (Kiabel & Nwanyanwu, 2014). A good example of this is the formulation of the results of revaluation of fixed assets, according to which the impairment loss should be immediately attributed to the financial results of the reporting period, and the increase from the revaluation to the equity of the entity (Beuren & Klann, 2015).

The authors argue that these temporal differences in financial results from the principle of accountability may have some bearing on the decisions made by users of the information (Bui et al., 2020). After all, fixed assets are non-current assets, at least for a long time, they will not be alienated or traded at the time of reporting. The question then arises as to why the impairment losses incurred at the time of their devaluation results should be attributable directly to the financial performance of the entity's the reporting period and not to equity, which is attributable to the increase in revaluation gains. In our opinion, in such a case, the report provides users with information with double standards, which causes a possible "information confusion" in their management decisions.

Moreover, in the case of inventories, when the International Accounting Standard requires a presentation of fair value less the actual cost of the residual net realizable value, the short useful life of the inventories is not taken into account. And even if circumstances are created that contribute to the increase in the value of inventories, the previous devaluation results of inventories are clarified, and reversals of formulations are made. It follows that year-on-year inventory balances can be re-evaluated multiple times, giving rise to significantly different information in the decision-making process of users of the published financial statements.

According to International Financial Reporting Standards (IFRS), the fair value is the amount that would be received from the sale of an asset in a normal transaction or would be paid for the transfer of a liability in a normal transaction at the measurement date (Christensen et al, 2013). Therefore, the accounting principle is somewhat at odds with this requirement of the standard, as the fair value of the asset is often presented without taking into account the time of the usual transaction or the “out of reach” approach in the market.

Chartered financial analysis (CFA) want clearer results which isn’t biased. Where there are uncertainties they would like management’s best estimate with the appropriate disclosures of the basis on which this has been made. The inclusion of prudence is not necessary as it contradicts other accounting assumptions. As discussed earlier, the debate came about due to the conflict with neutrality. Prudence conflicts with neutrality. As Hoogervorst (2012) said, “When the IASB revised the first chapters of the Conceptual Framework in September 2010, it replaced the concept of Prudence by Neutrality. Ever since, IFRSs have been periodically criticized for actually being imprudent, allegedly leading to overstated profits and/or understated liabilities. For example, critics blame the incurred loss model for understating losses on bad loans and the use of fair value accounting for inappropriately recognizing unrealised profits” (p. 2). Thus keeping both prudence and neutrality in the framework will only lead to confusion and misrepresentation of the truth in the accounts. Furthermore, other areas of the framework such as faithful representation also clash with the concept of prudence, as the information decisions which are made under the prudence concept do not always represent transactions faithfully, leading to information not being fully reliable. Therefore, as long as financial statements are as accurate as possible and represent the reality of the accounts as much as possible following the other frameworks, prudence is not needed (Sebrina & Sari, 2016).

Only the publication of financial statements of organizations with a philosophical foundation of conservatism leads to the emergence of disagreements between external and internal users of this accounting information. In particular, internal stakeholders find that the prudence concept unnecessarily reduces the book value of current assets in practice. In this regard, the article also suggests not to show an unambiguous approach in the valuation of assets at fair value and to review the philosophy of measuring current and non-current assets at fair value.

Limitations of the Philosophical Interpretation of Fair Value Assets Measurement

The philosophical interpretation of fair value is staying on the price, that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. However, such a philosophical interpretation often creates a mismatch between the information expectations of organizations presenting financial statements and their users. Consequently, the philosophy of measurement inventories again is conducted with prudence approach principle, which is requiring, that the inventories shall be stated at the lower of cost and net realizable value. Net realizable value (NRV) - the estimated selling price less the estimated costs of completion and the estimated costs necessary to make the sale IAS 2 Inventories (2017). Cost of inventories – all costs incurred in bringing the inventories to their present location and condition, including the costs of purchase and conversion.

In this situation, the management of the organization shows reluctance in presenting the stocks with net realizable value, because in many cases there is an artificial reduction of the value of these assets in the financial statements. As a result, indicators of financial stability of organizations is declining. Hence, the philosophy of the approach of valuation of inventory at fair value by accounting standards does not always become acceptable for the management of organizations (Ramanna, 2020).

The same problem arises in case of philosophical interpretations of the results of revaluation of fixed assets at fair value. In the current international accounting standards philosophical approach is applied, that the result of revaluations should not be directly attributed to the profit of the reporting period of the organizations, but would capitalized and amortized in the following years. Of course, such a philosophy of revaluation of the increase in the value of fixed assets is not considered acceptable for the management of organizations in most cases, because in this circumstance it is not possible to adequately represent the increase in profit. And all this has a negative impact on the investment environment formed in organizations (Hu et al., 2014).

Therefore, in practice, the philosophy of valuing assets at fair value in organizations often does not satisfy all internal and external stakeholders using the information and thus presents itself with certain limitations.

Research Methodology

The research methodology is based on the principles and approaches of accounting reporting. In particular, due to the need to present assets at fair value, the requirement to measure assets at market value changes has been taken into account, according to market price fluctuations. At the same time, the assets were assessed on the basis of the potential economic potential of their long-term use. In this case, the assessment is based on the risk of asset impairment, which is formed by comparing the discounted cash flows and the carrying amount of the asset with the expected future use of the property, plant and equipment (Paulo, 2017). In all cases, when presenting an asset at fair value through profit or loss, the valuation results were re-recorded and attributed to the entity's financial results for the reporting period (Fig. 1).

Simultaneously applying the asset revaluation methodology, both in terms of prudence and "arm's length" principles, it has been possible to detect disproportion in recording financial results as a result of asset revaluation. It turns out that the center of gravity of the financial results of the revaluation of assets is more than transferred to the area of recording losses, and the recording of benefits from the revaluation increase is delayed until the moment of sale of the asset (Fig. 1).

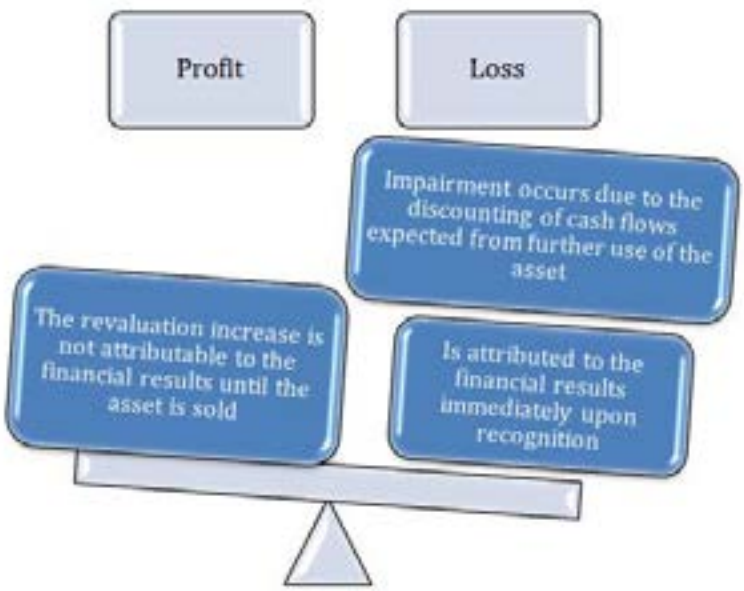

Figure 1. Profits and Losses Recognition Philosopy, Bases an Asset Fair Value Prudence Concept Aproach. (Composed by the authors)

Therefore, the research methodology was developed on a systematic basis, using not only the duplication of revaluation results, but also a combination of their different directions in the accounts to find the formula for realistic valuation of assets in the financial statements.

Fair value financial statements mainly cause problems with long-term non-current assets. In accordance with the requirement of IAS 36 Impairment of Assets (2017), whether or not an asset is impaired, an entity shall examine each year the impairment of an intangible asset with an indefinite useful life or an intangible asset not yet available for use by comparing its carrying amount. with the reimbursable amount. Moreover, according to the requirement of the standard, when assessing whether there is any indication that the asset may be impaired, the entity shall consider at least the following indications:

a) there are indications that the value of the asset has decreased significantly over a period of time as expected over a period of time or normal use;
b) significant changes in the technological, market, economic, or legal environment in which the entity operates or in the market for which the asset is intended have occurred or will occur in the near future;
c) market interest rates or other market investment rates have increased over the period; the increase is likely to affect the discount rates used to calculate the value in use of the asset;
d) the carrying amount of the entity's net assets exceeds its market capitalization (IFRS 13 Fair Value Measurment, 2011).

Depending on the usefulness of the property, plant and equipment, the carrying amount of the asset should be reduced to its recoverable amount only if the recoverable amount of the asset is less than its carrying amount. At the same time, this decrease is a loss from depreciation.

In accordance with International Financial Reporting Standards, the fair value is the amount, that would have been received from the sale of an asset in a common transaction or would have been paid for the transfer of a liability in a ordinary transaction at the measurement date Shkulipa (2021). Therefore, the principle of accountability is somewhat at odds with this requirement of the standard, as the fair value of the asset is often presented without taking into account the time of the usual transaction or the "at arm's length" approach in the market.

Thus, the organization in January 2019 bought $ 20 million a conveyer line with a 10-year operation period, the alienation costs of which will make 3 million at the end of the operation. In December 2021, it turned out, that the real value of the conveyer line in the market has risen by 5%. At the same time, another circumstance emerged. A solid competitor has appeared in the market, which produces the same product, as a result of the organization's conveyer line capacity has decreased from $4 million per year to $2.6 million outcome. The bank deposit rate is projected at 10% for the next seven years.

If we are going to follow the international accounting standards, in 2021 we have to formulate two contradictory correspondents on assets. On the one hand, in accordance with IAS 16 Property, plant and equipment (2017), the revaluation of the asset will increase, and the result will be the increase in the capital of the organization during the reporting period. On the other hand, IAS 36 Impairment of Assets (2017) will impair the asset as there is an indication that the carrying amount of the asset exceeds its recoverable amount. In this case, for the same asset, the impairment result for the same reporting period will be recorded in the entity's financial results as required by IAS 36 Impairment of Assets (2017).

Naturally, such an ambiguous assessment of the fair value of a flow line can confuse users of financial statements and negatively affect their decisions.

However, it should be noted, that at the end of the reporting year (December 31, 2021), two conflicting financial results were issued to adjust the fair value of the asset at the same time. The first related to the benefits of increasing the market value of the asset, and the second related to the impairment losses from a decrease in the asset's ability to generate further economic benefits.

Naturally, the recording of the simultaneous benefits and losses of adjusting for real assets and the loss of an entity's financial performance information may cause disagreement among users and affect their decision-making. Therefore, we consider it expedient to take into account only the degree of their usefulness when estimating the fair value of long-term assets, and at the same time not to take into account the current market price. In other words, when assessing the fair value of long-lived assets, do not be guided by the principle of "at arm's length" in the market. And to provide information users with the results of valuation of long-lived assets at market prices simply by disclosing financial statements. In this case, adjustments to the fair value of the non-current tangible assets will no longer be made available to users of the information with ambiguous financial implications. In addition, the fair value of an asset in IFRS that would have been received from the sale of an asset in an ordinary transaction between market participants at the measurement date would be presented as additional information in the disclosures in the published financial statements.

When challenged over the desirability of restraint in profit recognition it is often pointed out that while prudence may hold back profits in one year such restraint may simply lead to their release in a subsequent period, which as a result will show exaggerated results. Daimler Benz's restatement of its profits record from (prudent) German accounting to US GAAP for its New York listing illustrated this 'smoothing' effect of prudence very well. The Spanish banks and the dynamic provisioning during the crisis are cited as a further case in point – prudent reserves temporarily masked their underlying weakness as conditions changed, and delayed remedial action (Sharma, 2017).

Conclusions and Recommendations

The philosophy of creating information on the reporting entity's financial resources, the nature of the claims and the amount helps users to identify the financial strengths and weaknesses of the reporting entity. This information is used to assess the reporting entity's liquidity solvency, need for additional funding and how well the entity will be able to obtain that funding. The presentation of assets at fair value helps users to predict how future cash flows will be distributed among entities with a claim on the reporting entity, including the degree of economic autonomy and liquidity of the entity.

However, studies have shown, that on the one hand, financial statements published by organizations require accounting standards to present assets at fair value that would be available in the current market conditions for sale in the ordinary course of business. Measuring the fair value of an asset, on the other hand, also takes into account its ability to generate further economic benefits.

Therefore, in order to avoid such conflicting estimates, we propose to apply only one valuation approach to long-term non-financial assets based on the requirements of IAS 36 Impairment of Assets (2017). That is, to estimate the fair value of the assets at the amount of the consideration, which is the maximum amount of the fair value of the asset or cash-generating unit the difference between the cost of disposal and the cost of use received. Simultaneously, according to requirement of IFRS 13 Fair Value Measurment (2011), include the long-term non-financial assets in the disclosures in the financial statements, showing the fair value of these assets at market price.

Taking these considerations into account, we make a number of improvements to the philosophical approaches to the recognition of companies assets fair value mesurment.

First of all, current assets, which are constantly changing in the financial statements of organizations and, as a rule, registrating with their accounting balance sheets for less than a year, it is appropriate to present them not at the minimum of the actual cost and net realizable value, but at the market sales value. In this case, the inventory will be reflected in the balance sheet at fair value and will not be subject to the philosophy of the principle of conservatism.

As for the evaluation of non-current assets, in this case we suggest, on the contrary, to maintain the philosophical approach of evaluation with conservatism, because the above-mentioned assets are recorded in the financial reports of organizations for a long period of time, which requires approaching their valuation more cautiously, ensuring the philosophy of prudence concept.

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