INFORMATION ON FINANCIAL INSTRUMENTS INCLUDED IN THE ANNUAL FINANCIAL STATEMENTS

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Abstract: *This survey aims at emphasizing several aspects of the recognition, measurement and presentation of information on capital assets and how they are reflected in accounting. In this respect, here is a presentation of the calculation, preparation and regulation of impairment that can affect capital assets and the way accounting entries may influence the financial status and performance of a company. Although the bookkeeping variants of asset impairment, namely the Romanian and the international ones, are different, the information reported in annual financial statements is the same and assets are shown at their fair values. The issues approached in the paper herein are vast and they open new prospects to scientific research.*

Key Words: *financial instruments, shares, impairment, fair value, impairment loss*

JEL Classification: G23, M41

1. Introduction

Modern economy forces one to identify the best solutions in terms of financing or investment. Irrespective of one's being natural or legal persons, it is necessary that one should permanently look for the best opportunities from the perspective of costs along with one's rights and obligations that subsequently emerge.

Trading companies are interested in identifying the best solutions for performance financing and investment. To the extent to which the amounts invested aim at capital assets and at a long term, investment shall be reflected in the category of capital assets. The decision to purchase financial instruments may rely on raising revenues as a result of the price differences reported between the time of purchase and the time of subsequent sale, the receipt of potential dividends or owning some of the registered capital as compared to company concerns. Since the value of a financial instrument is not constant on the market as a result of both macro- or micro-economic factors and subjective factors, there is the issue of reflecting fair values in financial statements so that management decisions and the decisions of other stakeholders (shareholders, customers, suppliers, creditors etc.) be expedient enough.

2. Research Method

The present paper relies on the qualitative method in terms of research, namely analyses that pursue the online gathering of information on the progress of financial instruments' prices traded on Bucharest Stock Exchange, along with the examination of documents issued in the accounting and capital market field.

The idea underlying the accomplishment of this survey has been that the price of capital assets may vary both increasingly and decreasingly but annual financial statements providing information on asset value must reflect their true and fair view.

3. Theoretical Approaches to Capital Assets

Modern economy has such a contradictory development that the need for investment is felt more and more. Trading companies have the chance to carry out investment in a wide range of assets. To the extent to which investment targets long terms and aims at financial assets, they shall be reported in the category of capital assets. Capital assets

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include shares owned by affiliated entities, loans granted to affiliated entities, equity interests, loans provided to entities which a company is connected to in terms of their mutual equity interests, other investment held as assets, other loans (ORDER No. 3055 of 29 October 2009 for the endorsement of accounting regulations compliant with European standards).

In view of International Financial Reporting Standards (IFRS), a **financial instrument is a contract simultaneously resulting in a capital asset for an enterprise and a financial debt or own capital instrument for another enterprise.** The coverage area of financial instruments is wide, namely the latter aim both at instruments typical of a capital market (shares, bonds, equity securities, derivatives etc.) and at instruments typical of a money market. As far as capital market-related instruments are concerned, specialty literature identifies at least the following two categories:

- *primary financial instruments* issued for mobilizing equity or for attracting loan equity (shares, bonds, government securities etc.);
- *secondary financial instruments (derivatives)* which are timely standardized transactions that confer a holder certain future rights connected to the trading of supportive assets (Ene, 2010, p.55)

Capital asset investment in the form of financial instruments raises several questions that envisage the way they are measured in the end of a reporting year or whenever it is needed or required.

At the time of a financial instrument purchase, accounting entries of financial instrument values are made according to their purchase price which, in the event of financial instruments traded on an organized market, corresponds to their market price.

According to international accounting standard IAS 39 Financial Instruments: Recognition and Measurement*, the initial measurement of capital assets and financial debts relies on historical costs being equal to the fair value of a given or received counterparty.* Subsequent to the initial measurement, capital assets are measured at their fair values except for the investment held until due date, measured at their depreciated costs and using the method of effective interest rate. Assets whose fair value cannot be credibly estimated are measured at their initial costs.

Impairment testing of capital assets takes place in the end of every reporting year during asset inventory. In order to assess the size of impairment, fair value is compared to the value reported in bookkeeping. According to the principle of prudence while preparing financial statements, the increase in a financial instrument price in relation with a purchase price is not entered. The resulting difference is entered as an impairment loss.

When trying to correctly emphasize the aspects mentioned above, the present survey focuses on shares as they are financial instruments most frequently used in investment processes.

A share/stock is a negotiable security bond which provides its holder with the status of a collective owner of the issuing company’s indivisible property.

In Romania, the trading of shares is done at Bucharest Stock Exchange (BVB). Since 1995, the year the stock exchange performance came into being up to the present, its progress has not always been favorable as its position has been increasing and decreasing, too. Regarded from the perspective of its progress, from the perspective of the number of share issuers, stock exchange performance is shown in Table no.1.

Table no.1 Changes in stock market at BVB

Year	Number of trading sessions	Number (amount) of traded shares	Value (RON)	Daily average value (RON)	Capitalization (RON)	Number of issuing companies
1995	5	42,761	250,000.00	50,000.00	25,900,000.00	9
1996	84	1,141,648	1,520,000.00	18,095.24	23,100,000.00	17
1997	207	593,893,605	194,590,000.00	940,048.31	505,600,000.00	76
1998	255	986,804,827	184,650,000.00	724,117.65	392,200,000.00	126
1999	253	1,057,558,616	138,915,000.00	549,071.15	572,500,000.00	127
2000	251	1,806,587,265	184,292,000.00	734,231.08	1,072,800,000.00	114
2001	247	2,277,454,017	381,277,000.00	1,543,631.58	3,857,300,000.00	65
2002	247	4,085,123,289	709,800,000.00	2,873,684.21	9,158,000,000.00	65
2003	241	4,106,381,895	1,006,271,130.00	4,175,398.88	12,186,600,000.00	62
2004	253	13,007,587,776	2,415,043,850.00	9,545,627.87	34,147,400,000.00	60
2005	247	16,934,865,957	7,809,734,451.60	31,18,358.10	56,065,586,984.76	64
2006	248	13,677,505,261	9,894,294,096.72	39,896,347.16	73,341,789,545.86	58
2007	250	14,234,962,355	13,802,680,643.77	55,210,722.58	85,962,389,148.60	59
2008	250	12,847,992,164	6,950,399,787.38	27,801,599.15	45,701,492,618.85	68
2009	250	14,431,359,301	5,092,691,411.02	20,370,765.64	80,074,496,089.64	69
2010	255	13,339,282,639	5,600,619,918.35	21,963,215.37	102,442,620,945.15	74
2011	255	16,623,747,907	9,936,957,504.54	38,968,460.80	70,782,200,350.27	79
2012	250	12,533,192,975	7,436,052,589.07	29,744,210.36	97,720,863,603.03	79
January 2013	22	1,009,533,188	565,864,487.26	25,721,113.06	102,539,570,365.64	79

Source: http://www.bvb.ro/TradingAndStatistics/GeneralStatistics.aspx

At first view, it could be said that the above context is not pleasant, however appreciating the quality of trading performance must take account not only of the number if issuing companies traded but also of the quality of activities regarded from the perspective of capitalizing stock exchange and trading values. The data in Table 1 show that the value of transactions taking place at BVB was ascending until 2007. The measurement of 2008 – 2012 not only reflects the Romanian but also the world economic context with the economic crisis felt at the BVB, too.

Appreciating stock exchange activities and transactions made in shares outlines the chance issuers have in order to access a market regulated according to several quantitative criteria (the value of equity, the level of stock exchange capitalization, dispersion of shares among the public) and to qualitative criteria (growth prospects, profit). Romanian issuers may be admitted for trading in the event of shares financial instrument in three categories, in the sector called ***Equity Securities.*** Admission to the ***Equity Securities*** Sector is regulated by the Code of Bucharest Stock Exchange which stipulates general and specific terms and conditions which must be met in order to be allowed in a quota.

The status of issuers in the ***Equity Securities*** Sector as it is at present is shown in Table no.2.

Table no. 2 Structure of share issuers at BVB

Issuer	Entities	Number		
	Romanian entities	77, of which		
		25-1st category	51-2nd category	1-3rd category
	International entities	1 - issuer: Erste Group Bank AG		

Source: http://www.bvb.ro/Companies/QShares.aspx

Therefore, stock exchange performance in Romania is more attractive to Romanian issuers yet not too appealing to foreign issuers as the market is not interesting enough to the latter.

4. Reflecting Financial Information on Shares' Fair Value

Investors always monitor the changes in the price of financial instruments purchased either by means of the stock exchange if a security is listed, or by the analysis of financial instruments' price when being issued by listed companies that belong to the same sector of activity. In reference with a purchase price, a fair value can be higher than, lower than or equal to a purchase price (book value).

If in the end of a reporting period a fair value is lower than a book value, the respective company ascertains the depreciation of the respective securities.

Example of depreciation entry in Romania (Luță, 2005, p. 212):

1,000 "X" shares have been purchased at the quotation of 10.50 lei/share on the 3rd of March, year N. On the 30th of June, upon financial statement closing for the first term, the quotation of securities was 10.30 lei/share.

If depreciation is thought as reversible, an enterprise has a value shortfall representing the impairment of fixed assets-capital assets.

Yet it is supposed that the decrease in market share is temporary and after the announcement of financial results at "X" Company during the first term, it shall go back to higher levels than the quotation on purchase date.

- Purchase of securities:

261	=	5121	10.500
"Shares in affiliated entities"		*"Lei bank accounts"*	

- Impairment preparation to decrease securities:

10.5-10.3 = 0.2 lei/share

1000 securities purchased x 0.2 lei / share = 200 lei

Depreciation is reversible and there is impairment for financial account expenses.

6863	=	2961	200
"Impairment losses on financial non-current assets"		*"Impairment of investment in affiliated entities"*	

If a quotation comes back to 10.40 lei/share without reaching the level on purchase date, the impairment thereof decreases accordingly:

10.50 lei/share – 10.40 lei/share = 0.10 lei

1000 securities purchased x 0.10 lei/share = 100 lei

- Decrease in impairment thereof:

2961	=	7863	100
"Impairment of investment in affiliated entities"		*"Reversal of impairment losses on financial non-current assets"*	

If a quotation comes back to and even exceeds the level on the 3rd of March, the impairment thereof is cancelled by revenue resumption.

2961	=	7863	200
"Impairment of investment in affiliated entities"		*"Reversal of impairment losses on financial non-current assets"*	

There are no accounting records for the value increases due to securities' quotation increases. They are emphasized only in the event of security sale by the emergence of profit from financial activities.

According to Standard IAS 36 "Impairment of Assets", a capital asset is described as impaired if its entry value is higher than its estimated recoverable value.

In compliance with international accounting regulations, the impairment of fixed assets is recognized as an impairment loss and is recorded as an impairment loss expense in a direct relation with a depreciated asset. Subsequently, if a capital asset is appreciated (by a value increase), a financial revenue is recognized in a direct relation with a capital asset.

If an enterprise ascertains capital asset depreciation, the asset book value must be narrowed to its estimated recoverable amount either directly or by using a value cut-down account. The value of loss must be included in the financial result of the reporting period.

A company must measure on the date of every balanced whether there is objective proof that a capital asset or an asset group might be described as deteriorated. If such a proof is available, the company must estimate the recoverable value of the respective asset or group of assets and recognize any depreciation losses as such:

- ***in terms of capital assets entered at their depreciated cost***, loss value is the difference between the asset book value and the present value of expected cash flows updated according to the real interest initial rate of the financial instrument (recoverable amount);

- ***in terms of capital assets revalued at their fair value,*** the loss value that has been recognized must be taken out from equity and recognized in the category of net profit or reporting period-related loss. Loss value is the difference between asset purchase price and asset current fair value, less any loss resulting from the respective asset depreciation previously recognized in the net profit or net loss.

The objective proof that a capital asset or asset group is depreciated or impossible to recover includes information on:

- the significant financial difficulty of an issuer;

- the actual infringement of contract, such as for example failure to pay interest or principal;

- creditor's granting to debtor from economic reasons or reasons related to financial difficulty of a certain concession the creditor would not have considered under different circumstances;

- high likelihood for bankruptcy or another financial reorganization of the issuer;

- recognition of a depreciation loss (value decrease) generated by the respective asset during a previous financial reporting period;

- removal of an active market in terms of the respective capital asset;

-a historical pattern of debt recovery which indicates that the entire portfolio nominal amount is not to be received.

As a technique to cancel the depreciation of capital assets, the value depreciation loss is cancelled, either by increasing asset value, or decreasing the value reduction account, with compliance ensured by affecting the financial result account of the reporting period.

A value reduction account in our country can be an adjustment account for assets' impairment.

According to *IFRS*, there are no operations with adjustment accounts for asset impairment, but there are "allowance accounts" whose role is to reduce the value of assets in a balance sheet.

This reduction/cancellation of value impairment must not lead to a current depreciable cost higher than the value which could have been reached if the respective asset had not been impaired.

According to IFRS standards at international level, value loss statement is provided in all asset categories. Value loss according to international standards is recognized as an expenses during the reporting period and directly decreases asset book value. Practically, this approach changes the solid foundation of presenting assets at their historical costs. Yet, implications are much more complex. For example, impairment adjustments help keep separate track (up to a certain stage) of a “historical cost” and of the “market values” of assets with the possibility to “return” to origins at any time.

International practice ascertaining asset value as compared with the practice in our country involves different variants of impairment accounting.

The two ways to enter asset impairment are shown in the table below:

Table no. 3 Entry variants of asset impairment

Romanian (current) variant		International variant	
• Entering the decrease in asset value:			
“Asset impairment-related adjustment expenses”	*=”Adjustments of asset impairment*	*“Asset impairment expenses”*	*= “Asset accounts*
• Entering value impairment cancellation:			
“Adjustments for asset impairment”	*=”Revenues from adjustments for asset impairment”*	*“Asset accounts”*	*= ”Revenues for asset impairment”*

In both variants, the profit and loss account recognizes a potential unachievable expense when achievable value is lower than book value. Value loss is potential because the asset has not been sold, consumed or transferred. But “potential earnings” are not recognized when they ensue in the event of achievable value exceeding book value (principle of prudence).

The difference between the two variants is the fact that in the international variant, the result of a tax year does not recognize a “necessary revenue” in order to cancel some previous expenses, but it reverses the initial entry. Thus, the calculation of profitability indicators can generate other values. Moreover, an asset can be presented in a balance sheet, too, and the subsequent passage to expenses is to take place according to this new value.

Conclusions

A company’s accounting policy on adjustments has an influence upon the result of a tax year and, implicitly, upon corporate tax by the impact of reversible value impairment recognized as an expense during the reporting period when it is fiscally deductible.

Although in accrual accounting, the principles and standards fully allow the entry of asset impairment, thus leading to a “true and fair view” of an entity's status, fiscality imposes restrictive rules for impairment adjustment deductibility. Unfortunately, in the countries where accounting is connected to fiscality, trading companies aim by adjustment preparation only at the fiscal advantages, not at the requirements to reflect a “true and fair view”. Analyzing impairment adjustments only from the perspective of fiscal rules, as they are non-deductible and companies give up the adjustment mechanism, they are to raise deformed fixed capital assets, far from accounting truths.

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