

ISSUES ABOUT THE EVALUATION OF THE FINANCIAL INSTRUMENTS AND TAX IMPLICATIONS

Camelia-Cătălina, Mihalciuc¹
Anișoara, Apetri²
Teodora, Oleniuc³

Abstract:

Accounting assessment is a process with tax implications on accounting figures. In fact, when it comes to evaluation, we need to clarify exactly what is being referred to: it is about the individual assessment of an asset or liability, or about the global assessment of a business. So, in a narrower approach, in accounting we are particularly interested in the individual assessment of assets and liabilities.

In the evaluation, the concept of value is the primary element, accounting, especially along with the application of the principle of economic prevalence over the juridic, managed to convey the best measure those interested, information about how to create, to measure and how to communicate to business partners the value.

The tax implication that arise after the evaluation of the individual elements of the asset, influence the result of the exercise by including the expenditure in the total expenses generated by the evaluation.

The main asset elements, which following the evaluation generate tax implications are the tangible fixed asset, financial and stocks. Based on this consideration, one of the main objectives of this paper is to highlight the tax implications arising from the evaluation of financial instruments that generate tax liabilities.

Keywords: *financial instruments, evaluation of financial instruments, the tax implications, fair value, IAS 39/IFRS 9*

JEL Classification: G23 Financial Instruments

1. Introduction

The objective of this paper aims to achieve an overview of the main changes contained in IFRS (International Financial Reporting Standards) related to financial instruments, capturing their consequences for entities that apply IFRS or are preparing to apply IFRS.

The evaluation of financial instruments is performed in order to gain their recognition in the financial statements.

Thus, an important aspect presented also in the content of the paper refers to the debt evaluation and financial assets. In the scientific approach of the paper, points of analysis focused on the one hand the concept of fair value, present the advantages in terms of fair value measurement of the financial instruments compared to historical cost, evaluation of financial instruments in the four moments of evaluation, depreciation presentation of financial instruments, as well as an overview of IFRS 9 – Financial Instruments, on the other hand surprise some tax issues relating to evaluation of financial instruments.

For financial instruments, since the taxation of the financial instruments evaluation refers to how they are recognized accountant, is important to note that from an accounting perspective, they can be recognized as financial assets or short-term investment. From a fiscal perspective, the evaluation of financial instruments as assets have a general rule that income and expenses resulting from the evaluation are included in the tax base, but only consider gains and losses were made. From a fiscal perspective, the evaluation of financial instruments held as assets, have a general rule according to which the revenues and expenditures that results from evaluation are not included in the taxable base, but take into account only gains and losses which were made.

¹ Associate Professor Ph.D., University „Stefan cel Mare” of Suceava, Romania, Faculty of Economics and Public Administration, cameliam@seap.usv.ro

² Lecturer Ph.D., University „Stefan cel Mare” of Suceava, Romania, Faculty of Economics and Public Administration, anisoarad@seap.usv.ro

³ Economist, SC Carpatis Suceava, oleniuc.teodora@yahoo.com

If the financial instruments are not held as fixed assets, if the evaluation has recorded income, these will be registered as taxable incomes. If following the evaluation is recorded expenses from the losses of value, these are registered as expenses non deductible, even if they are held as assets or not.

2. The Concept of Fair Value

A controversial issue in establishing the fair value occurs in the situation of debts and financial assets, since there are discussions on the historical cost advocates and supporters of fair value.

The historical cost is a defining concept of traditional accounting, representing the value of the asset at the time when it is obtained or liability when it is contracted. Depending on how to obtain the evaluated elements, the historical cost may be represented by acquisition cost, production cost or nominal value.

Currently the historical cost guides the accounting entity to the past because it reflects the values of the balance sheet items, at the time when they were purchased, being maintained over time. This does not provide a true and fair view of the heritage (assets), even if it has entered the correction of historical cost with the amortization, this procedure is being used only when the value decrease because in case of growth, this proceeding is not applicable.

Thus currently, the objective of accounting is not to show an past picture of heritage but a present reality. That is why the historical cost began to be exceeded, because the more intense use of financial instruments did not made possible their registration in the financial statements. Thus arises the concept of fair value.

„Fair value appeared in order to try to supply the shortfalls of historical cost by correcting the acquisition costs of assets with their market value which is achieved through constant re-balance sheet items”. The correction takes into account the profit and the potential loss, and not just the effective, as in the case of the historical cost, leading to a result that puts into consideration the current economic situation.

In Table no. 1. are a number of advantages of the fair value, compared with the historical cost of the evaluation of financial instruments.

In our country we chose to combine these two systems of evaluation, except that fair value is used only for the evaluation assets, received with free title.

Accounting regulations according to European Directives only allow the use of fair value for financial instruments and derivatives found in the consolidated financial statements.

Table no. 1. Advantages of the fair value compared with the historical cost

Fair value	Historical cost
Enhance the usefulness by providing information on the assets benefits and the disadvantages of assuming liabilities in the current market conditions.	Providing information on the assets benefits and the disadvantages of assuming liabilities in the current market conditions, only at the time of their acquisition, having a lower utility
Shows the effects of management decisions to preserve assets and liabilities or to purchase / contract others, on company performance.	Shows the effects of management decisions to preserve assets and liabilities or to purchase / contract others, but ignores those that are kept or not settled.
The total accounting values, in derivative financial instruments.	Does not appear in the balance sheet in terms of using the historical cost.
The estimation of future cash flows (predictability).	The estimates does not provide reliable information.

3. The Evaluation Moments of Financial Instruments

The initial evaluation techniques and the subsequent financial instruments were provided in the IAS 39 standard - Financial Instruments: Recognition and Measurement. According to this standard, assets and financial liabilities as well as derivatives are initially measured after a single rule that is the fair value. Following the requirements expressed by the G20 Group to review the way in which the financial instrument are accounted, the IASB published IFRS 9 "Financial Instruments" in several stages. IFRS 9 Financial Instruments was published in November 2009, replacing the international standard IAS 39, including requirements for measuring financial assets.

Based on the controversies surrounding the fair value measurement of financial liabilities and the recognition of a gain when the entity's credit risk deteriorates, IFRS 9 initially has treated only the aspects of financial assets accounting. Since October 2010, were added to IFRS 9 requirements for valuing liabilities financial, most of the requirements for financial liabilities have been taken over unchanged from IAS 39. Thus, the issues of derecognition of financial assets and liabilities were taken from IAS 39, IFRS 9 maintaining the IAS 39 fair value option in case of financial liabilities, the only modification is related to the portion of the fair value of financial liabilities of the entity associated to credit risk (changes in value) which would not affect the profit and loss, as in IAS 39, but other elements of comprehensive income in the balance sheet (with some exceptions).

Financial institutions are the most affected by the application of this standard, which is why they must aim the changes adopted to ensure the continuity of IFRS. In December 2011 the Council amended the IFRS 9 to its application for annual periods beginning on or after January 1, 2015. From this date would not require the restatement of financial statements of the comparative period from initial application. IFRS 9 now contains guidance for: recognition and derecognition of financial instruments, the classification and evaluation of financial asset and the classification and evaluation of financial liabilities.

On initial recognition, an entity shall measure a financial asset or a financial liability at its fair value plus or minus, in the case of a financial asset or a financial liability which is not to fair value through profit or loss, transaction costs that are directly attributable to the acquisition or to the emission of the financial asset or financial liability. We can take thus, the example of an entity that has a portfolio of loans with early payment, and the fair value of the loans at the date of transaction is 20 200 um and the fair value of additional margin of 0.5% is 40 um.

The entity will calculate the gain or loss to the sale of 80% of cash flows. Assuming that, on the transfer date are not available the fair values of 80% transferred part and the 20% retained part, the entity allocates the carrying amount of the asset as follows in Table no. 2:

Table no. 2. The allocation of the carrying amount of the asset

Parts	Fair value	Percentage	Carrying amount allocated
Transferred part	16.160	80%	16.080
Retained part	4.040	20%	4.020
Total	20.200		20.100

The fair value is the input value that is entered in the accounts the financial instruments, being composed of elements shown in Table no. 3.

Table no. 3. The components of fair value

No. crt.	Components	Elements which do not become part of fair value
1.	Transaction price	The financing costs, internal management and retention
2.	Transaction costs	Premiums and discounts

Generally, it is considered that, at the time in the accounting, the best evidence of fair value of a financial instrument is determined by the transaction price (paid or received). Transaction price can be determined knowing the market and prices, the prices which is practiced on that market of similar instruments. If this market does not exist, is taking into account the similar markets with the recent transactions of the same instruments. But if there is a situation in which we can not determine a market price, it does not exist, it's arising to update the future cash flows.

For example a company acquires 150,000 stocks with a fair value of £ 7,500,000. The Company pays a commission of £ 150,000 to brokerage companies, classifying the actions in assets for trading, registering the commission per expense.

%				7.650.000
Financial asset	=	Balances with banks	7.500.000	
Current expenditure (transaction costs)			150.000	

If the company considers the actions available for sale, in addition to their initial fair value, the costs will be included and trading. For example, we'll consider the case where the price of the transaction (still outstanding) is £ 7,500,000 and the commission of payment is £ 150,000.

Financial assets available for sale (including transaction costs)	=	%	7.650.000	
		Debt		7.500.000
		Balances with banks		150.000

The operations which are performed after the initial evaluation are considering the transaction costs, which are included in the value of the instrument, at amortized cost, is attenuating along it's life period, periodic cost being registered in profit and loss account by the effective interest method. For instruments which have no fixed maturity and doesn't offer payments, the generated cost are registered at the time of their sale, affecting the result of that period.

The Romanian companies which do not apply the IAS and the IFRS, realize the initial measurement of financial instruments according to some requirements similar to those of IAS 39. *Financial Instruments: Recognition and Measurement*, as follows in the Figure No. 1.

The future evaluation: At the initial evaluation of the financial instruments the things were very simple, whereas all were recognized at fair value, instead for further evaluation are some difficulties in applying the evaluation rules, as they are constantly changes depending on the instrument, as can be seen in Figure no. 2.

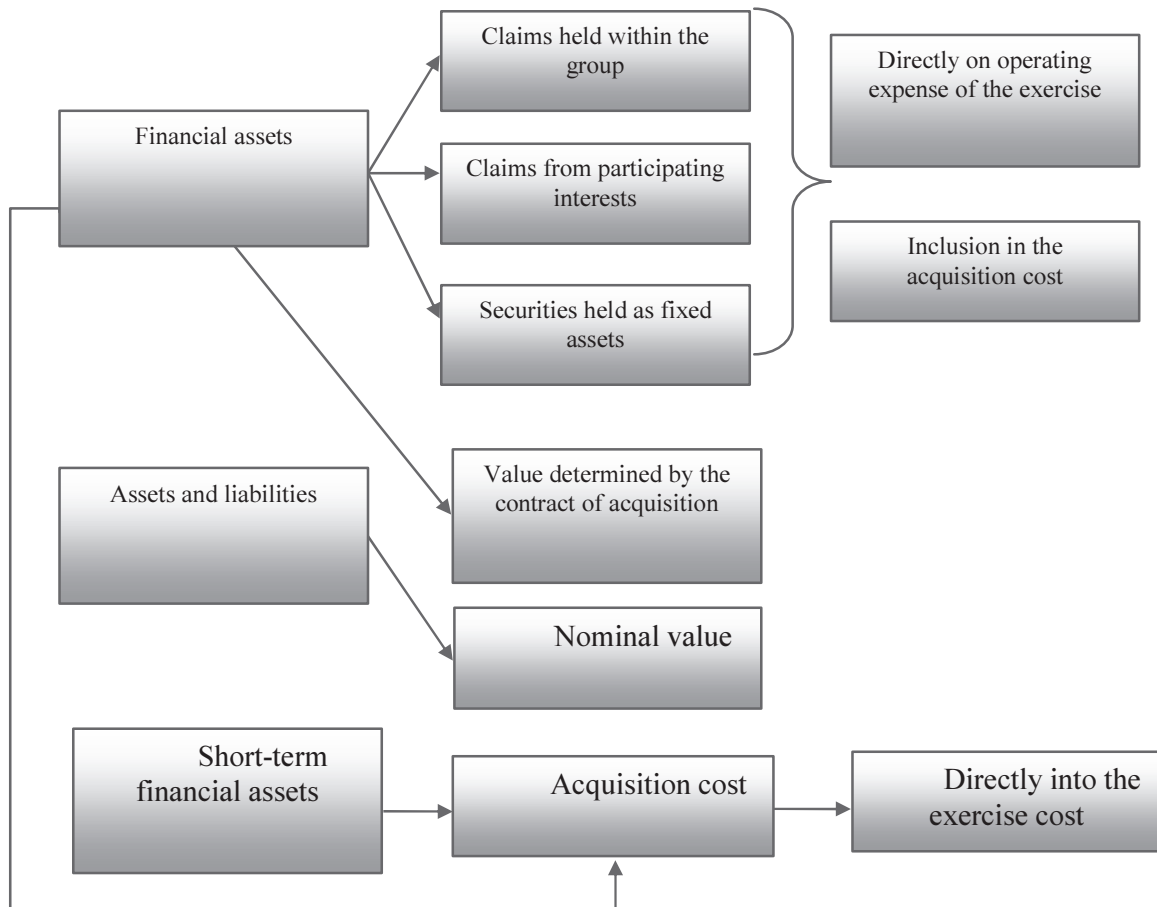


Figure No. 1. The evaluation of financial instruments of companies that do not apply IAS and the IFRS

4. Depreciation of Financial Assets

All the financial instruments evaluated at fair value having the registrations of changes in the profit and loss account do not depreciate, instead the other financial assets require depreciation testing. The losses of value which is registered after the impairment test, can be calculated as the difference between the discounted present value and the book value. The existence of financial assets depreciation can be felt through the presence of the following factors related in Figure no. 3.

Depending on the way of further evaluation, different accounting treatments of depreciation are apply to financial assets, such as: *amortized cost, fair value and historical cost*.

Depreciation of assets evaluated at amortized cost. Depreciation in the case of evaluation at amortized cost is determined by the difference between the book value (carrying amount), being the largest and the present value of future cash flows, which are updated according to the original effective interest rate. The registration of losses is realized in the profit and loss account on a current period, based on an adjustment account for depreciation.

Depreciation of assets evaluated at fair value. For financial assets evaluated at fair value, their depreciation involves the transfer of losses in the profit and loss account from equity. The loss which will transfer into the result of period, will have a value equal to the difference between the acquisition cost and the fair value, excluding the depreciation previously recognized.

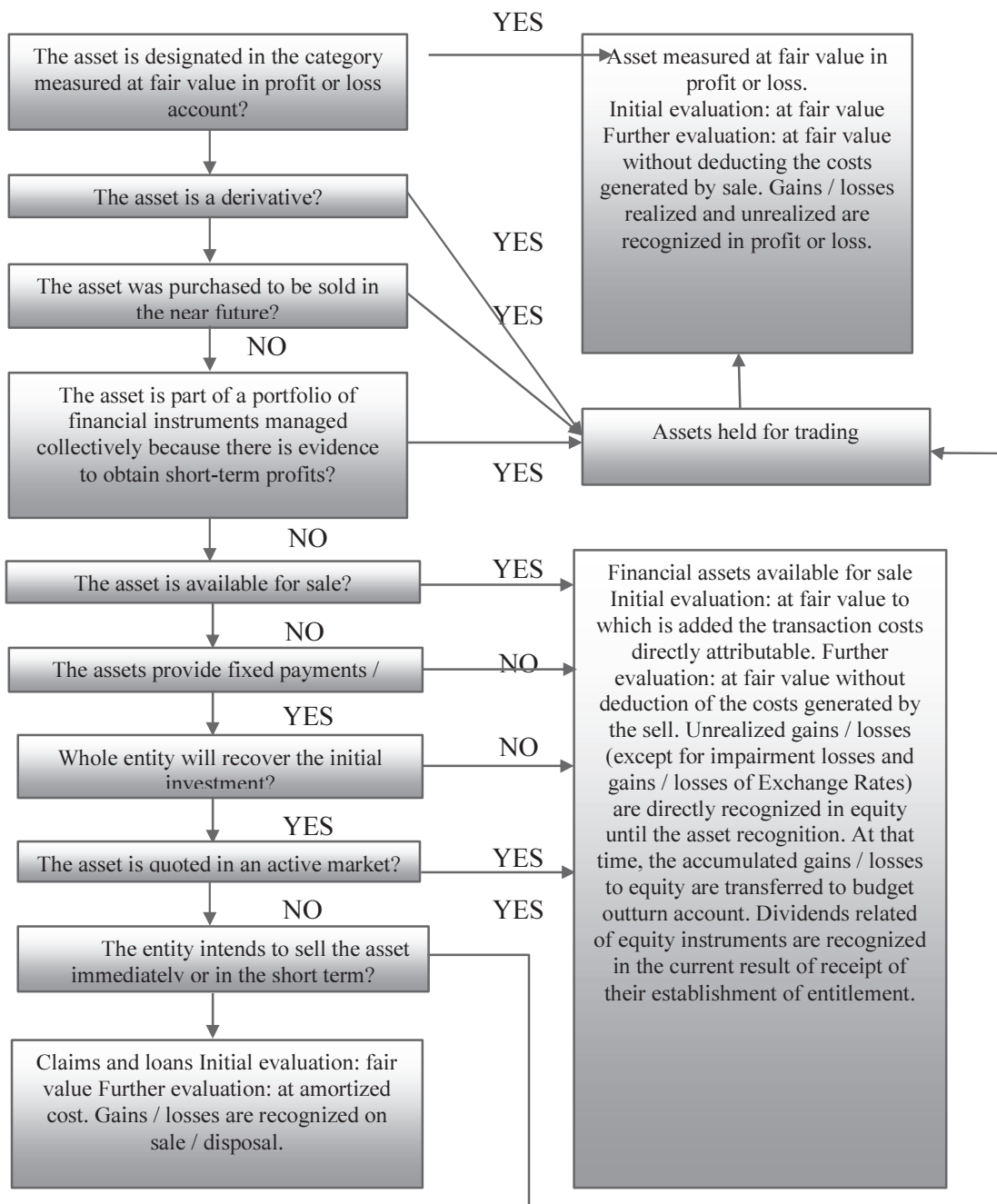


Figure No. 2. Subsequent evaluation rules for financial assets

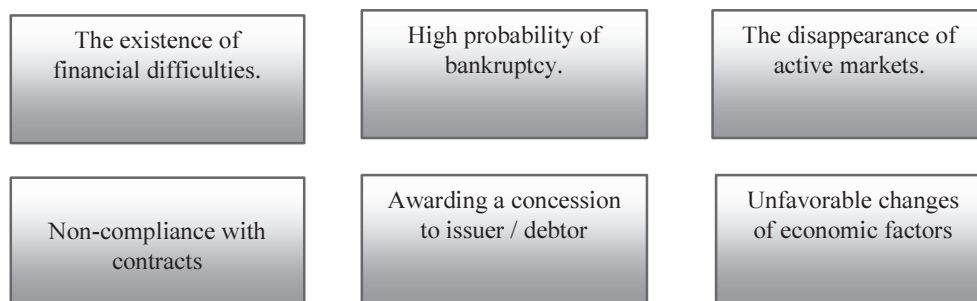


Figure No. 3 The evidence of depreciation (loss in value)

Depreciation of assets valued at cost. The financial assets evaluated at cost are unquoted equity instruments for which the fair value can not be reliably determined, as well as the derivatives related to settlement or through the delivery of such unquoted instruments.

If the impairment losses are registered, these are determined as the difference between the carrying amount and the present value of estimated cash flows, the loss can not be resumed.

5. Fiscal Issues in the Evaluation of Financial Instruments

Entities that have in their portfolio various financial instruments such as equity, stock and shares and other investment funds should have the costs that are generated by their management as well as fiscal related costs. Since the taxation of financial instruments evaluation refers to how they are recognized accountant, is important to note that in accounting terms it can be recognized as financial assets or short-term investment.

Compared with the participation titles, if the problem that appears is rather of interpretation of the legal text, in the case of stock and shares issued for long term, there is an obvious discrepancy situation between the applicable fiscal arrangements income and expenses from revaluation. This discrepancy is based on different criteria taken into account in determining the income tax system and respectively, the costs of unrealized evaluation differences. Thus, in terms of revenue, it is regarded the accounting recognition criteria of the instrument (as immobilization or not), in terms of expenditure it is regarded the maturity criterion of the instrument (if issued for long term or short term).

More precisely, the income from revaluation of stock and shares are considered taxable income, if the financial instruments are held as assets. On the other side, the expenses from revaluation of the same financial instruments are deductible if the stock and shares are issued for long term. Given the above, in the event that a company will have in heritage long term stock and shares issued, but will not be registered as assets because they are purchased with the intent to be alienated in a very short time horizon, the income from the evaluation of such instruments will be taxable, while expenses will be deductible.

In this case, the current wording of the legislation makes it almost impossible to apply a consistent fiscal treatment regarding the income and the expenses arising from the evaluation of long-term stock and shares issued that are not recognized as assets from accounting point of view. This situation is most often seen in major financial institutions which have significant portfolios of government securities, long-term, but not held as assets but also for trading of government securities issued for long-term, but not held as assets, but also for trading.

Also, a similar situation to those listed above for stock and stock and shares may appear with other types of financial instruments held in the portfolio. In this regard, I want to mention that while the provisions relating to the classification of an income as tax fee are general and aim any financial instrument, the provisions relating to the recognition of costs as non-deductible, refers only to certain categories of financial instruments, namely participation titles and stock and shares issued for long-term.

To facilitate law enforcement, it would be appropriate and equitable to ensure the consistency tax treatment in terms of income and expenses, resulting from periodic evaluation of the financial instruments. In this sense it can be considered un uniform framing criterion, for both income as well as expenses.

The recognition criterion of accounting as assets, currently used to determine if the evaluation income are taxable or not could be applied by the authorities in regard to the deductibility of costs evaluation regime.

In addition, such an approach would also have an economic justification since it allows, for the financial assets of which the price can fluctuate significantly over time, the tax may not reflect income or expenses that do not correspond to actual gains or losses.

6. Conclusions

In conclusion, the aspects of applying IFRS 9, indicates a significant impact on the classification and on the evaluation of financial assets, and of a reporting change for those entities, which have designated financial liabilities using the option of fair value evaluation. Thus, the classification of financial assets evaluated at fair value assets and assets evaluated at amortized cost, according to IFRS 9, will take place at initial recognition and depends on how the entity will manage the financial instruments and the flows of cash characteristic of those financial instruments.

We have to remember that in July 2014, IASB published the final version of IFRS 9 giving a brief overview of this standard, providing also the most recent additions and changes. The structure of IFRS 9 includes the fellow parts: a logical, single classification and measurement approach for financial assets that reflects the business model in which they are managed and their cash flow characteristics; a new expected loss impairment model, that will result in more timely recognition of loan losses; an improved hedge accounting new model that aligns the accounting treatment with risk management activities, the objective of hedge accounting being to represent in the financial statements the effect of an entity's risk management activities.

The Standard will come into effect on 1 January 2018, but entities can however choose to apply IFRS 9 before then. These entities would need to apply the version published in July 2014, taken in consideration all three parts of the summary project: the classification and measurement, impairment, and hedge accounting.

The entities that prepare financial statements in accordance with IFRS will be required to examine whether the accounting policies used will be changed as a result of amendments to fullfills IFRS 9 (a section of the financial statements is allocated the amendments to IFRS and their impact on the financial statements). The entities which prepare the transition to IFRS will have to take into account these amendments in selecting the accounting policies and configuration information systems to perform the necessary restatements and ensure the preparation of financial statements in accordance with IFRS.

“ACKNOWLEDGMENT

This paper has been financially supported within the project entitled „SOCERT. Knowledge society, dynamism through research”, contract number POSDRU/159/1.5/S/132406. This project is co-financed by European Social Fund through Sectoral Operational Programme for Human Resources Development 2007-2013. Investing in people!”

Bibliography

1. Feleagă Niculae, Malciu Liliana, (2004), *Recunoaștere, evaluare și estimare în contabilitatea internațională*, Editura CECCAR, București.
2. Feleagă Liliana, Feleagă Niculae, (2007), *Contabilitate Financiară. O abordare europeană și internațională*, Ediția a doua, Editura Economică București.
3. Greuning H., (2007), *Standarde Internaționale de raportare financiară, Ghid practic, Ediția a II-a revizuită, traducere de Solomon, M., Șerban, C., Editura Irecson, București.*
4. Huiian, Maria, Carmen, (2008), *Instrumente Financiare: Tratamente și Opțiuni Contabile*, Editura CECCAR, București.

5. Mateș, Dorel, s.a.,(2010), *Contabilitate Financiară conformă cu Directiva a IV-a a Comunităților Economice Europene*, Editura Gutemberg Univers, Arad.
6. Mateș, Dorel, s.a.(2008), *Contabilitatea Evenimentelor și Tranzacțiilor între Standarde, Directive și Reglementări Fiscale*, Editura Mirton Timisoara.
7. Ristea, Mihai, (2005), *Contabilitatea financiară a întreprinderii*, Ed. Universitară, București.
8. <http://www.pwc.com>
9. <http://www.ifrs.org/Current-Projects/IASB-Projects/Financial-Instruments-A-Replacement-of-IAS-39-Financial-Instruments-Recognitio/ALO/Pages/ALO.aspx>
10. <http://www.ifrs.org/current-projects/iasb-projects/financial-instruments-a-replacement-of-ias-39-financial-instruments-recognitio/Pages/financial-instruments-replacement-of-ias-39.aspx>
11. <http://www.ifrs.org/Current-Projects/IASB-Projects/Financial-Instruments-A-Replacement-of-IAS-39-Financial-Instruments-Recognitio/Documents/IFRS-9-Project-Summary-July-2014.pdf>
12. <http://www.icaew.com/en/library/subject-gateways/accounting-standards/ifrs/ifrs-9>