

A PRACTICAL POINT OF VIEW FOR THE ALTERNATIVE VALUATION TREATMENTS

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Abstract: *The present article aims to emphasize the application of different valuation treatments in various practical situations. Being an actual issue, it generates numerous debating possibilities. There will be taken into consideration even the IAS (International Accounting Standards) and the Continental and North-American points of view. The main theme of the paper is the cash flow method.*

Key words: *valuation treatment, cash flow, market value, historical cost, IAS.*

INTRODUCTION

The tendency of the international accounting reference standard is to opt for a structural evaluation approach that looks at future cash flows, and pays less attention to the traditional and conservative approach that looks at historical cost and hangs on the safety practices that insure a better feasibility and traceability of the accounting data. Indeed, the modern vision of the evaluation concept betrays, at the content level, a secular principle of accounting, which is the justification of recorded accounting data.

The North-American movement, which set the tone for the reformation of evaluation methods and procedures and the recognizing of the financial-accounting structures, has convinced other states of the benefits of cash flow based accounting. In our country, the implementing of cash flow accounting, in the detriment of the already existent rigid and fiscal engagement accounting, represents a real solution for the improvement of the relevance of accounting data.

MATERIALS AND METHODS

In order to piece together this study, multiple methods have been used concurrently as follows: comparative analysis, in theory as well in practice, synthesis, induction and deduction.

RESEARCH RESULTS

Let's look at the situation of a piece of equipment purchased through financial leasing. Its fair value is 1.000.000 lei, which coincides with the market value of the equipment, because our entity has procured this piece of equipment directly from the market. In this situation there has been no negotiation between the parts involved in the sale-purchase, through which a price lower than the market price could have been obtained.

However, IAS 17 requires the equipment to be registered as a debt by the owner, at a value representing the minimum between the fair value and the present value of the minimum leasing payments.

This is a form of hybrid evaluation that is often met in accounting practice.

The fair value of the equipment is 1.000.000 lei. When it comes to the utility value of the equipment, which is equivalent, in this case, with the present value of the minimum leasing payments, it is:

Formula 1

$$150000 + \sum_{i=1}^5 \frac{185000}{(1+0.057)^i} + \frac{85000}{(1+0.057)^5} = 981056 \text{ lei.}$$

Therefore, the purchased equipment will be recorded with the value of 981.056 lei, the difference of 18.944 lei representing the expense for the period recorded by the lesser.

The earning thus obtained by the lessee is justified by the increase in the unexplained residual value, which is meant to make the option to buy within the contract much more attractive.

In this case as well, the lessee's wish to buy the equipment at the end of the contract is quite clear, keeping in mind that the estimated residual value at the time of the contract signing was 85.000 lei, while the option to buy was set to a residual value of only 60.000 lei. In the end, the value of 18.944 lei represents the present value of the unwarranted difference of the residual value of 20.000 lei. Mathematically, this is determined through the formula:

Formula 2

$$\frac{85000 - 60000}{(1+0.057)^5} = 18944 \text{ lei}$$

By this evaluation approach, the cash-flow size afferent for each annual period is substituted by the size of the annual minimum leasing payments, representing a clear example of the evaluation by cash-flow approach.

What happens if the cash generating unit, represented by the acquired equipment, gives clear indications of depreciation?

For this, IAS 36 "assets depreciation" has a specific test. The asset depreciation set is relatively simple; placing in the center of attention the inequality truth value set between the accounting value of the asset and its recoverable amount is given by the minimum between the asset use value and its selling price.

After two years in use, the purchased equipment is estimated at 900.000 lei, generating an extra value of 185.714 lei. After four years in use, some justified signs of possible depreciation start coming from sources in the market.

Experts evaluate the equipment to be worth 300.000 lei on the market. In case the decision to sell is made, there will be selling costs of 40.000 lei. At the same time, it is important to take into account an inflation rate of 15%, and an implicit deflated interest rate of 8%.

Last but not least, it is estimated that the equipment will generate future benefits expressed in present values of: 300.000 lei, 250.000 lei, and 200.000 lei for the years 5, 6 and 7 of use.

Table 1**Evolution of Cash Flow and of Discounted Cash Flow during the Years 5,6,7**

Year	Discount factor	Cash Flow	Discounted Cash Flow	
5	0,681	250.000 lei	170.146 lei	
6	0,63	200.000 lei	126.034 lei	
7	0,583	150.000 lei	87.524 lei	Interest earnings
Total		600.000 lei	383.703 lei	216.297 lei

In a graphic manner, these data could be represented as it follows:

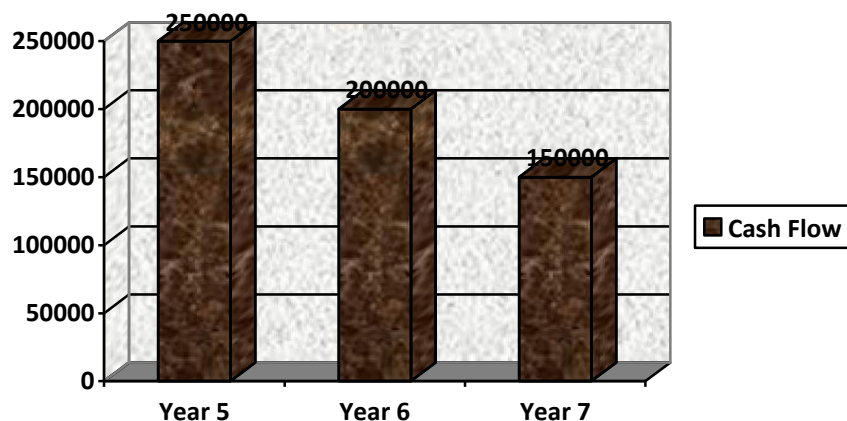


Figure 1 Evolution of Cash Flow during the years 5,6,7

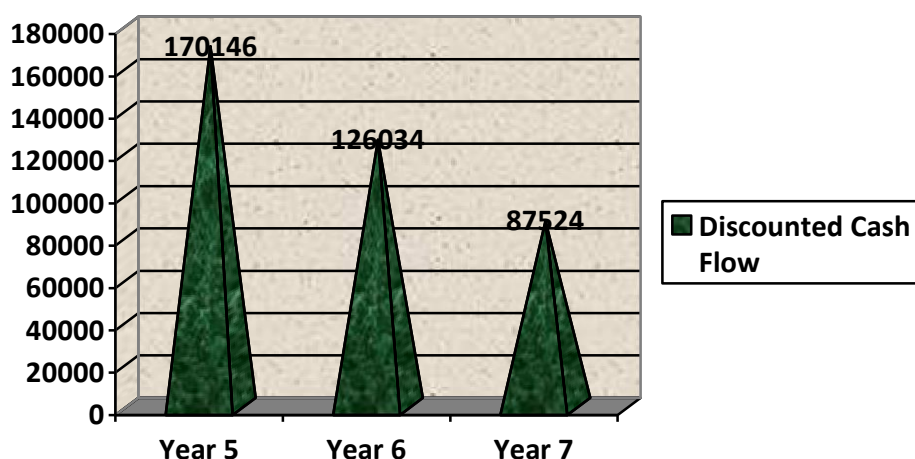


Figure 2 Evolution of Discounted Cash Flow during the years 5,6,7

This data will help us determine whether the equipment has actually suffered a loss in value:

Selling price (fair value)	300.000 lei
- Selling cost	40.000 lei
= Realizable value	260.000 lei
Use value (Present value)	384.703 lei

Max (realizable value, use value)	
= Recoverable value	383.703 lei
Fair value	900.000 lei
- Accumulated depreciation	588.879 lei
= Accounting value	507.150 lei
= Loss by depreciation	123.447 lei

The use value is given by the formula

Formula 3

$$\frac{250.000}{(1+0.08)^5} + \frac{200.000}{(1+0.08)^5} + \frac{150.000}{(1+0.08)^5} = 383.703 \text{ lei.}$$

But because the inflation rate is significant, it is recommended to work with an accounting value that is adjusted to the inflation rate $1.15 \times 441.000 \text{ lei} = 507.150 \text{ lei}$. This adjusted accounting value is what truly represents the cost to replace the equipment.

However, keeping in mind that this asset started from a reevaluated value of 900.000 lei, registered at the end of the second year of use, there is no need to list the loss through depreciation of 123.447 lei as an expense, instead it should be recorded as a balancing of the current balance of the account “Differences from reevaluation” which comes to be 185.714 lei. After this operation, the differences from reevaluation account reach the sum of 62.267 lei, credit balance.

There are many difficulties associated with using present cash flow values as an evaluation base such as: the uncertainty of the volume of estimated future cash flows; the problem of disintegration of the origin of generated cash flows, by establishing cash generating units, according to IAS 36 “asset depreciation;” establishing the timeframe for forecasting cash flows, which has to take into consideration the concepts for maintaining financial capital; selecting the discount rate, for which the entity has available a large pallet of indicators: weighted average cost, marginal lending rate, and the current interest rate on the bank loan market.

It is important to note that such an approach, based on cash flows, represents a worthy alternative for mitigating negative effects regarding financial informing, generated by the profit and loss account, which offers only a static image of the entity’s performance, without taking into account future estimates and risks involved. This is why a multiannual result forecasting account is welcomed when looking at financial statements and it should be accompanied by a cash flow table broken down over the course of many years. Although difficult, such an approach can be implemented especially in enterprises that adopt a management by cost, based on an integrated and well defined system of multiannual budgets.

Even so, although IASB does not express a specific preference for either one of those evaluation bases, weather we are talking about traditional evaluation bases or modern ones, it is recommended to use mixed evaluation bases that use these individual evaluation bases combined together.

As a consequence, we will find that within the conceptual frame of the IASB the use of evaluation bases like:

✓ IAS 2 “inventories”, considers, due to safety, that inventories should be evaluated at the lowest value between historical cost and net realizable value;

✓ IAS 39 “Financial instruments,” claims that tradable titles must be evaluated at their market value when there is an active market for them; in the balance, these titles will be recorded at the lowest value between the historical cost and the market value.

A hybrid form, representing an evaluation base, was used in England and Holland, and is represented by the “value of dispossession.” An edifying case is that of Philips Electronics N.V., which used the value of dispossession in evaluating tangible and non-tangible assets. This evaluation base starts off from the principle which states that every tangible asset has an equivalent value to the monetary loss the entity would incur if it

would be stripped of the asset. Mathematically, the value for the owner, or the value of dispossession is found in the following formula:

$$VD - \min (CI; \max (VRN; VA)),$$

Where we used the following notations: CI – replacement cost, VRN – net realizable value, VA – present value.

Thus, if the asset is considered to still be useful for the entity, the maximum lost value is the replacement cost. However, if the entity estimates that the asset isn't useful, the asset value represent the maximum between the asset's net realizable value and, respectively, the accumulation of future cash flows that could be generated by using the asset. Therefore, the dispossession value represents the entity's effort to minimize its total loss incurred by dispossession.

Unfortunately, in Great Britain, this method has failed. The remarks regarding this evaluation base are quite vehement, studies having proven its utility only in the case of insurance companies. Furthermore, the value for the owner challenges the homogenous evaluation criteria of financial structures registered in summary financial statements.

Although, in theory, engagement accounting has no direct link to the option for one method or another based on cash flows, in practice, the users of accounting data would understand much better, without difficulty, the content of financial statements. The necessity to take uncertainty into consideration is just as real, dictated by the precautionary principle, but these precautionary mentions could be included in the accounting notes within the appendices to the balance sheet and the profit and loss account.

CONCLUSIONS

The IAS 36 norm "asset depreciation," puts all the above mentioned evaluation bases face to face. Each one of these evaluation bases, even historical cost, presents advantages as well as disadvantages in the use for evaluation of financial structures. The option for a specific evaluation base is placed around two essential characteristics of the accounting data, relevance and feasibility. This is why we find it adequate to use historical cost in the analysis of medium and long term projects, because it confers a high level of accounting data feasibility. In exchange, the market value is much more appropriate in a short term look at an entity's evolution, because it integrates in its size the immediate variations registered on the market.

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