Fair Value in Financial Statements of Bulgarian Enterprises

Assist. Prof. Iva Bankova Moneva
Bulgaria, Varna, VFU 'Chernorizetz Hrabar', ivamoneva@abv.bg

Bulgarian enterprises apply International Accounting Standards (IAS/IFRS) or National Accounting Standards for small or middle enterprises (NFRS for SME) as accounting basis. The conception of fair value is rather new for the Bulgarian practice. The definition of fair value is considered more as a function of the evaluator rather than of the accountant. Accountants are afraid to go out of the frame of their own competency. In this paper the author makes a review of the problems connected with using and applying the fair value in financial statements of Bulgarian enterprises.

Key words: fair value; financial statements; IAS/IFRS; NFRS for SME; Bulgarian enterprises; Bulgarian

Jel Classification: M41 Accounting

Fair Value in Financial Statements of Bulgarian Enterprises

Globalization of Economy is an objective and irreversible process of internationalization of capital and unification of transactions of economic entities. In connection with this, new demands are put towards financial information as a primary source for decision making and it makes it necessary for it to be standardized within global economy.

Information - a source of vitality on the capital market. Investors risk their capital by relying heavily on information which companies as potential objects of financing provide. Precisely because of this information should be reliable and timely. Its language should be comprehensible and its form should facilitate its analysis. Investors need assurance that the information coming into the companies is complete, accurate, reliable and trustworthy.

The development of market relations in Bulgaria has increased the demands for adequate information on business events, facts, processes. Moreover, accounting is one of the basic and affordable instruments for obtaining information. The role and requirements towards the composition of information which is disclosed in the financial statements of enterprises increase with the development and aggravation of economic processes.

Financial statements are a key element of the system of economic information; they provide in different manifestations of theirs intra-company and inter-company communication. They are a special type of built systems of management decisions, estimates and assumptions in which successes and weaknesses of the activity of enterprises are reflected. The report develops along with the economy and it subjects to the information management needs. The development occurs in the form of processes of differentiation and integration of the different reports.

In financial accounting, the conception of value/evaluation, cost/ of formation and use of assets, liabilities and capital plays an important role and in accordance with this, in varying degrees and in various combinations different evaluation methods are used. The process of evaluation is a procedure of allocation of financial accountability of the monetary value to objects. In recent years, problems associated with the requirement for the implementation of real, actual monetary evaluation of input and used in enterprises assets, liabilities and capital. To satisfy this requirement as a monetary basis, enterprises are recommended and regulated to use the so called ‘fair value’, ‘fair evaluation’ or ‘fair cost’ [1] instead of the used in the past ‘historical cost’ for assessment and presentation of assets, liabilities and capital in their financial statements.

The purpose of the evaluation at fair value is the users of financial statements to obtain information about the enterprise's financial position and results of its operations starting from the real existing, estimated rather than historical values. This approach ensures relevance and usefulness of the submitted information in the financial statement and also allows the true value of the business to be determined.

---

[1] The concept of fair value for the first time appears in the U.S. Financial Reporting Standards in the early 90's of the last century when the Committee on Standards of Financial Statements of the U.S.A. /Financial Accounting Standards Board, FASB/ issued the standards FAS 105 and FAS 107 in 1991 determining the rules for disclosure of information on financial instruments.

In terms of accounting, there is no unanimous opinion on whether to recognize the existence of the principle of fair value of the objects of the financial statement as well as the special place that he might have taken among other principles. These issues are of particular interest and the greatest polemics on a global scale. [2]

In the Bulgarian theory and practice of financial statements the ‘fair value’ concept is not yet fully equal as an alternative evaluation although the method of evaluating assets at fair value is mentioned in the International Accounting Standards/International Financial Reporting Standards /IAS/IFRS/.[3] The application of fair value is difficult.

Fair value can not fit within a single standard, a single enterprise or in a single object of accounting. It is a complex task in the field of financial statements. The very definition of fair value is evidence for that.[4] In order to establish fair value in financial statements should be subject to certain important conditions, such as:

1. free market trade;
2. stability of international trade;
3. accessibility and comparability of prices;
4. possibility of a price expertise;
5. public accountability;
6. active market;

In Bulgaria, the enterprises’ financial statements are prepared in accordance with IAS/IFRS or with the near to them NFRS for SME. In other words, the principles of evaluation for each type of assets, liabilities, revenues and expenses are in accordance with the standards. Usually, the bases for evaluation are disclosed in the accounting policy to the financial statements.

---

[2] The theme of the fair value regarding its definition, nature, meaning and application is a subject of discussions not only in financial literature. Three hundred and more years BC Aristotle and his treatise on fair value are at the heart of this discussion in general.

[3] IAS/IFRS, developed and published by the International Accounting Standards Board (IASB) and adopted by the EU, have been applied in Bulgaria since 01.01.2003. Except IAS/IFRS, in Bulgaria National Accounting Standards for small or middle enterprises (NFRS for SME) is applied too. Regarding contents, AFRSSME are close and analogous to IAS/IFRS.

[4] Fair value – the amount for which an asset could be exchanged or a liability - settled between knowledgeable, willing parties in a transaction at fair market terms.

Real estate, plant and equipment are initially evaluated by cost, including the purchase price as well as any directly attributable costs of bringing the asset to working condition. Subsequent evaluation is made on the basis of the purchase price decreased by the accumulated amortizations and depreciation losses. The made depreciation is recorded as an expense and is recognized in the Revenue statement for the respective period. Subsequent expenditures related to certain fixed /non-current/ tangible asset are added to the carrying amount of the asset when it is probable that the enterprise to have future economic benefits in excess of the originally evaluated effectiveness of the existing asset. All other subsequent expenditures are recognized as an expense for the period in which they have been incurred. Fixed /non-current/ tangible assets acquired under conditions of finance leases are amortized on the base of the estimated useful life determined by reference to similar assets or based on the value of the lease contract if its time is shorter.

In accordance with IAS 17 – Leases, ownership of a leased asset is transferred to the lessee where the lessee bears substantially all the risks and rewards of ownership of the leased asset. The asset is recorded in the balance sheet of the lessee at the lower of the two values – the fair value of the leased asset and the present value of the minimum lease payments. The balance sheet also reflects the respective obligation under a finance lease, whether part of the lease payments are payable in advance upon signing of the finance lease contract. Subsequently, the lease payments are apportioned between finance expense and reduction of the outstanding finance lease obligation. Assets acquired under conditions of finance leases are amortized in accordance with the requirement of the standards.

Intangible fixed /non-current/ assets are initially evaluated by cost price. In cases of self-acquisition, it is equal to the purchase price as well as any paid import duties and non-recoverable taxes and any directly attributable expenditures in connection with the preparation of the asset for exploitation. Subsequent expenses incurred in connection with intangible assets after initial recognition are recognized in the Revenue statement in the period of their occurrence unless they are likely to enable the asset to generate more than originally expected future economic benefits and when these expenditures can be reliably evaluated and attributed to the asset. If these two conditions are met, expenditures are added to the cost of the asset.

In cases when the company intends to sell fixed /non-current/ assets or a group of assets and if the sale is expected to be implemented within 12-month term from the date of the balance sheet, the asset or the group of assets are classified and recorded in the balance sheet as ‘held for sale’. Assets classified as ‘held for sale’ are evaluated at the lower than their carrying amount before their classification as ‘held for sale’ and their fair value is decreased by the expenses incurred for the sale. They are not amortized.

Financial assets are financial instruments. They are recognized on the date of settlement. Upon initial recognition of a financial asset, the enterprise shall evaluate it at a fair value. Transaction costs, which can be directly attributable to the acquisition or issue of financial assets, relate to the value of the asset or liability except for financial assets or liabilities reported at fair value in the profit or loss. Derecognition of financial instruments occurs when an enterprise loses control over contractual rights which constitute the financial asset, i.e. after the rights to receive cash flows have expired or substantially all of the risks and rewards of ownership have been transferred. Tests for depreciation are undertaken at any date of preparing the balance sheet in order to determine whether there is objective evidence of existing depreciation of specific financial assets or groups of financial assets.

Loans and receivables, originated initially in the enterprise, are financial instruments with fixed payments that are not traded on an active market. Loans and receivables are subsequently evaluated at amortized value using the effective interest method, decreased by the amount of depreciation. Any change in their value is written in the Revenue statement for the current period. The majority of trade and other receivables of the enterprise fall into this category of financial instruments. Usually, the discount does not take place when the effect of it is negligible.

Considerable receivables are tested for depreciation separately when they have been overdue upon the balance sheet date or whenever there is objective evidence that the counterparty will not fulfil its obligations. All other receivables are tested for depreciation in groups which are determined depending on the industry and the region of the counterparty, as well as on other credit risks, if any exist. In this case, the percentage of depreciation is determined on the base of historical data on outstanding obligations of counterparties for each identified group.

Inventories comprise raw materials, unfinished goods and commodities. The cost price of inventories includes the cost of purchase or production, processing and other direct costs associated with their delivery. Financial costs are not included in the value of inventories. At the end of each reporting period, inventories are evaluated at the lower than their cost price and their net realizable value. The amount of any depreciation of inventories to their net realizable value is recognized as expense for the period of depreciation. In case of sale of inventories, their carrying value is recognized as expense for the period in which the respective revenue is recognized.

Revenues are evaluated at fair value of received or due to be received payment or consideration, taking into account the amount of all trade discounts and volume rebates made by the enterprise. Revenue connected with a transaction for the provision of services is recognized when the outcome of the transaction can be assessed reliably. Operating expenses are recognized in the Revenue statement upon utilization of the service or upon the date of their occurrence.

Current tax assets and/or liabilities are those obligations or receivables from the budget which relate to the current period and which are not paid upon balance sheet date. They are calculated in accordance with applicable tax rates and tax rules for taxation of revenue for the period to which they relate, based on taxable financial profit for the period. All changes in tax assets and liabilities are recognized as a component of tax expenses in the Revenue statement. In practice, deferred taxes are calculated using the liability method on all temporary differences. This includes a comparison between the carrying amounts of assets and liabilities and their respective tax base. Existing tax losses are evaluated in terms of available criteria for recognition in financial statements prior to writing in the deferred tax asset. Such asset is recognized when there is likelihood of its realization through future taxable profits. Liabilities on deferred temporary differences are recognized in full. Assets on deferred temporary differences are recognized only to the extent that they are likely to be offset against future taxable profits. In order to determine the amount of assets and liabilities on deferred tax, tax rates, which are expected to be valid during the period of implementation, are applied. A considerable part of the changes in deferred tax assets or liabilities is recognized as a component of tax expense in the Revenue statement for the period. The change in deferred tax assets or liabilities due to changes in fair value of assets or liabilities, which is reflected directly in the capital (such as revaluation of land), is reflected, usually directly, in the enterprise's own capital.

Financial liabilities comprise bank loans and overdrafts, trade and other payables and finance lease obligations. They are recognized when there is a contractual obligation for cash payments or another financial asset to another enterprise or contractual obligation for exchanging financial instruments with another enterprise under potentially adverse conditions. All costs related to interest are recognized as expenses in the Revenue statement. Trade payables are initially recognized at nominal value and are subsequently evaluated at amortized cost decreased by payments to settle the obligation.

In order to evaluate the objects of accounting at fair value, it is necessary the evaluator to have wide economic, financial expertise and erudition, to be an expert in evaluation, etc. A serious shortcoming of the Bulgarian accounting community is the lack of practice of professional ratiocination of accountants. They are placed in the role of people whose job is to observe laws, decrees, letters and instructions, and at a great extent they do not express their own opinion. The main point, however, in IAS/IFRS are the principles and not the rules because it is not possible to establish rules for all cases arising in business. Based on the principles of international standards, the accounting ratiocination, view, professional financial opinion should be formed. In Bulgaria, the work of the accountant is assessed in terms of proper giving balances and the turnover from accounts in compliance with the articles of the legislatively regulated financial statement at the end of the reporting period. Until recently, management of Bulgarian enterprises paid great attention to the need for disclosure and publication of data from the accounting reports, trying to reduce their volume to a minimum. Moreover, there are attempts to assign financial statements the status of trade secret which, in principle, contradicts normative documents. The enterprise should provide the opportunity for users to familiarize with financial reporting. All this is due to the fact that management is not yet really interested in the need to initiate expansion of the indicators of financial reporting to the level of a quality product, and the state has not yet created conditions for the formation of a social order for substantial financial information by the owners, business partners, and the personnel of the enterprise. This order comes only from tax authorities, thus financial reporting of the enterprise is primarily tax oriented. In traditionally developed economies, accounting reports are not seen as an end in itself but as a source of information and ‘accounting reports’ means above all financial reporting, i.e. reporting directed to external users of information.

In conclusion, the issue of fair value remains underdeveloped in the methodological and organizational aspects. The status of fair value in the hierarchy of elements in the basic concept of financial statements has not been established. The ratio of accounting principles, the impact of fair value over the methodology and organization of financial statements has not been examined. Appropriateness of the use of fair value to satisfy the information needs of users of the report has not been disclosed.