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Reclassification of assets and the need to provide a true and fair view of a business entity

Abstract. *To run a business, economic entities have to use assets: physical assets, intangible assets, and financial assets. Reclassifications are often accompanied by a change in the measurement method. The high initial amounts and/or revalued amounts may significantly impact the balance sheet total and the financial result. This is especially true when it comes to fixed assets. From the perspective of a business entity, it might not be possible, or indeed desired, to reclassify assets in every case or in every sector of the economy. In some situations, however, the move may have a major influence on the profitability (let us call it apparent profitability), contradicting, in a way, the principle of a true and fair view. This is the subject matter of this paper.*

The paper was written on the basis of a critical analysis of legal regulations and case studies (financial documents and accounting policies) and a deductive method to show potential areas where business entities might manipulate information disclosed in financial statements.

Keywords: *reclassification of assets, measurement methods of value, true and fair view*

Introduction

The subject matter of accounting is identification of and connection between economic events and data registered on that basis and further communicated in financial reports [cf. Ijiri 1972: 446; Beaver 1998: 13; Misińska 2002: 138]. The accounting system is designed in the way so that it can inform the interested parties of the financial resources management process by describing the capability of a business entity to generate a stream of economic advantages, the risk related to the process and the efficiency of utilizing resources by a business entity. The unit used in the accounting measurement process is a monetary unit. Thus accounting evaluates economic events, assets and sources of funding, processes influencing the financial result by applying legally eligible value measurement methods (valuation). In the course of business activities it can make changes to the asset allocation. Reclassifications are often accompanied by a change in the measurement method, and the high initial amounts and/or revalued amounts may significantly impact the balance sheet total and the financial result. Especially, it comes to fixed assets. From the perspective of a business entity, it might not be possible, or indeed desired, to reclassify assets in every case or in every sector of the economy. In some situations, however, the move may have a major influence on profitability (let us call it apparent profitability), contradicting, in a way, the principle of a true and fair view. The aim of the present paper is to discuss the case of measuring assets after they have been reclassified and analyse the consequences of asset reclassification for the balance sheet total and the financial result of entities, particularly in the context of the need to provide a true and fair view of their standing.

1. Measurement methods used in accounting

The objective of accounting measurement is to determine the value of the assets held by an entity together with their funding sources, which also indirectly influences the entity's costs and profitability. As the entity may choose from among the measurement methods permitted by law, it has some leeway in the way its accounting system presents key information to internal and external customers. Its accounting policy should, however, clearly spell out the methods used to determine the value of specific items in the balance sheet. The methods chosen should be used consistently from one period to another for all assets of the same type instead of selectively[1]. The key objective of accounting to provide information requires that data disclosed to internal and external customers through financial statements conform to a certain standard in line with the principle of a true and fair view. The Accounting Act does not contain a list of such standard qualities, but it does impose the obligation to offer a fair and clear picture of an entity's assets

[1] The Accounting Act of 29 September 1994, Official Journal No. 121, item 591, as amended, art. 5, paragraph 1.

as well as its financial standing and result[2]. The International Financial Reporting Standards (IFRS), on the other hand, highlight the fact that financial reporting information is only useful for making business decisions when it is of good quality. The fundamental qualities of useful financial information are relevance and faithful presentation. Such information will be even more useful if it is also comparable, verifiable, timely and understandable [Conceptual Premises 2014: 7].

For years, the clear tendency in the measurement model adopted in the International Accounting Standards and the International Financial Reporting Standards has been to measure assets at present (market) value. Data presented in financial statements are brought closer to the present value by the category of fair value. Taking its cue from the solutions adopted in the IAS and the IFRS, the Polish Balance Sheet Law has also introduced a number of ways to better approximate the results of measuring assets and liabilities to their market value. These focus on shifting the emphasis from historical cost to fair value when making measurements. In addition, there is a group of businesses which are obliged by law to draw up their financial statements pursuant to the IAS and the IFRS and so they have to use the measurement model adopted in these documents directly.

According to the Polish Balance Sheet Law, the category of fair value is used for the following assets and liabilities:[3]

1) property and intangible assets held as investment – these may be measured at the balance sheet date in accordance with the rules put in place for fixed and intangible assets (i.e. at the cost of acquisition or construction or at the revalued amount) or at market price or otherwise established fair value,

2) shares in other entities (not held as short-term investment) and investment other than property and intangible assets – measured at the balance sheet date at acquisition cost less impairment losses or at fair value or adjusted cost if the asset has a maturity date. Impairment takes place when there is a good probability that the asset controlled by the business will not yield expected economic benefits in a significant part or as a whole. This justifies impairment write-downs to bring the book value of the asset to its net sales price or, the price missing, to an otherwise determined fair value. On the other hand, the adjusted acquisition price of financial assets and liabilities is the cost of the asset at which is was first recognised less any payments of the principal adjusted for the accumulated, discounted difference between the initial value of the asset and its value on maturity calculated using the effective interest method and net of any write-downs,[4]

3) short-term investment – measured at market value or at the lowest of acquisition cost or market value or at adjusted acquisition cost for the assets with

[2] Ibidem, art. 4, paragraph 1.
[3] Ibidem art. 28, paragraph 1-8a.
[4] Ibidem, art. 28, paragraph 8a.

a maturity date; short-term investments which are not traded in an active market are measured at otherwise determined fair value,

4) receivables and loans – at the amount due, with prudence,

5) liabilities – at the amount due.

In addition, receivables and loans held as financial assets as well as financial liabilities may be measured at adjusted cost of acquisition and, if the business intends to sell them within 3 months, at market value or otherwise determined fair value.[5]

The Accounting Act specifies that "fair value is the amount for which an asset could be exchanged or a liability settled between interested and knowledgeable parties in an arm's length market transaction".[6]

The words "could be" mean that the transaction is one which is hypothetically possible at the date of measurement. The expression "market transaction" lays down the condition that there should be no relationship between the (independent) parties whereby they could collude to set a price deviating from the market one. "Knowledgeable" parties will be such businesses whose management boards have sufficient knowledge of the transaction's object, the factors bearing upon the price and the market conditions at the date of measurement. Moreover, the transaction should be made voluntarily, motivated by business considerations and conducted in the best interest of each party [Engelgardt 2011].

Measurements made at fair value are supposed to contribute to a true and fair presentation of an entity's financial standing as opposed to measurements made on the basis of historical cost which, in a dynamically changing environment, quickly become obsolete. Hence, a correctly used fair value is to reflect the approximate market value and will be preferred by capital market players.

Consequently, measurement at fair value is used when measuring financial instruments, intangible assets and investment property, that is say those items whose initial amount and carrying amount (i.e. the amount measured at the balance sheet date) are often high. When businesses measure assets at fair value, they have the grounds to revalue these assets at the balance sheet date and, consequently, exert a major influence on the balance sheet total and the financial result. Selecting the measurement method it will use, a business should consider whether it will contribute to the true and fair presentation and identify the practical obstacles it may run against.

We should remember that, after fair value was incorporated into international regulations followed by the Polish Balance Sheet Law, it provoked concerns about the rationale of introducing estimates to accounting practice, a step treated as a violation of the principle of prudent measurement. After all, a business may revalue

[5] Ibidem, art. 28, paragraph 1.

[6] Ibidem, art. 28, paragraph 6.

the cost of acquisition to the market price or base its measurements directly on market prices which means that, for individual assets, it is possible to make measurements at fair value higher than the historical cost represented by the cost of acquisition or construction. Because it could be verified, measurement at historical cost reduced the potential for allegations of incompetent or intentional distortion of measurement results. In time, however, it ceased to ensure an adequate approximation of true values and users of financial statement stopped treating it as a credible source of information [Surdykowska 2001: 197].

We should also bear in mind that businesses could use asset reclassification to indirectly influence the measurement method adopted for these assets. When, once reclassified, an asset qualifies to be measured at fair value, the new measurement method can be applied to impact carrying amounts and the financial result.

In a nutshell, it is possible to reclassify assets held for investment (and vice versa) and carry out reclassifications of the investments themselves, i.e. reclassify short-term investments as long-term ones and vice versa.

2. Reclassification of tangible and intangible assets

Let us now consider the case of reclassifying tangible and intangible assets as investment. According to the Accounting Act, fixed and intangible assets used by en entity are measured at cost or at revalued amount less any amortisation write-offs and impairment losses.[7] Their reclassification as investment allows the business to measure them at market value or otherwise determined fair value. Where the market value is higher than cost, such reclassification will increase the balance sheet total and the financial result as the consequences of revaluation will be recognised in the financial result as income. But where the market value is below cost, the reclassification will result in measurements decreasing the balance sheet total and the financial result because the change will be recognised as cost.[8]

One obvious example of asset reclassification used to create the value of the balance sheet total and the financial result is provided by reclassifications in the property development sector. The nature of the business requires that developers have property in the form of land which may be used for investment projects or resold. The land owned by developers is classified as tangible current assets, i.e. work in progress and may be measured at historical cost of acquisition[9]. Again, if the intended use of such land is changed to classify it as investment property, it

[7] Ibidem, art. 28, paragraph 1.
[8] Ibidem, art. 35, paragraph 1, 3 and 4.
[9] Ibidem, art. 28, paragraph 11, point 1; art. 34, point 1.

may be measured at fair value. The consequences of reclassification and the new measurement (at fair value exceeding cost) will be disclosed directly in the financial result – as increase in the case of profits or decrease in the case of losses. At every instance, the practice will increase the profitability (let us call it apparent profitability) of the business.

3. Reclassification as part of investment

Pursuant to art. 35 of the Accounting Act, it is possible to reclassify long-term investment as short-term investment and vice versa. Let us consider a major component of investment at any business entity, that is financial instruments.

As it was mentioned Point 1 of the paper, an entity may measure financial instruments (classified as long-term investment) at their cost less any impairment losses or at market value or otherwise determined fair value. If long-term investment is measured under the fair value model the consequences of an increase in the market value of the investment will be credited to the revaluation reserve, whereas the consequences of falling prices will deplete the previously created reserve. Therefore, they will not influence the financial result, unless the consequences of falling prices exceed the previously created revaluation reserve. But when an entity reclassifies financial instruments as short-term investment, it will be able to recognise the consequences of their increased value as revenue in its financial result. Moreover, if the investment was revalued before with the consequences influencing the revaluation reserve, the amount of the reserve will also be disclosed as revenue. The consequences of falling prices, on the other hand, will be reflected as financial costs at the moment of reclassification, unless the investment was revalued before in which case they may only decrease the revaluation reserve or, again, be disclosed as costs (to the relevant extent). Hence, if an entity intends to improve its financial result, it can achieve the effect by reclassifying long-term investment as short-term investment when the market situation is good or keep long-term investment unchanged when the market is down. In the latter case, if revaluation reserve has already been created, a fall in investment value will not impact the entity's result at all.[10]

If an entity measures long-term investment under the cost model, any decrease in the investment's value at the balance sheet date should be adjusted for impairment losses. The consequences of such adjustments are accounted for pursuant to art. 3, paragraph 2, point 32 of the Accounting Act and disclosed in the profit and loss account as cost. The Act also provides for revaluing the cost of acquisition

[10] Ibidem, art. 35, paragraph 6.

to the market price at the balance sheet date (under art. 28, paragraph 1). In such a case, the change in value will be shown in the revaluation reserve.

Let us analyse the consequences of reclassifying long-term investment measured at cost as short-term investment. Where the cost is higher than the market value, reclassification as short-term investment will require a decrease in the value of the asset regardless of the method applied to measure short-term investment, which will also decrease the balance sheet total. Further, the consequences of such a reclassification will have to be shown as cost in the financial result. As the financial result would be diminished, the move could be deemed disadvantageous from the perspective of a business entity. If the cost is lower than the market price, reclassifications as short-term investment may be considered advantageous from the point of view of the entity as the increase in value will have a positive impact on the balance sheet total (which would also happen if investment stayed long-term) and improve the financial result (which would not happen if investment continued to be held as long-term).

Let us now consider the opposite situation when short-term investment is reclassified as long-term one. The change takes place pursuant to art. 35 of the Accounting Act. Financial instruments classified as short-term investment at the balance sheet date may be measured at market price or the lower of market price or cost of acquisition. When the market situation is unfavourable for an entity, for example due to falling prices of securities, this measurement method will decrease the value of assets and diminish the financial result as the consequences of the change will be recognised as financial cost.[11] But if they are reclassified as long-term investment, the entity may keep their cost of acquisition less any impairment losses. Recognising an impairment loss gives the entity more leeway to impact individual amounts presented in its financial statement because the amount of impairment is influenced both by the period in which the asset may be sold and the interest rate used to discount future cash proceeds.

However, if the entity reclassifies short-term investment as long-term investment measured at fair value, the consequences of a fall in investment value will diminish the value of assets and will have to be shown as cost in the financial result as it will not be possible to recognise them in the revaluation reserve, such reserve not having been created earlier.

Importantly, the very possibility of reclassifying financial instruments as well as the consequences of such a move must be checked against the Regulation of the Minister of Finance on the detailed rules for the recognition, measurement, disclosure and presentation of financial instruments as amended. Right at the outset,

[11] The Accounting Act, changes in short-term investment prices.

it must be said that there is a discrepancy between the Accounting Act and the Regulation. The Regulation specifies the following financial instruments:[12]

– financial assets and financial liabilities held for trading,
– loans and receivables,
– financial assets held to maturity,
– financial assets available for sale.

The Accounting Act does not directly specify the categories mentioned in the Regulation. It defines financial instruments as a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity, provided that the contract made between two or more parties produces clear economic consequences regardless of whether the performance of the rights or obligations under the contract is unconditional or conditional. It also points out that financial assets understood as monetary assets or equity instruments issued by other parties as well as a contractual right to receive monetary assets or the right to exchange financial instruments with another party under conditions that are potentially favourable are one of the components of investments which may be held by an entity.[13]

The Regulation does not directly define the category of financial assets available for sale, pointing out that they are other assets which do not qualify to be classified under other categories.[14] Neither does it classify the financial instruments in the list as short-term or long-term investment. It specifies the nature of financial assets held for trading and includes in this category assets purchased to obtain economic gain resulting from short-term price changes and fluctuations of other market factors or the short life cycle of the purchased instrument as well as other financial assets regardless of the intention at the time of concluding the contract if they are part of a portfolio containing similar financial assets, a portfolio which is highly probable to yield the expected economic benefits in a short term perspective.

Hence, financial instruments held for trading may be considered to be part of short-term investment. In light of the Regulation of the Minister of Finance of the 18th December 2008 amending the previous regulation, an entity may reclassify items previously held for trading as other categories, which was not possible before the amendment. Pursuant to art. 6, paragraph 4, reclassifications are justified

[12] Regulation of the Minister of Finance of the 12th of December 2001 on the detailed rules for the recognition, measurement, disclosure and presentation of financial instruments, Official Journal No. 149, item 1674, art. 5, paragraph 1.

[13] The Accounting Act of 29 September 1994, Official Journal No. 121, item 591, as amended, art. 3, paragraph 1, point 17, 23 and 24.

[14] Regulation of the Minister of Finance the 12th of December 2001 on the detailed rules for the recognition, measurement, disclosure and presentation of financial instruments, Official Journal No. 149, item 1674, art. 9.

only by extraordinary circumstances understood as circumstances resulting from a one-off, extraordinary event which is highly unlikely to recur in the near future. This means that, both in the Act and the regulations discussed, it is possible to change the intended use of financial instruments by reclassifying them from short-term to long-term investment.

Financial assets reclassified pursuant to art. 6, paragraph 4 and 5 of the Regulation should be measured at fair value established at that date. The fair value at the date of reclassification becomes the new cost of acquisition or adjusted cost of acquisition, respectively. Profit or loss from revaluing reclassified financial assets stays in the profit and loss account.[15] The fair value of financial instrument thus reclassified will be obtained through:[16]

– measuring the financial instrument at the price established when trading in an active, regulated market, information about the price being publicly available,

– estimating debt instruments by a specialised, independent body providing such services, provided that it is possible to provide a fair estimate of cash flows related to such instruments,

– applying a correct model to measure the financial instrument, provided that the input data for the model come from trade in an active, regulated market,

– estimating the price of a financial instrument for which there is no active, regulated market on the basis of a publicly announced price at which a materially similar financial instrument is traded in an active, regulated market or the prices of assets in a compound financial instrument,

– estimating the price of a financial instrument through commonly recognised estimation methods.

Measurement is not made at fair value and can be based on the cost of acquisition only if it is not possible to determine the former in a credible way and if there is no market price established in an active, regulated market.[17]

Conclusions

The conclusion to draw from the above reflections is that if the principle of a true and fair view is to be observed in a situation where business entities

[15] Ibidem, art. 22a.

[16] Regulation of the Minister of Finance of the 19th of December 2005 amending the regulation on the detailed rules for the recognition, measurement, disclosure and presentation of financial instruments, Official Journal No. 256, item 2145, 2146, art 1, paragraph 5.

[17] Regulation of the Minister of Finance the 12th of December 2001 on the detailed rules for the recognition, measurement, disclosure and presentation of financial instruments, Official Journal No. 149, item 1674, art. 14, paragraph 2.

reclassify and revalue assets, their accounting policies must clearly specify asset measurement methods – especially in the case of financial instruments – and the adopted methodology of classifying assets into the four basic categories mentioned in the Regulation of the Minister of Finance on the detailed rules for the recognition, measurement, disclosure and presentation of financial instruments. A business entity should also describe the rules it follows to classify financial instruments as long-term or short-term investment. What is also very important for the correct interpretation of data disclosed in financial statements is the additional information provided by entities on disclosures of revaluations together with their causes and consequences. The scope of such disclosures is specified in the Regulation of the Minister of Finance on the detailed rules for the recognition, measurement, disclosure and presentation of financial instruments as amended. However, there are no Polish regulations which provide for disclosures of other revaluations. The matter is regulated in a general way by art. 48 of the Accounting Act.

When assessing financial statements for their fairness and credibility, particular attention should be paid to the following elements:

– first, whether assets were revalued at the balance sheet date,

– second, what was the reason for the revaluation (if it did take place). A change of value should result from a change in market conditions, which would be in line with the essence of the fair value concept,

– third, what was the scale of revaluation compared to the initially recognised amount,

– fourth, on what basis was the fair value determined,

– fifth, what are the consequences of such revaluation (which means analysing it from a wider perspective against the results of the entity as a whole). The reason is that reclassification of assets and their revaluation might be a way of manipulating financial reporting information.

This raises the question of whether a recipient (user) of information generated by the accounting system is able to assess it in the way presented above.

Given the mechanisms described and the requirements to be met in order to observe the principle of a true and fair view of an entity's standing, what seems to be of key importance is the role of a statutory auditor. It should be his job to verify whether the information disclosed by an entity is sufficient to correctly evaluate the data in its financial statement.

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Zmiana przeznaczenia składników majątku a zachowanie zasady wiernego i rzetelnego obrazu jednostki gospodarczej

Streszczenie. *Jednostki gospodarcze wykorzystują w procesie gospodarowania składniki majątku w różnej postaci: rzeczowej, niematerialnej i finansowej. W toku prowadzonej działalności jednostka może dokonywać zmian przeznaczenia składników majątku. Zmiana przeznaczenia składników majątku związana jest często ze zmianą metod ich wyceny, a wysoka wartość początkowa lub/i wartość po przeszacowaniu mogą w istotny sposób wpływać na poziom sumy bilansowej oraz wyniku finansowego. Dotyczy to w szczególności składników majątku trwałego. Zmiana taka może w przypadku niektórych jednostek czy też branż w istotny sposób wpływać na poziom rentowności (nazwijmy ją pozorną) i w pewnym stopniu pozostawać w sprzeczności z zasadą wiernego i rzetelnego obrazu. Zjawisko to jest przedmiotem niniejszego artykułu.*

Przygotowując artykuł, posłużono się krytyczną analizą aktów prawnych oraz analizą przypadku (dokumentów finansowych wraz z polityką rachunkowości) i metodą dedukcji, wskazując potencjalne obszary, w których jednostki gospodarcze mogłyby dopuszczać się manipulacji informacjami przekazywanymi w sprawozdaniach finansowych.

Słowa kluczowe: *zmiana przeznaczenia składników majątku, metody wyceny, zasada wiernego i rzetelnego obrazu*