Criteria of Recognition of Financial Reports'Structures

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CRITERIA OF RECOGNITION OF FINANCIAL REPORTS'STRUCTURES

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The definition and characterization of structures component of financial reports are not sufficient in order to establish and present the balance and the profit and loss account.

That is why "for the establishment and presentation, the elements (structures) must satisfy a concept of recognition".[1]

In other words, when an enterprise does a transaction or when within its framework takes place a relevant event, the effect of the transaction or of the event on the elements of financial reports will have to be recognized (ascertained) if certain criteria are observed.

In this context, we can define the recognition as being the process of formal incorporation of an article in financial reports, by its description and by the integration of its value in the total of financial reports.

With IAS and Romanian accounting settlements, recognition is "the process of incorporation within a balance or in the profit and loss account of an element that complies with the established criteria of recognition"[2], a process that "involves the description in words of the element in question and the association of a certain sum, as well as the inclusion of the sum in the total balance or in the profit and loss account".[3]

There is mentioned that only in the balance and in the profit and loss account must be presented the elements that comply with the criteria of recognition , since the non-recognition of these elements cannot be corrected neither by the presentation of used accounting policies, nor by notes or supplementary information.

For the recognition of a financial structure it is necessary the cumulative observance, such as:

-the financial structure is frameworked within the definitions of the elements of financial reports;

-there is sufficient proof that there has been a change of assets or debts or that a positive flow or negative flow of benefits will occur;

-the element can be measured and expressed in value with sufficient objectivity.

These criteria are presented in the latest conceptual framework that is the one issued by British normalizers.

IASC, within the formulated conceptual framework, formulates two criteria of recognition, so that an element must be recognized in financial reports if it is likely that any future economic benefit enter or leave the enterprise and the element has a cost or value that can be evaluated in a credible way.

The same criteria of recognition of elements of financial reports are found also in national economic norms.

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[1] Paşca N., *Situaţii financiare ale unităţilor economice din România*, Editura Presa Universitară Clujeană, Cluj Napoca, 2002.

[2] ***, *Reglementări contabile pentru agenţi economici emise de Ministerul Finaţelor Publice*, Editura Economică, Bucureşti, 2003.

[3] ***, *Standardele internaţionale de Contabilitate*, Editura Economică, Bucureşti, 2002.

FASB enunciates in the Statement of Financial Accounting Concepts no 5 the fundamental criteria that lie at the basis of recognition and presentation of the components of financial reports, such as follows:

- "the definition-the element corresponds to the definition of an element that must be present in financial reports;
- The measurable character-the element presents an adequate measurable character founded on a sufficiently reliable basis;
- The relevance-to furnish or not this fundamental informational element has an incidence on the users' decisions;
- Reliability- the used information is reliable, verifiable and objective.[4]

In formulating the criteria of recognition, American normalizers have taken into account the restriction cost-advantages and the criteria of relative importance.

Coming back to IASC, we notice that this defines its own criteria of recognition, criteria which take into account the probability of appearance of economic benefits and the objectivity of measurement (evaluation).

IASC has retained only two criteria of recognition, because some of these criteria enunciated by other conceptual frameworks have been placed in a much larger context, respectively that of the qualities of financial information.

Considering that the first criterion of recognition of elements of financial reports as being the probability of obtaining several future economic advantages, we express the opinion according to which this concept is linked to the incertitude that characterizes the economic environment in which any organization operates.

The second criterion, respectively the objectivity of measurement (evaluation) emphasizes the necessity and objectivity of rational estimations of the dimension of financial reports, estimations used in the elaboration and presentation of financial reports.

When we cannot do a rational estimation of an element, this must not be presented in the balance account or in the profit and loss account.

There are reports in which an element, at a given moment, cannot comply with the established criteria of recognition, but which later on can be recognized as a consequence of later circumstances or events.

In IAS as well as in the national accounting norms, there is stipulated the fact that information regarding an element that has the essential characteristics of a structure of financial reports, but does not comply with the recognition criteria, can be presented in notes and supplementary information.

Since the objective of financial reports is circumscribed to the furnishing of information on the financial position, on the performances and changes of financial position of an enterprise, the financial reports elaborated and presented in this set of synthesis documents must be associated to these objectives.

Thus, the financial position will be reflected through the correlation between assets, debts and own capitals, components of the balance.

The definition of assets considers that these are economic goods (with or without ownership right) owned by the enterprise, whose use will make the enterprise benefit by the future cash flows.

The cumulative criteria established for the recognition of an asset are:

- the probability of realization of a future economic benefit;
- the determination of the value/cost of the asset in a credible way.

According to us, this definition is influenced by several principles whose effect coexists, such as follows:

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[4] Feleagă N., *Îmblânzirea junglei contabilității*, Editura Economică, București, 1996.

- the economic prevalence on the juridical form (the asset is a controlled resource, without being also necessary to have an ownership right over it);
- the principle of realization supposes that the controlled resource is realized/obtained as a consequence of past events;
- the principle of continuity demands the estimation of the future benefits (direct or indirect) which the asset will generate, supposing that it will be used according to the expectations.

The same principles are kept in mind in the case of debts assimilated as structures of financial reports.

In order to be recognized as financial reports, debts must comply with the following criteria:

- the probability of an exit of resources, bearers of economic benefit;
- the evaluation is done in a credible way.

We consider that it is highly recommended to make the distinction between present obligation and a future engagement, being recognized as debts included in the balance only the present obligations (also entitled current liabilities) appeared as a consequence of past events. We must, as well, not make confusion between obligation (debt) and commission.

Even if the commission represents a present obligation, that will probably generate an exit of resources which affect the economic benefits and whose value is reasonably determined, the differences between this concept and that of debts are determined by the incertitude linked to the final value of the commission or by the exigibility (honoring) of debts.

Since the own capitals (net assets) represent the difference between assets and debts, we emphasize the major importance that must be granted to the adequate recognition of the assets and debts in determining and delimitating this concept.

An accurate representation of own capitals is realized if and only if the assets and debts are properly recognized and evaluated. In fact, the financial position of any entity, the dimension of own capitals is given by the way of managing the assets and debts. That is why we agree with the opinion according to which own capitals represent the essential indicator which the balance, in the present format, must represent.

The recognition of performance elements of the entity is the subject of the process of recognition of incomes and expenses. Thus, the criteria of recognition are:

- the increase of future economic benefits, by increase of assets or reduction of debts;
- credible evaluation.

We consider that it is necessary to make the distinction between incomes and gains, even if both are to be found in the same segment of the profit and loss account. The distinction consists in the fact that a gain implies a favorable result of a transaction, as a consequence of compensation of effects with adequate efforts, while incomes represent increases in economic advantages during a period of time, whose effects consist in the increase of own capitals.

In order to be recognized, an income must be realized/obtained or there must be a sufficient degree of certitude for its accomplishment.

The cumulative criteria of recognition of expenses are:

-the diminution of future economic benefits, by the diminution of assets or increase of debts;

-credible evaluation.

In this context, acts the principle of connection of expenses with the incomes obtained during the same periods of management.

There are expenses which are not recognized in the profit and loss account by systematic allocation, in a certain interval of time (for example, expenses with liquidation) or are recognized as expenses of the period, expenses which do not generate anymore economic benefits or associated assets present in the balance.

Consequently, we express the opinion according to which an expense is immediately recognized in the profit and loss account when the payment does not produce a future economic advantage or when the future economic advantages do not give the right or cease to give the right to the recognition of an asset in the balance.

The income sand expenses directly generate the result (profit or loss) that appears as a measure of performance or non-performance of the entity. The recognition of assets, debts, incomes and expenses must be done if and only if the two conditions are observed, and respectively the credible evaluation.

Romanian accounting settlements consider that "evaluation is the process by which we determine the values at which the structures of financial reports will be recognized in the balance and in the profit and loss account, a process that supposes the choice of an evaluation basis." Financial reports use different evaluation bases of its structures in varied combinations.

For the evaluation of the structures of financial reports, we will retain the following evaluation bases:

-the historical cost;

-the current cost;

-the achievable value (of discount);

-the actualized value.

There has been noticed that the evaluation basis most frequently adopted in the elaboration of financial reports is the historical cost which is usually combined with other evaluation bases.

We notice the fact that the harmonization of the Romanian accounting system with the European Directives and IAS (International Accounting Standards) has lead to important changes in the evaluation problem, a domain in which the professional reasoning will find its meaning. Thus, great attention is granted to the evaluation at the elaboration of financial reports, respectively the evaluation of the outcome and effect in financial reports.

Coming back to the bases of evaluation retained by IASB and to the national settlements in the domain, without expressing a preference for a certain basis, their content refers to:

-the evaluation of the historical cost supposes that:

-debts are registered at the values of discount in cash, in equivalents of cash or at the just value established at the moment of their purchase;

-debts are registered at the value of equivalents obtained in their exchange or, in certain cases, at the value at which we expect for it to be discount in cash or equivalents of cash with the aim to pay them off.

-the evaluation at the current account supposes that:

-the assets are registered at the value in cash or in equivalents of cash which must be paid if the same asset or a similar asset would be purchased at present;

-debts are registered at the nominalized value in cash or in equivalents of it, necessary to presently discount the obligation;

-the evaluation at achievable value (of discount of obligation) supposes that:

-the assets are registered at the value in cash or equivalents of it, which can be obtained by selling of assets;

-debts are registered at the value of discount which represents the non-actualized value in cash or in equivalents of it that must be paid to pay off the obligation.

-the evaluation at actualized value supposes that:

-assets are registered at the actualized value of future net incomes of cash, which are going to be generated by the unfolding of the enterprise activity;

-debts are registered at the actualized value of future outcomes of cash, which wait to be necessary for discounting the debts.

In the elaboration of financial reports it is highly important to use the concept of used capital. The concept of capital and maintenance of capital include the financial capital and the physical capital.

The financial capital is synonymous of the net assets/proper (own) capitals, being defined in the terms of nominal currency unities, and the physical capital is defined in the terms of productive capacity, respectively the capacity of production of the entity, expressed in physical units.

We consider that the choice by an entity of the most suitable concept concerning the capital must have at its basis the necessities of information specific to the users of financial reports. Thus, if the users of financial reports are preoccupied by the maintenance of the invested nominal capital or by the purchase power of the invested capital, we must adopt the concept of financial capital of the capital. But, if they are preoccupied by the capacity of exploitation of the entity, we must choose the physical concept of capital.

The maintenance of the level of capital leads to the following concepts:

-the maintenance of the financial capital according to which the profit represents the increase of nominal currency capital along the period; it can be evaluated either in nominal currency units or in the constant purchase power;

-the maintenance of fix capital, according to which profit represents the increase of the productive capacity along the period of time.

The distinctions between the two concepts regarding the maintenance of the capital are represented by the treatment of the effects of the variation of assets' prices and debts of the entity.

We consider necessary to emphasize the link which is generated between the concepts of capital and profit through the concept of capital maintenance, without which the profit cannot be measured.

Of the facts presented above, we can assert that, in general terms, an entity maintains its capital if at the end of the period it registers a similar level to the one at the beginning of the period. Any value in addition to the one necessary for the maintenance of the capital at the level from the beginning of the period is considered a profit.

The criteria which determine the option towards a certain evaluation basis and a certain concept of maintenance of the level of capital depend on the entity's policy, on the informational needs and on the professional reasoning.

The evaluation basis and the concept of maintenance of the level of capital will determine the accounting model used for the elaboration of financial reports. Even if IFRS are open to diversity, they still limit the options, in the sense that when an entity will choose the alternative treatment of an economic specie it will have to offer in explanatory notes for compatibility, the effects of the basis treatment.

That is why we consider it is highly justified that normalizers take into account the problem of determining the actualized values, a segment where there are still a lot of approaches, obviously with different effects on financial reports.

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