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METHODS FOR THE VALUATION AND PRESENTATION OF CAPITAL DEPOSITS IN THE INVESTOR'S SEPARATE FINANCIAL STATEMENTS – SELECTED CASES

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Introduction

The development of global markets, accompanied by an increased demand for new sources of financing business activities, encourages popular trading in capital deposits.

Entities which purchase deposits record them as their assets (financial investments) and, consequently, become co-owners of the purchased object through contributed capital. Investors treat deposits as the components of assets which are designed to lead to future economic benefits[1] (just to mention dividends, participation in profits, interest or an increase in the value of invested funds). In some cases investment activities are limited by the specific character of activities, e.g. in (re)insurance companies.

The paper discusses the issue of the valuation and presentation of investments in financial reporting, giving special attention to solutions applied in insurance companies.

The scope of the investor's impact on managing associates

Interests in other entities enable investors to exert influence on the management of entities in which they have placed their deposits. The area which is subject to investors' de-

[1] The Accounting Act of 29 September 1994, consolidated text, announcement of the Speaker of Parliament of 2 September 2009 concerning the publication of the consolidated text of the Accounting Act (DzU "Journal of Laws" No 152/2009, item 1223 as amended), Art. 17.

cisions depends on the amount of their interests, and this directly translates into the adopted methods for their valuation.

Pursuant to the Polish Accounting Act,[2] **exercising control** over another entity is understood as the dominant entity's power to govern the financial and operating policies of another entity so as to obtain benefits from its activities. According to IAS27 (2008) Consolidated and Separate Financial Statements[3] and IAS28 (2003) Investments in Associates:[4] "Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities."[5]

Joint control,[6] on the other hand, is the ability of the partner of a co-dependent entity, to the same extent as that of other partners, and in accordance with the principles set forth in an agreement concluded between partners, in the articles of association or the articles of incorporation, to govern the financial and operating policies of an entity to obtain joint economic benefits from its activities. IAS28[7] (2003) defines joint control in a similar manner: the contractually agreed sharing of control of a business activity, which exists only when strategic financial and operating decisions related to its activity require the unanimous consent of the parties sharing control.

Significant influence, as stipulated in the Accounting Act,[8] is an entity's ability, but not control or joint control, to influence the financial and operating policy of another entity. It is evidenced in the following ways:

- participation in decision-making with regard to profit distribution or loss coverage,
- representation on the management, supervisory or administration board,
- material transactions with this entity,
- provision to this entity of technical information of vital importance to its activities,
- interchange of members of management, supervisory or administration bodies.

According to IAS28 (2003), however, the number of voting rights is not the major criterion for determining a type of relations between entities. The most important factor is the fact whether the investor has significant influence over an entity. Significant influence

[2] Art. 34.

[3] IFRS/IAS 2011, *International Financial Reporting Standards*, Vol. 1, Vol. 2, IASB, SKwP, Warszawa 2011, p. 773.

[4] *Ibidem*, p.793.

[5] Currently, in accordance with the recently adopted package of Standards (since 2013, developed in 2011) related to consolidation, the terms of control and co-control are defined in IFRS 10 Annex A *Consolidated Financial Statements*, IFRS 11 Annex A *Joint Arrangements* and in Art. 3 IAS 28 *Investments in Associates and Joint Ventures,* and in Art. 4 IAS 27 *Separate Financial Statements*. Pursuant to the new assumptions: *Control of an investee exists when an investor possesses power over an investee, has exposure to various returns from its involvement and has the ability to use its power over the investee to affect its returns*. www.iasplus.com.

[6] Art. 35, UoR.

[7] IFRS/IAS 2011, *op.cit.*, p. 793.

[8] Art. 36 UoR.

is understood to be the power to participate in financial and operating policy decisions. It exists when:

- investor is represented on the management board of an investee,
- investor has influence over preparing an associate's operating strategy, its policy as well as decisions with regard to dividends and the distribution of profit,
- material transactions are concluded between the investor and the investee,
- managerial personnel are transferred between entities,
- investor provides essential technical information to an associate.

According to IFRS recommendations, the determination of the number of voting rights should take into account **potential voting rights, which may result** from the rights to purchase shares and from holding options to acquire shares and other financial instruments which have potential influence on voting rights.[9]

Table 1 presents a classification of capital deposits and valuation methods.

Table 1

Holdings as determinants of influence and selection of deposit valuation method

Holdings	Influence over associate	Deposit valuation method
less than 20% of voting power	lack of control, lack of significant influence	short-term deposit – cost method (LCM variant) long-term deposit – cost method (revaluation variant)*
20–50% of voting power (not more than 50%)	significant influence	short-term deposit – cost method (LCM variant), long-term deposit – cost method (revaluation or equity method) if such is the decision of the capital group's dominant entity**
more than 50% of voting power	excercising control	short-term deposit – cost method (LCM variant) long-term deposit – equity method

* Art. 28, point 1, and Art. 35.
** Art. 28, point 1 UoR.

Source: author's research.

Types of capital deposits and valuation methods

Depending on the adopted assumptions with regard to expected benefits the investor classifies capital deposits as short-term and long-term financial assets.

Short-term financial assets are payable, fall due or are disposed of within 12 months of the balance sheet date or the date of deposit, issue or acquisition, or they represent cash assets. Long-term financial assets are held by an entity for a period exceeding 12 months.

[9] IFRE/IAS 2011, op.cit. Art. 6–10, pp. 794–795. The provisions are retained in amended IAS 28 (2011), Art. 5–9), www.iasplus.com.

Pursuant to the Accounting Act, assets and liabilities are to be evaluated at least once a year at the balance sheet date. In order to meet this obligation, short-term investments are evaluated at the market price (value) or at the purchase price or market price (value) depending on which of them is lower, or at the adjusted purchase price – if the maturity date is determined for a given component of assets and short-term investments for which active markets do not exist are based on fair value determined in a different way.[10] According to these assumptions such deposits are evaluated at the value which is lower at a given moment: a lower cost or market value (LCM –Lower Cost or Market Value).

Holdings in subordinated entities, which the investor classifies as fixed assets, are evaluated at the purchase price reduced by the write-offs resulting from a permanent decrease in value, or at fair value or adjusted purchase price – if the maturity date is determined for a given component of assets – the value at purchase price may be revalued to reflect the market price (the difference resulting from revaluation should then be accounted for), based on the revaluation method (a variant of the purchase price method).[11] The equity method can also be used on condition, however, that it is applied in a uniform manner to all subordinated entities.[12] In this case it is assumed that the investor's holdings are not below 20–50% of voting rights.[13] When holdings are below that level, additional conditions must exist to meet the requirements of significant influence.[14]

The purchase price method (cost method) is the most commonly applied method for evaluating deposits placed by investors who invest their funds to benefit from dividends or the distribution of profits. It is assumed that they do not plan to acquire an investee.

The balance sheet unit valuation of short-term deposits is usually based on the LCM version of the purchase price (cost method). It is mainly based on the conservative valuation principle. Changes to the value of deposits, at the level below the purchase price, are recognised as costs or financial income (up to the level of the previously written-off costs), while an increase in prices above the purchase price is not recognised for the needs of a conservative valuation.

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[10] UoR, Art. 28, point 5.

[11] The effects of revaluating investments classified as fixed assets other than those specified under Art. 28 point 1, 1a, which increase their value up to market prices, increase capital (funds) resulting from revaluation. A decrease in the value of previously revalued investments to the level of the amount by which capital (funds) is increased as a result of revaluation, if the revaluation difference has not been accounted for by valuation date, decreases that capital (funds). In other cases the effects of a decrease in the value of investments are recognised as financial costs. An increase in the value of a given investment directly related to the previous decrease in its value, recognised as financial costs, is recorded as financial revenues in the amount of such costs. (UoR, Art 35, point 4).

[12] UoR, Art. 28, point 4.

[13] see: S.M. Bragg, *Accounting Reference Desktop*, John Wiley&Sons,Inc., New York 2002, pp. 480–481, W. Steve Albrecht, Earl K. Stice, J.D. Stice, *Accounting Concepts and Applications*, 2nd ed., South-Western Cangage Learning, USA 2010, p. 575.

[14] When interests exceed 50%, the applied methods include the acquisition or accumulation of interests and respective consolidation procedures. The paper does not discuss this issue as the valuation of deposits in subordinated entities is presented only in the context of the investor's separate financial statements.

The other version of the cost method is the so called revaluation method, which is used for the valuation of long-term deposits. It is based on the adjustments of the historical price of the purchase of deposits (*in plus* or *in minus*) determined by the observations of long-term trends of changes in their market values.

Changes in the value of long-term deposits which are not in excess of the purchase price are accounted for as costs or financial income. Changes which exceed the purchase price are recognised as capital resulting from revaluation.

A different situation occurs when investors, as a result of their holdings, have a significant influence over the investee. Under such circumstances the equity method is applied.

The equity method – in accordance with the Accounting Act, is a method adopted by a dominant entity, a co-dependent entity's partner or a significant investor, for evaluating interests in the subordinated entity's net assets, which accounts for goodwill or negative goodwill, determined as of the date of taking over control, joint control or significant influence. The initial value of interests is revalued as at the balance sheet date, accounting for changes in the net value of assets held by a subordinated entity, which occur during the reporting period. They result from an associate's financial result adjusted to goodwill or negative goodwill changes in a given reporting period as well as from other changes resulting from settlements with the dominant entity or significant investors.[15]

The equity method aims to present the item ”Interests in subordinated entities evaluated on the basis of the equity method” belonging to balance sheet fixed assets, at the purchase price increased or decreased by an increase or decrease in equity in the dominant entity, co-dependent's partner or significant investor, which occur as of the date of taking over control, joint control or significant influence until the balance sheet date, including reductions resulting from settlements with owners, with the share of the subordinated entity's net profit (loss) being adjusted by goodwill or negative goodwill and the difference in the valuation of net assets at fair value and book value in a given reporting period.[16] This procedure has an impact on the annual adjustment of the value of deposits resulting from the performance of the entities in which deposits are invested.[17]

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[15] UoR, Art. 3, point 47.

[16] UoR, Art. 63, point 1. See: M. Remlein, *Skonsolidowane sprawozdania finansowe według polskich i międzynarodowych standardów rachunkowości*, SKwP, Warszawa 2010, 115–116, B.J. Epstein, E.J. Jermakowicz, 2010 *Interpretation and Application of International Financial Reporting Standards*, John Wiley&Sons, Inc., New York 2010, pp. 453–455.

[17] In accordance with IASB proposals, if approved by the European Commission, the status as the date of publication should be as follows: IAS 28 “Investments in Associates and Joint Ventures” (until 31.12.2012, IAS 28 „Investments in Associates”); the equity method is discussed in IAS 27 „Separate Financial Statements” (until 31.12.2012, IAS „Consolidated and Separate Financial Statements”), IFRS 5 “Combinations of Business Entities”, IAS 31 “Interests in Joint Ventures” replaced by IFRS 11 as of 1.01.2013. The present regulation will remain binding if the above proposals are not approved by the European Commission.

According to amended IAS28 "Investments in Associations and Joint Ventures" (18), the entity which has a joint control over an investee, or which holds a significant control, records its investments in an associate or joint venture based on the equity method.[18]

According to the Accounting Act, in applying the equity method, the entity uses the most recent available financial statements of the associate or joint venture. If the dominant entity's accounting period end is different than the one adopted by the associate or joint venture, then the associate or joint venture – for the needs of the dominant entity – prepares additional financial statements as of the same date unless it is impracticable to do so.

If the investor is an insurance company, it must act in compliance with the Accounting Act as well as with the Insurance Activity Act,[19] the rulings of the minister of finance[20] and, in the near future, an EU directive which introduces new solutions related to ensuring solvency (Solvency II).[21] An insurance company is obliged to invest its assets in a manner which considers the type and structure of its products and ensures the highest possible standard of security and profitability, maintaining the desirable level of liquidity. The principle of the security of funds is given priority, while the profitability of investments is of lesser significance. Moreover, the assets which cover technical and insurance provisions must be invested in a diversified and dispersed manner so that they are not linked to one type of assets or one entity or committed to other than insurance-related liabilities. In addition to that, the maturity date for such assets should be consistent with the maturity of instruments resulting from insurance agreements. The assets which cover the technical and insurance provisions related to reinsurance activities are additionally secured by their separation and management which is independent from other activities directly related to insurance, and such assets may not be transferred.

Insurance and reinsurance companies are obliged to assess their deposits as of the balance sheet date according to the prudential principle:

1) financial assets held for trading and available for sale should be assessed at fair value if fair value can be determined in a reliable way;
2) if it is not possible to measure fair value in a reliable way, financial assets with set maturity dates are assessed on the basis of the adjusted purchase price and account-

[18] Exceptions to the application of the method are set forth in Art. 17–19 of amended Standard (Art. 13 IAS 28 from 2003).

[19] The Act of 22 May on insurance activities, DzU (Journal of Laws) No. 124, item 1151, and the Act of 13 February 2009 on changes to the Act on insurance activities and other Acts, DzU (Journal of Laws) No. 42/2009, item 341.

[20] The ruling of the Minister of Finance of 28 December 2009 concerning the specific accounting principles for (re)insurance companies, DzU (Journal of Laws) No. 226, item 1825, and the ruling of the Minister of Finance of 23.04.2004 concerning the recognition of assets outside the EU territory as the coverage of technical and insurance provisions, DzU (Journal of Laws) No. 94, item 910.

[21] The Directive of the European Parliament and the Council 2009/138/EC of 25 November 2009 concerning the undertaking and running of (re)insurance activities (Solvency II), Official Journal L Series 335.

ing for the write-offs resulting from the permanent decrease in value; in other cases the purchase price is used instead of the adjusted price;

3) financial assets held until maturity as well as extended loans and accounts receivable are assessed as under 2);
4) interests in subordinated entities are evaluated with the use of the equity method;
5) real estate is evaluated at the purchase price or cost of development reduced by the amount of depreciation until the balance sheet date and a permanent decrease in value;
6) deposits for which risk is borne by an insuree are evaluated at fair value;
7) deposit-related receivables from assignors are evaluated at the amount due in accordance with the provisions of a reinsurance contract; if a deposit is a financial instrument, the contract also provides for its assessment.

Insurance and reinsurance companies classify deposits as short-term when, as a result of their liquidity, they can be disposed of within a shorter period than one year, or when an insurer or reinsurer intends to dispose of them during such a period. Long-term deposits are all other deposits which are defined in a different way.

If an insurance (reinsurance) company records differences resulting from the revaluation of deposits, they are accounted for as revenues or losses related to deposit activities. Deposits classified as financial assets available for sale which are not accounted for in setting the level of technical and insurance provisions are directly presented as “change resulting from revaluation”. A similar procedure is applied in the case of interests in subordinated entities. In the case of disposing of identical deposits or deposits regarded to be identical, expenditures are assessed on the basis of the FIFO method or average prices.

The EU Directive “Solvency II” introduces somewhat different principles for assessing the insurer’s assets. In the first place, member states are obliged to ensure that the valuation of the insurer’s assets, including investments, are based on the amounts at which they could be exchanged between the interested and well-informed parties on a market basis, i.e. at fair value.[22]

The (re)insurance company presents its investments/deposits in financial statements, dividing them into two groups. The first group of deposits includes the following:

– real estate,
– deposits in subordinated entities,
– other financial deposits,
– deposit receivables form assignors.

The other group includes deposits presented as “Life insurance net assets when deposit- (investment-related risk) is assumed by the insurer”. All deposits under this item are presented jointly.

[22] Art. 75 of the Directive of the European Parliament...

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Summary

An entity which has disposable funds may invest them in various types of deposits. Investments in securities which represent interests in other entities, depending on the amount of invested funds, enable investors to have influence over the activities of such entities. The paper presents different methods for valuating such deposits depending on the value of interests held by the investor. The subsequent part of the paper discusses additional requirements to be met by investments in insurance companies.

METODY WYCENY ORAZ PREZENTACJI LOKAT KAPITAŁOWYCH W JEDNOSTKOWYM SPRAWOZDANIU FINANSOWYM INWESTORA NA WYBRANYCH PRZYKŁADACH

Streszczenie

Każda jednostka posiadająca wolne środki może je zainwestować w różnego rodzaju lokaty. Jeśli inwestuje w papiery wartościowe stanowiące udziały w obcych podmiotach to w zależności od wielkości tej inwestycji pozwala ona na wywieranie wpływu na ich działalność. Artykuł prezentuje różne sposoby wyceny takich lokat w zależności od wielkości posiadanych przez inwestora udziałów. W dalszej części zaprezentowano dodatkowe wymogi jakim podlega inwestowanie w zakładach ubezpieczeń.