7th International Scientific Conference
"Business and Management 2012"
May 10-11, 2012, Vilnius, LITHUANIA

ISSN 2029-4441 print / ISSN 2029-929X online
ISBN 978-609-457-116-9 CD
doi:10.3846/bm.2012.029
http://www.bm.vgtu.lt

IS FAIR VALUE A PLUS OR A MINUS FOR INDUSTRIAL COMPANY?

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Abstract. Measurement of assets in financial accounting is extremely complex and it can be stated that it represents the basic problem of accounting, which determines the content and the explanatory ability of the financial statements. Since the items of the accounts represent the input data for the calculation of financial ratios, from their measurement are dependent the results of financial analysis and overall assessment of the financial situation of an enterprise. Currently, at the time of continuing financial crisis the most discussed issue in measurement is the application or non-application of fair value measurement for assets. Can the current crisis change the approach to fair value measurement in financial accounting? This article is aimed at the assessment of risks arising from extending fair value measurement use and at the issue of fair value measurement at the time of financial crisis for industrial company.

Keywords: fair value, financial accounting, financial crisis, assets, measurement.

Jel classification: M41, M48, M20, G01

1. Introduction

One of the crucial and important elements of accounting that is currently considered to be a chronic problem is the measurement of the assets. The content and the explanatory ability of the financial statement depends on the used method of measurement, applied principles, methods of measurement, cost bases in the chosen system of accounting. The information provided in the financial statements are inevitable for financial decisions of the interested entities.The measurement of the assets and liabilities at the level of financial accounting has been amended in the legal standars of all the national legislatives of the EU countries in order to be compatible with the Financial Reporting Standards (IFRS) or with Generally accepted accounting principles (US GAAP).

Several cost bases are applied at the measurement of the assets and liabilities in accounting. One of them is also the fair value. In the accounting practice there are various names used for fair value, such as the current value or the objective value, but there exists also a different concept of fair value, so called hypothetical fair value (Škoda 2010).

„Fair value is the amount for which an asset could be exchanged, or a liability setled, between knowledgeable, willing parties in an arm's length transaction" (Dvořáková 2009). This requires that the assumptions as to how the asset can be used are those adopted by the market, rather than the "entity specific" beliefs of the current owner.Fair value is in fact the market price, for which the assets or liabilities can be exchanged between business parties on the market.

2. Fair value in Slovak accounting

The highest legal standard amending the methods of measument in the Slovak republic is the Act and subsequently legal measures. In the Act the fourth part „The methods of measurement"deals with the issue of meaurement. In ths part of the Act there are defined the time of measurement, as well as measurement quantities. According to the Accounting Act the following measurement quantities are used when measuring the assets and liabilities: cost of acquisition, the replacement cost, costs of production, the nominal and fair value (Zákon o účtovníctve 2011).

The concept of fair value has already become quite conventional in the Slovak accounting practice. The recent amendment of the Accounting Act enumerates the range of the assets that are measured by the fair value. The legal regulation of accounting doesn't include the definition of the fair value; it states only what can be considered to be the fair value.

As the fair value we can consider (Šlosárová 2006):

a) market value,
b) qualified estimate or expert appraisal,
c) value prescribed by special legislation.

The legislative amendments in Slovakia allow the possibility of the revaluation of the assets to the fair value, but it is not applicable to all the elements of the financial statements. This revaluation is applicable only to those items of the financial assets and comodities, in which the showing of the changes of the market price is inevitable for providing reliable accounting information for the users. What still remains the problematic area is the measurement of the long-term tangible assets that cannot be revalued to fair value according to the national legislation.

3. Fair value in IFRS and US GAAP

In Anglo-Saxon countries, where anglo-saxon model of accounting predominates, prevailing type of enterpreneurship is primarily in the ownership of the minor shareholders who are usually anonymous for one another. In such environment it is inevitable that all the owners of an enterprise have an opportunity to get an objective view of what is the subject of the submitted financial statements. Owing to the fact that the stocks of these enterprises are listed on the most prominent stock exchanges, measuring the assets and liabilities of any kind in historical prices is unacceptable. For these reasons revaluation to the current value is applied in these economies both for tangible assets, as well as intangible assets, even though IFRS doesn't require it explicitly but states it as one of the alternatives of the measurement of the assets as of the balance sheet date (Škoda 2010).

In countries where the continental model of accounting predominates, prevail so called family enterprises with limited number of owners who know each other and together decide about the strategic direction of the enterprise. The revaluation of the particular balance sheet items is not so important for the use of the information from the financial statements, and therefore it is not applied.

It has already been mentioned that also Slovak legal regulations of accounting explicitly determine the items that must be revalued to fair value as of the balance sheet date. In the Slovak accounting still prevails the measurement at the continuous acquisition costs that has a great disadvantage from the point of view of the users of the financial statements that it doesn't always enable to view the financial situation of the enterprise truthfully and faithfully (Jusková 2011).

The measurement at the continuous acquistion costs also prevails in the anglo-saxon model of accounting. Before this system was applied almost all over the world, various different systems of accounting occurred in the history of accounting. For example, currently so widely discussed fair value measurement used to be wide-spread in the 19th and at the beginning of the 20th century and its use ended up in the twenties of the 20th century (Krupová 2009). At that time originated American accounting standards US GAAP as a reaction to the fall of the New York's stock exchange that are viewed as the foundations of the modern accounting in the world. And even at that time there were accepted the most significant postulates in those standards- realization principle, matching principle, the presupposition of the constant purchasing power of the monetary unit and prudence principle.The reason for the application of continuous acquisition costs into the American accounting standards was mainly the objectivity at the time of reporting. This argument persists in them up to now; in US GAAP most items in the balance sheet are measured in continuous acquisition costs.

4. Is the use of the fair value risky?

We all know how important are reliable information reported in accounting. History has taught us that the accounting statements that don‘t provide their users relevant and reliable information about the financial situation, the profitability and the changes in the financial situation may be one of the serious causes of the economic crisis. It was like that for example in the twenties of the 20th century after the fall of the New York's stock exchange or in recent history in the case of Enron when it was found out that their accounting statements were deliberately misleading. We mustn't forget the massive mortgage crisis that also started in the USA in 2007 and its consequences can be still experienced. This crisis also proved that illegal accounting practices that overstated assets and fictive profits resulting from them seriously threatened not only American continent but the whole world.

The professor of the economics J.H. Soto who lectures at the University of the King Juan Carlos in Madrid offers a very interesting view of the problem of the application of the fair value. Professor Soto (2009) states that the given system of measurement violates traditional accounting principles, but mainly the principle of prudence and is trying to replace them with others that „are in accordance with trends“.

To violate the traditional principle of prudence and require that accounting entries reflect the market values is to provoke, depending upon the conditions of the economic cycle, an inflation of book values with surpluses which have not materialized and which, in many cases, may never materialize. The artificial "wealth effect" this can produce, especially during the boom phase of each economic cycle, leads to the allocation of paper (or merely temporary) profits, the acceptance of disproportionate risks, and in short, the commission of systematic entrepreneurial errors and the consumption of the nation's capital, to the detriment of its healthy productive structure and its capacity for long-term growth. Clearly, accounting principles which, like those of the IFRS, have proven so disturbing must be abandoned as soon as possible and all of the accounting reforms recently enacted. This is so not only because these reforms mean a dead end in a period of financial crisis and recession, but especially because it is vital that in periods of prosperity we stick to the principle of prudence in valuation, a principle which has shaped all accounting systems from the time of Luca Pacioli at the beginning of the fifteenth century to the adoption of the false idol of the IFRS. The prudence principle is replaced with the "fair value" principle, which is simply the introduction of the volatile market value for an entire set of assets, particularly financial assets (Soto 2009).

The presented opinion represents a very critical view of the use of the fair value in particular standards. In any case it can be stated that IFRS partially refrains from respecting of the principle of prudence. The application of this approach may be viewed for some industrial enterpises as a positive step forward, for the others as controversial.

Fair value measurement is so complicated that even the European directives from 2001, which have been implemented to the accounting of some accounting entities, don't oblige the member states to apply it accross-the-board (Žárová 2008).

Therefore, nowadays, fair value has its proponents, as well as opponents. In general, it can be stated that the use or non-use of the fair value measurement of the assets in the financial statements depends mainly on the information needs of the users. We also have to take into account whether the country is a part of the anglo-saxon or continental accounting system.

Despite all these arguments there still exist reasons that support the opinion that it is necessary to practise fair value measurement. The professor (Tumpach 2011) expert in the field of IFRS states that: „fair value should in principle express the neutral measurement- thus the value, for which particular assets or liabilities should be acquired without taking into account:

– specific circumstances or
– elations.

Therefore, if an investor, creditor or any other reader of the financial statements receives the information about the fair value of the particular assets, then they know that they can realize the value without any circumstances. These advantages of the fair value led to its wide application when compiling financial statmenents. Therefore, the fair value needn´t be underestimated, as it may have a negative impact on the enterprise, as well as the users of the accounting information. Non-application of the fair value leads to an incorrect quantification of the assets, liabilities or trading income".

The difference of the opinions on the use of the fair value could result from the fact that until May 2011 there was a distinct definition of the fair value in particular standards and the practice stated this measurement quantity in a non-uniform way.

Another problem was the non compliance of the definition of the fair value between US GAAP and the regulations of the IFRS. Under these circumstances IASB together with American FASB prepared a common standard IFRS 13Fair Value Measurement, the objective of which is to solve the problem of the fair value in a complex way. IFRS 13 refers to all the standards that use or enable the fair value measurement (Štepko 2011).

IFRS 13 defines fair value „as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date", provides guidance on its determination and introduces consistent requirements for disclosures on fair value measurement (IASB 2011).

Fair value measurement represents a current problem in the field of IFRS, particularly in the field of the nonfinancial assets. Time will show whether the adoption of the IFRS13 will move fair value measurement in particular standards forward. What is for sure is the fact that the adoption of the standard proves that IFRS is an open system of the accounting regulations that has been constantly developing.

5. Fair value measurement of non-current assets in the financial statement under IFRS of industrial companies

Several standards refer to the reporting of the non-current assets. In this article we will deal with the reporting and measurement of the non-current assets only according to the standards IAS 16 Property, plant and equipment and IAS 40 Investment property that offer the possibility to revalue these assets to fair value.

5.1. IAS 16 Property, plant and equipment

Historicaly, tangible long.-term assets have been the major assets of companies. *IAS 16 Property plant and Equipment* (PP&E), covers the main non-current tangible assets (Walton 2009).

These assets burden to economics of industrial enterprise mainly with fixed cost. The acquisition cost is gradually transferred to the value takes the form of depreciation (Baštincová 2009).

According to this standard, the PP&E are tangible items that (IAS 16):

a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

b) are expected to be used during more than one period.

PP&E are recognized as assets if they meet the definition of assets, as set out in the Framework:

– it is probable that future economic benefits associated with the item will flow to the entity; and

– the cost of the item can be measured reliably.

At the acquisition and first reporting PP&E are measured at acquistion costs. It depends on the method of acquisition if the acquisition cost acquires the form of a purchase price (when acquiring through purchase) or the form of the own costs (when producing the assets internally) (Soukupová 2008).

The cost comprises (IAS 16):

a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates,

b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management,

c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located.

The borrowing costs that are directly attributable to the acquisition, construction or production of qualifying asset shall be capitalised as a part of the cost of that asset (IAS 23).

The cost of the asset is allocated to cost in the form of depreciation during useful life.

After initial accounting recognition, for the purposes of preparing financial statements, the enterprise selects a measurement model for each class of PP&E (Krupová 2011).

The enterprise may choose the cost model and revaluation model (Fig. 1).

Cost model: After recognition as an asset, an item of PP&E shall be carried at its cost reduced by any accumulated depreciation and any accumulated impairment losses. This model is based on the principle of the valuation of assets at the moment of acquisition and does not respond to fluctuations in the price level upwards. Here we can copy the asset price developments only downwards under IAS 36 Impairment of Assets. This reduction is charged as a loss in profit/loss and affects the profit of the enterprise.

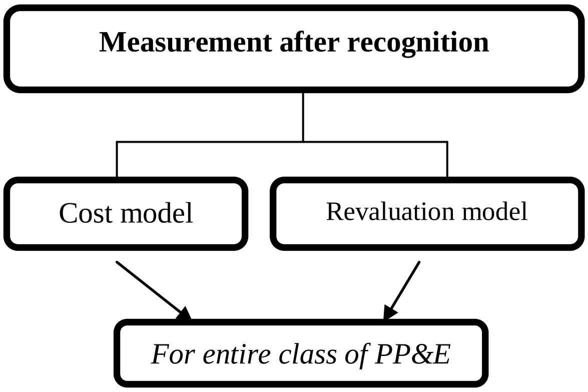

Fig.1. Measurement models for PP&E (Krištofík 2011)

Revaluation model: After recognition as an asset, an item of PP&E whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation reduced by any subsequent accumulated depreciation and subsequent accumulated impairment losses.

The fair value of land and buildings is usually determined from market-based evidence by appraisal that is normally undertaken by professionally qualified valuers. The fair value of items of plant and equipment is usually their market value determined by appraisal (IAS 16).

If there is no market-based evidence of fair value because of the specialised nature of the item of PP&E and the item is rarely sold, except as part of a continuing business, an entity may need to estimate fair value using an income or a depreciated replacement cost approach.

Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period. The frequency of revaluations depends upon the changes in fair values of the items of PP&E being revalued. Some items of PP&E experience significant and volatile changes in fair value, thus necessitating annual revaluation. Such frequent revaluations are unnecessary for items of PP&E with only insignificant changes in fair value. Instead, it may be necessary to revalue the item only every three or five years (IAS 16).

If an item of PP&E is revalued, the entire class of PP&E to which that asset belongs shall be revalued.

The items within a class of property, plant and equipment are revalued simultaneously to avoid selective revaluation of assets and the reporting of amounts in the financial statements that are a mixture of costs and values as at different dates. However, a class of assets may be revalued on a rolling basis provided revaluation of the class of assets is completed within a short period and provided the revaluations are kept upto date (IAS 16).

If an asset's carrying amount is increased as a result of a revaluation, the increase shall be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss. Depreciation of assets is charged to the revaluation of a revalued amount (IAS 16).

If an asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognised in profit or loss. However, the decrease shall be recognised in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. The decrease recognized in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus (IAS 16).

The revaluation surplus included in equity in respect of an item of PP&E may be transferred directly to retained earnings when the asset is derecognised. This may involve transferring the whole of the surplus when the asset is retired or disposed of. However, some of the surplus may be transferred as the asset is used by an entity. In such a case, the amount of the surplus transferred would be the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on the asset's original cost. Transfers from revaluation surplus to retained earnings are not made through profit or loss.

The effects of taxes on income, if any, resulting from the revaluation of PP&E are recognised and disclosed in accordance with IAS 12 Income Taxes.

5.2. Cost model versus revaluation model

Although a high quality standard, IAS 16 (as currently in force) contains one serious flaw, in that it allows company's to choose between two, diametrically opposed model (historical cost and revaluation) putting it in direct conflict with the concept of comparability (between and among entities) (Mládek 2009).

In practice at PP&E cost model prevails at the subsequent reporting. The evidence of the statement that the revaluation model is less used are the results of our survey that was carried out on the analysis of the samples of the consolidated financial statements of 20 industrial enterprises reporting according to IFRS, from which 11 are in Slovakia and 9 abroad. I carried out this survey with regard to the given facts, for my dissertation thesis, in which I deal with the problem of the measurement of the PP&E. Consolidated financial statements were gathered from accessible internet sources through random selection.

The most important for my analysis was to review the balance sheet and subsequently the additional information in the notes connected to the individual items of this statement. The result of the survey is shown in picture 2.

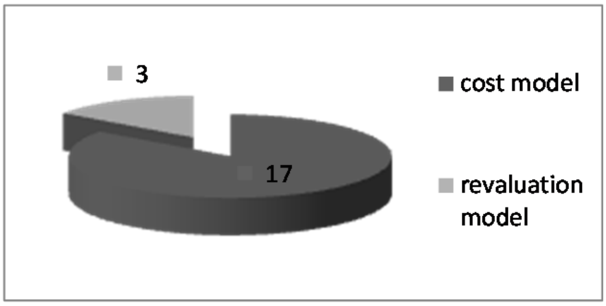

Fig.2. Measurement under standard IAS 16 (Talnagiová 2010)

We subsequently found out that the scope of the application of the revaluation model is different. The first of the analysed enterprises applies revaluation model only for land. The second of the enterprises applies revaluation model only for some classes of the assets according to IAS 16 and the third of the analysed enterprises applies this model for all the assets in terms of IAS 16.

There may be several reasons why these enterprises chose the revaluation model:

– The revaluation model increases (in case of the revaluation upwards) the assets and own capital and thus contributes to the improvement of the financial situation of the enterprise (Krupová 2011).

– The revaluation surplus charged for owns capital will never be a part of the trading income and the object of allocation, which ensures the production ability of the enterprise.

– The revaluation model in the situation when the depreciated assets are revalued upwards, reports lower profit than the model of the acquisition cost in consequence of higher depreciation that leads to paying less dividends to its shareholders.

– When revaluing the assets upwards, the enterprises have higher depreciations, that is subsequently reflected into their prices.

– Last but not least the revaluation of the assets to the fair value enables the owners whenever to compare the offer for the purchase of the enterprise with its current market value.

It is necessary to mention that according to the results of the analysis, 17 remaining enterprises don't apply the model of the revaluation of the long-term tangible assets. What may be the reason for this? (Krupová 2011)

– Negative impact on profit/loss - If we increase the value of assets to fair value, it has negative impact on profit/loss.

– Application model is expensive - costs associated with regular measurement of these assets.

– Application of the model is complicated - model requires complicated calculations. These calculations relate to the recognition of deferred income tax.

5.3. Investment property

The standard IAS 40 Investment property deals with the problem of the identification, measurement and presentation of the investment property and related requirements for the disclosure of this scope. Investment property is sometimes called a passive investment to differ from the other, actively used assets.

Investment property is property (land or a building—or part of a building—or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for (Krupová 2011):

a) use in the production or supply of goods or services or for administrative purposes; or

b) sale in the ordinary course of business.

An investment property shall be measured initially at its cost. Transaction costs shall be included in the initial measurement.

Measurement after recognition

Industial company shall choose as its accounting policy either the fair value model or the cost model. Assets that are valued at fair value are not depreciated.The entity that chooses the fair value model shall measure all of its investment property at fair value. A gain or loss arising from a change in the fair value of investment property shall be recognised in profit or loss for the period in which it arises (IAS 40).

The fair value of investment property is the price at which the property could be exchanged between knowledgeable, willing parties in an arm's length transaction. The fair value of investment property shall reflect market conditions at the end of the reporting period. The best evidence of fair value is given by current prices in an active market for similar property in the same location and condition.

In the absence of current prices in an active market, an entity considers information from a variety of sources, including: (IAS 40)

a) current prices in an active market for properties of different nature, condition or location, adjusted to reflect those differences,

b) recent prices of similar properties on less active markets,

c) discounted cash flow projections based on reliable estimates of future cash flows, supported by the terms of any existing lease and other contracts.

If an entity has previously measured an investment property at fair value, it shall continue to measure the property at fair value until disposal even if comparable market transactions become less frequent or market prices become less readily (Jílek 2011).

Cost model

After initial recognition, an entity that chooses the cost model shall measure all of its investment property in accordance with IAS 16's requirements for that model.

When analysing consolidated financial statements we found out that 5 enterprises out of 20 invest in real estates. We subsequently investigated which companies out of those investing in real estates apply the model of the fair value. The results of the survey are shown in picture 3.

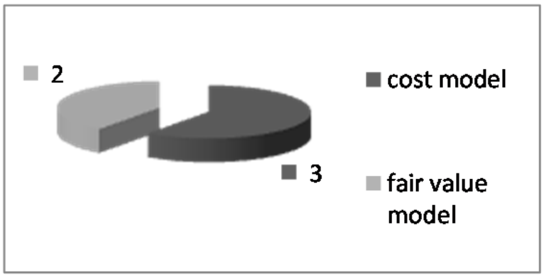

Fig.3. Measurement under standard IAS 40 (Talnagiová 2010)

Fair value model are revalued items of investmetnt property to fair value at the balance sheet date and profit or loss arising from a change in the fair value of investment property shall be recognised in profit or loss.

Why is the fair value measurement important? If, for example, some financial institution is obliged to have 20 % of the assets covered by the equity capital and currently amounts to only 16 %, then the revaluation of some category of the PP&E to fair value may help it to meet the requirement.

(Tumpach 2010) But if it is the industrial enterprise, what can be the reasons?

The reasons for the application of the fair value model for the investments in real estates may be the following:

– The enterprises may dispose of the information, according to which they suppose that the price of the real estates in the given locality will increase in the long term, not dicrease (Talnagiová 2011).

– The increase in prices of property can have a positive impacton the profit/loss of industial company each year.

– If the managers of the company are rewarded according to the acquired outcome management, their objective will be to improve the outcome management towards the achievement of higher profits (Mederly 2010).

The application of the revaluation model might be considerably risky. Imagine the situation that the price of the real estates will be reduced in the long term as a result of the continuing financial crisis. The enterprises applying this model will report a loss from the impairment of the assets. It will be very difficult for them to expain to their shareholders, auditors, creditors that the losses are insignificant, unrealized, so called losses reported only on paper.

Fair value measurement in times of the financial-economic crisis isn't riskless. But we have to admit that in some cases its more objective explanatory ability in comparison with the historical measurement outweighs some subjective aspects.

Fair value measurement reflects the impact of inflation or the impact of price changes. The values expressed this way may be objective and thus express the actual value of the assets (Kadlečík 2011). But it mustn't be forgotten that the fair value measurement partially refrains from the principle of prudence what influences the decision of the industrial enterprises in its application.

This year we have analysed the consolidated financial statements of these enterprises again (drawn up as of 31. 12. 2010) and we have concentrated on the application of the fair value according to IAS 16 and IAS 40. This analysis confirmed that the application of the fair value in terms of IAS 16 and IAS 40 is identical with the situation as of 31. 12. 2009.

6. Conclusions

The main objective of the financial accounting as the information system of the enterprise is to submit the users of the financial statements the information that are useful, comprehensible, comparable and particularly reliable.

The introduction of the fair value into financial accounting and reporting has had its proponents and opponents from the beginning.

As resulting from our analysis the industrial enterprises have also approached to fair value measurement very carefully so far.

Time will show whether the adoption of the standard IFRS 13 will move such an important scope as the fair value forward. IFRS 13 is an evidence of the fact that the accounting practice has been constantly developing.

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