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# Quality of Financial Reporting in the Context of the Adoption of IFRS

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The application of IFRS in an economic entity's accounting imposes the paying of special attention to not necessarily the similarities but most importantly to the differences which appear between the national referential and the IASB one. As regards the financial position of the entity, we may say that, more or less, all standards influence it, but some impose differences which must be mentioned.

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## 1. Introduction

According to the provisions in the international referential, IFRS 1 is applied when a firm draws up the first financial statements according to IAS/IFRS. The general principle of IFRS 1 is the retrospective application of IFRS.

IFRS 1 states that the sum of standards and interpretations must be applied to the opening accounting and the comparative periods applied in IFRS, in a retrospective manner, in their most recent form, meaning their form at the date of closing the first IFRS financial statements.

## 2. The influence of moving to IFRS on the reflection of the financial position by SFA

The influence on financial position occurs, in essence, through the use of rules for the recognition and de-recognition of elements in the annual financial statements.

Previously recognized assets and debts which are do not meet recognition criteria will have to be de-recognized. For example, recognized audit provisions, according to the national referential, but that do not meet recognition criteria according to IAS 37 will be de-recognized, meaning that they will be eliminated from the balance sheet. Conversely, some elements which have not been recognized as assets or as debts in the accounting balance used previously by the company in question, but that do meet the recognition criteria required by the IFRS, will have to be included in the IFRS opening balance sheet as well as in subsequent statements. For example, the provisions referring to retirement commitments, which were not recognized in the balance sheet and only mentioned in explicative annotations, will need to be accounted for, thus recognized, according to the old IAS 19.

The evaluation of certain structures of financial statements, such as assets, debts, expenses and incomes will be made according to the methods defined by the IASB referential. For example, we remind that the IAS 11 standard, *Construction contracts,* states that all construction contracts must be evaluated on the basis of the *percentage of advancement of the works.*A company which previously registered income generated by construction contracts based on the *at the end of the works* method will have to re-estimated them taking into account the degree of their advancement, starting with the opening date of the IFRS balance.

The adjustment trade-off imposes that all re-treating done for the development of the IFRS opening balance sheet must affect all equity capital of the firm in question. Thus, all differences resulting from the recognition, de-recognition and adjustment at evaluation will be treated as equity capital elements.

**A. Optional exceptions**

A company which adopts the IFRS standards for the first time may turn to all exceptions provided by the IASB (IFRS 1, par. 13-25) or only some of them. Which are they?

*1. Just value or deemed cost reevaluation*

At the date of adopting the IFRS standards, the reconstituting of the depreciation cost of some assets or debts may present some difficulty. From this point of view, IFRS 1 authorizes the evaluation of these elements in the opening balance sheet, at a different base than the historic cost, such as:

*Just value on the date of the opening balance*

- As an exception from this basis we note intangible assets, for which the just value cannot be retained as en evaluation basis except to the extent that these have an active market; *Reevaluated value* prior to the date of transition to the IFRS standards.
- The reevaluation may be made through a direct estimate of just value, at the date of the reevaluation, or by the application of an index of price variance.
- *Size reevaluated at just value* as a result of the listing of a company, a privatization or another specific event prior to the transition to IFRS standards. The size transcribed in the opening balance sheet will serve, afterwards as a basis for calculating amortizations and depreciations, according to the current dispositions of the applicable standards for the good in question.

2. *Company groupings* are the exception referring to maintaining the prior classifications and evaluations goodwill reproaches of adjustments of non-corporeal elements. Through the application of the exceptions, information referring to the groupings of companies that have been recognized prior to the date of moving to IFRS do not have to be re-treated. If companies choose to re-treat information referring to a group of companies prior to the move to IFRS, all groupings that took place subsequently are re-treated.

3. *Employee benefits: actuarial gains and losses*

The IAS 19 norm recommends that companies evaluate and provision the size of their commitments referring to employee benefits. Considering prior employee operation advantages, IAS 19 allows for the possibility of not immediately accounting for the actuarial differences, but to transform them into deferred installments, imposing, at the same time, that the companies proceed to choose a permanent method. According to IFRS 1, companies will be able to account fully for actuarial differences, with a trade-off in adjusting proprietary equity-capital, without losing the possibility to defer new actuarial differences in the future.

4. *Net investment in foreign entities: the balancing of accumulated conversion differences.* IFRS 1 allows the firm to consider the accumulated conversion differences referring to net investments in foreign entities null and if this option is used it will have to be extended to all foreign entities. Furthermore, IFRS 1 exempts companies that adopt IFRS for the first time to determine retrospectively the conversion differences.
5. *Composite financial instruments: the non-reclassification of the stock component from proprietary equity capital*

When the *debt* component of a compound security, issued by an entity that adopts the IFRS standards for the first time, is paid on the date of the opening balance sheet, the company is not required to reclassify the equity capital component. This would practically mean the identifying of two elements of equity capital.

6. *Branch, associated entities and participation associations' assets and debts*

There will exist, most likely, situations when adopting the IFRS standards by the parent company and by the companies that are controlled or notably influenced takes place on different dates. The most frequent case refers to the parent company and its branches.

The exception allows the branch that adopts IFRS standards at a later date than the parent company, to evaluate the assets and debts either at the carrying amounts included in the consolidated financial statements of the parent company, based on the date of the parent company's transition to IFRS, or on the base of IFRS 1 applied at the date of the branch's transition to the IFRS referential.

In the case when the branch decides to use the carrying amounts from the consolidated financial statements of the parent company, the respective values will be adjusted, if this adjustment is relevant, in order to exclude the consolidation adjustments as well as the adjustment resulting from the acquisition of the branches by the parent company.

In the situation when the parent company adopts the IFRS standards at a later date than the branch, it will have to evaluate the assets and debts of the banks in consolidated financial statements using the carrying amounts from the separate financial statements of this entity. The exception may be detailed on several elements, which regard these categories of assets and debts:

- *designation of afore known financial instruments* – a company is allowed to recognize a financial instrument as financial asset or debt that the date of transitioning to IFRS;
- *transactions with assets as payment* – companies are required, without being encouraged, to use the issued and legitimized IFRS 2 provisions before the date of transition to IFRS. In this case, a company may apply IFRS 2 only if it has previously published the just value of the issued instruments, determined at the evaluation date;
- *insurance contracts* – an insurer may choose to apply IFRS 4, prospectively, starting with January 2005;
- *modifications in the value of the decommissioning provisions in the cost of tangible fixed assets;*
- *leasing contracts;*
- *Just value evaluation of financial assets and debts.*

**B. Mandatory exceptions**

IFRS 1 imposes three mandatory exceptions from the principle of re-prospective application, as follows:

*1. De-recognition of financial instruments*

According to IFRS 1, it is forbidden for a company which adopts for the first time the IFRS standards to recognize again the financial assets or liabilities which have already been de-recognized prior to January 1st 2005.

*2. The recognition ofhedge accountingelements*

IFRS 1 mentions the conditions that must be fulfilled by an operation for its inclusion in *hedge accounting*. The four conditions refer to: a prior statement, a prospective justification of the efficiency of the coverage, a control of real efficiency and permanent documenting. IFRS 1 gives priority to declared intent. The standard forbids a company which adopts the IFRS standards for the first time to modify the means of qualifying the hedge operations (according to the old IAS 39 standard). Operations declared as hedge operations in the previous referential must conserve the respective qualification in the opening balance sheet according to IFRS. The operations that were not declared as hedging operations will not be able to be declared as being part of this category, in a prospective manner.

*3. Maintaining previous estimates*

According to IFRS 1, the data and hypotheses which were at the base of the evaluations of the financial statements in the previous referential must be maintained if the accounting policies at the time were in accordance with the dispositions of the IAS/IFRS standards.

In the effective application of IFRS 1, companies will have to go through the following stages:

1. Choosing the first reporting date and the date of the transition to the first time application of the IFRS;
2. Identifying the differences between existing accounting policies and the ones proposed by the IFRS standards. Selecting the accounting policies themselves by applying the IFRS standards;
3. The decision of whether or not to apply one or more of the six optional exceptions;
4. Applying the three mandatory exceptions from the retrospective application;
5. Developing the opening balance sheet, at the date of transitioning to the use of IFRS;
6. IFRS 1. Identifying the aspects which require detailed presentations, according to IFRS 1.

According to the presentation of this standard, the *impact of the transition to IFRS on the financial position of a firm* is observed. The practical application of this standard will have implications, mostly, on the reported result component, as a part of the equity capital of the financial position.

For this purpose, companies will have to develop an opening sheet at the date of the transition to IFRS, a sheet which represents the starting point for the following accounting according to the international referential. The date of transition to IFRS represents the beginning of the first period for which comparative information are presented in accordance with IFRS.

The transition to IFRS means, according to conducted studies, an improvement of the quality of accounting information. The implementation of IFRS improves profit management and leads to relevant values (including for financial position) from the point of view of informational content.

## 3. The influence of applying IFRS 5 "Noncurrent assets kept for selling and discontinued operation" on the financial position

For the user of information from the annual financial statements, being interested in the future of the entity, it is important to be able to distinguish within the financial statements (and especially, at the level of the result), what results from the recurring operation of the entity and what comes out of the operations that are to be abandoned.

Some entities have the tendency to present operations with losses as operations which are to be abandoned, but the negative results make their cession difficult, at least in the short term. This is the reason why IFRS 5 limits the classification of assets to "held with the purpose of selling" through a series of conditions destined to prove that abandonment is on course and will be finalized in 12 months.

A company will classify a noncurrent asset (or group of assets) as being held for selling if its carrying amount will be covered, mainly, more likely following a sale than continuous use.

For this purpose, the asset (or group of assets) must be available for immediate selling in its current state, exclusively under common and current selling conditions which exist for this type of assets (or groups of assets), and the sale of the asset must present a high degree of certainty.

For the sale of the asset to present a high probability, a series of conditions must be fulfilled:

• management must have developed a sale plan for the asset (or group of assets);

• an efficient program of buyer identification must have been initiated as well as one for the closing of the sale plan.

Furthermore, the asset (or group of assets) must be able to be sold within the framework of an active market for a price that is reasonably tied to its current just value. In addition, it is expected that the sale be qualified for recognition as "completed sale" within one year from the date of its classification, with the exception of the case in which the delay is not under the control of the entity and the necessary actions for the closing of the sale plan reflect the fact it is unlikely for significant changes in the plan to be necessary or that the plan be withdrawn. These conditions may seem excessively severe.

It will be noted, indeed, that the rule under which an asset or group of assets which are to undergo cession must be functional excludes any good that requires prior repair.

The 12 month duration may prove extremely short in some cases. Negotiations usually last for a long time if they concern an important part of the entity. It is to be desired that the operations being discussed may be isolated in the financial statements. However, IFRS does not allow this treatment.

Classification in "for sale" assets does not have an impact on the result or the equity of the entity, and only on the financial statements, affecting its financial position. They must be presented in the balance as current assets. The effects of IFRS 5 are, definitively, limited. IFRS requires that losses or gains from the surrender of depreciated assets be presented in the profit and loss account.

If, still, the components of the operation of an entity are sold, abandoned, liquidated or conceded in another way, then the results of the operations with continuity must be reported separately from the interrupted ones. Also, in the financial statements, the values corresponding to discontinued operations are presented separately from those of continuous operations. This helps the users of information held in the annual financial statements to make the distinction between continuous operations and future profitability on the one hand, and the discontinued operations on the other.

Furthermore, cash flows resulting from operating activities, investments or financing belonging to a discontinued operation must be presented separately in the cash flow standings or detailed in explicative annotations.

Also, it is recommended to include in the annotations information regarding the nature of operations up for sale, as well as the facts and circumstances that have led to the sale.

In order to facilitate the analysis of profitability, earnings or losses from the conceding of a company as a whole or of a segment, must be reported with the results corresponding to discontinued operations as a separate element in the profit and loss account, under the earnings from the continuous operations.

## 4. The advantages and disadvantages of adopting IAS/IFRS

Those who see the advantages of adopting IAS/IFRS show that this process is an opportunity for companies to optimize the way they:

- evaluate and measure internal performance;
- communicate with the exterior regarding more information, granted more quickly and with a higher frequency;
- and, finally, they gain a competitive advantage, more value for the shareholders, thus responding to the expectations of the market.

According to an investigation by Mazars – an international audit and expertise organization – on 425 European companies from 6 countries, the application of IAS/IFRS is a means of developing the European capital market. This is the opinion of 75% of interviewed listed companies and 55% of the unlisted companies which intend to apply the norms. The process regards 5 million European companies (7000 listed companies of the EU, the branches of the listed European groups, the unlisted groups which issue negotiable bonds on an EU regulated market, the branches of unlisted European groups from the countries where the use of IAS/IFRS is authorized or imposed).

In our opinion, the **advantages** of adopting the international norms may be listed as follows:

a) The construction of a capital market regulated by a European stock exchange organism (on the basis of common accounting norms) would be favored.
b) A better comparability of financial information in the European space is ensured. The disappearance of certain national accounting anomalies, such as the treatment of retirement commitments or leasing accounting is beneficial.
c) Analysts and investors will have more information regarding business units (sub-units, branches) so the poor performance of some of these units will no longer be able to hidden. This will force managers to invest resources in more profitable sectors or to quickly improve the performance of weak links.
d) The consolidation of results will be made by branches and operations, so the performance of companies based on geographic areas and operational sectors will be known.
e) The increase in the transparency of accounting information will lead to new business opportunities because it will reduce the cost of attracting capital by increase the investors' trust in financial reports and, consequently, it will reduce the risk premium that they demand.
f) Companies will be able to enter capital markets across the world without the hardship and expenses for converting the set of financial documents.
g) The market rate of companies will be improved. First of all because the value of a company is given by the cash flows it is capable of generating and should not be influenced by the accounting principles that are the basis of their financial reports, and by the fact that the common accounting principles are known the accounting results will be able to be easily corrected in order to transform them into cash flows. On the other hand, the improvement of the market rate is also the consequence of the fact that the performance previsions and cash flows of companies will be safer, considering the greater level of detail and transparency of the reports.
h) Some European companies and their analysts, which are represented on international capital markets, are familiar with the US GAAP and the UK GAAP and know, thus, the accounting principles of communication with capital markets (considering the Anglo-Saxon source of inspiration of international norms)
i) The accounting and IT service providers will garner benefits as well. The formers, because they will be trained in the explaining, implementation and application of the new norms and the latters because, in order to apply the norms, the companies will have to change their IT software (for example, for keeping track of the just value principle for assets, of the useful lifespan, of the residual value and for stock, of the net attainable value, which includes different expenses, including transport).

Among the **disadvantages** we may state, from among the most significant:

a) For the development of financial analyses at least two years of historical data on the pro-forma accounts are necessary, which attract additional costs for the companies. The must, however, be compared with the risk premium which will be attributed by investors to a company which would present significantly different costs than what was previously presented and which would supply only one year of pro-forma.
b) IASB must finalize the text of certain norms, and on the other hand, IAS/IFRS is continuously changing (new concepts appear; existent standards are replaced or modified). A reticence on the part of financial institutions that are directly interested in the IAS/IFRS norms which affect them to a significant degree, but which are concerned about the evolution of their content and even by the uncertainty that looms over their elaboration

and adoption. This instability attracts some national/company systems to selectively adopt some of the norms of concept, considered to be more stable.

c) Some IAS/IFRS cannot be easily accepted in countries or sectors where the respective issue is treated in a radically different manner. It is the case in Great Britain, for example, of the accounting treatment of pension costs. Or, the companies in the banking sector, financial services, energy and insurance would meet particular difficulties with regards to IAS 39 referring to financial instruments.

d) For the implementation of norms it is usually necessary for the appeal to external experts (especially accounting and financial experts) but also others who offer solutions to the companies regarding the procedures for internal organization, communication, personnel, information system diagnosis. All of this expertise incurs significant costs for the company.

e) The introduction of just value can aggravate the volatility of asset evaluation. It can have, first of all, an effect on the financial instruments, mergers and acquisitions, assets, employee retirement commitments.

f) The new norms present interpretation risks, some accusing even a "manipulation" risk of financial statements.

g) Another critique refers to the complexity of norms, with inherent comprehension and application difficulties.

h) Difficulties may appear in the application of sole norms, when a greater diversity of operation sectors and profiles is attested.

i) The closeness of the new norms to Anglo-Saxon concepts stirs unrest especially in Latin countries, because their implementation may lead to vaster interpretations than in those countries, where the presentation and accounting rules are codified in a regulated manner.

## 5. Conclusions

In context, one might mention difficulties observed by unlisted companies which apply or may apply the norms with hopes to become part of a listed group or their implanting abroad. They see the adoption of the new norms as an expensive and long lasting process, while accusing that they have limited means and a weak impact of the publication of accounts according to the new norms (considering that these companies do not communication with the capital market but, at most, with clients and suppliers).

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