

# CHARACTERISTICS OF FINANCIAL REPORTING ACCORDING TO IFRS

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## **Abstract:**

*The article presents the historical development of IFRS, the principal institutions linked to their adoption and the harmonization process of standards in the European Union. The article seeks to examine the main characteristics of IFRS which will improve corporate reporting. The article critically examines the harmonization process with the emphasis on the convergence process between IFRS and American GAAP. The current harmonization process is announcing the harmonization of world leading standards, which will ensure for the first time in the history comparable accounts of entities being part of world leading economies. In addition the article presents the evolution of IFRS for small and medium-sized companies. Despite the benefits related to more comparable standards for small and medium sized entities, their adoption is leading to higher reporting costs. The current harmonization process is announcing a new era of harmonized corporate reporting.*

**Key words:** IFRS, financial reporting, accounting harmonization

**JEL classification:** M410

## **1. INTRODUCTION**

According to the process of globalization and a rising phenomenon of foreign associate companies an indispensable need for more comparable financial reporting standards became apparent. The very beginning of international standards can be found in sixties. Since then many efforts were made to create international financial standards, which will ensure a uniform accounting approach for leading European companies.

In 2002 the regulation of the European Parliament and of the Council introduced as obligatory the use of international accounting standards for publicly traded companies. The application of International Financial Reporting Standards (IFRS) was obligatory for financial years starting after 1 January 2005. Since 2005 companies which securities are admitted to trading on a regulated market of any Member State have to prepare their consolidated accounts in accordance with IFRS (Regulation (EC) No 1606/2002). The regulative has introduced radical changes in accounting for numerous companies, which used domestic standards as IFRS introduced a more dynamic accounting approach.

In the first part the article presents a description of the historical development of IFRS. There are presented the principal institutions linked to their adoption and the harmonization process of standards in European Union. As follows the article seeks to examine the main characteristics of IFRS which will improve corporate reporting. In the second part the article focuses on the current harmonization process. The article critically examines the harmonization process between European IFRS and American Generally Accepted Accounting Principles (GAAP). Current harmonization process is announcing the harmonization of world leading standards, which will ensure for the first time in the history comparable accounts of entities being part of world leading economies. In addition the article presents the evolution of IFRS for small and medium-sized companies. Despite the benefits related to more comparable standards for small and medium sized entities, their adoption is leading to higher reporting costs.

## **2. HISTORICAL DEVELOPMENT OF IFRS**

The aim of the international standards was undoubtedly the minimization of reporting costs, which were rising due to the process of internationalization. According to the rising number of associate companies which were operating abroad, a growing

need for cross-border standards became apparent. Internationally adopted standards provide benefits also to investors, which can compare companies which previously reported by using different standards. A uniform accounting approach facilitates the cross-border comparison, which leads to a better allocation of capital in European active markets.

The very beginning of the harmonization process of accounting standards in Europe can be found in the year 1957 by signing the Treaty establishing the European Economic Community. The following three decades were denoted by following principal events (Chronology of IASC and IASB, 2005):

- in 1967 the Accountants International Study Group (AISG) was created, which was the precursor of International Accounting Standards Committee (IASC),
- in 1973 IASC was established and two years later it has published the first IAS 1-Disclosure of Accounting Policies and IAS 2-Valuation and Presentation of Inventories in the Context of the Historical Cost System,
- in 1977 followed the formation of International Federation of Accountants (IFAC),
- a major step towards the harmonization process was made in 1985, when IASC participated in a forum of Organization for Economic Co-operation and Development (OECD) on global accounting harmonization,
- two years later, in 1987 IASC began its Comparability and Improvements project with the aim to reduce or eliminate alternatives in international accounting standards (the project was completed in 1993). The project was supported by the International Organization of Securities Commissions (IOSCO).

In subsequent years many important bodies took part of the harmonization project, as Financial Accounting Standard Board (FASB) and European Accounting Federation (FEE). A major step towards multinational standards was made in 1995 with the agreement between IASC and IOSCO with the aim to develop the core standards that could be used for cross-border offerings. Their agreement was supported also by the European Commission. For the first time an important step towards international standards was made.

In 1997 followed the formation of the Standing Interpretation Committee (SIC). In the same year the very beginning of a more dynamic accounting approach can be found. IASC published a discussion paper regarding the use of fair value for all Financial Assets and Financial Liabilities. In 1999 the European Commission analyzed the International Accounting Standards (IAS) and did not find any significant conflicts between IAS and the European Directives. Consequently the Commission adopted a financial services action plan that included the use of IAS as 'European GAAP' (Chronology of IASC and IASB, 2005).

At the beginning of the new century the following events were notable for the development of IFRS:

- in 2000 IOSCO recommended for its members the use of IAS for cross-border offerings and listings,
- in 2000 the European Commission for the first time announced a plan to require IAS for listed companies in EU no later than 2005,
- in April 2001 International Accounting Standard Board (IASB) took over the work of IASC. The activity of long standing (1973-2000) IASC assumed the IASB. Since 2001 IASB is responsible for setting IAS,
- in 2001 was created the European Financial Reporting Advisory Group (EFRAG),
- in 2002 Standing Interpretations Committee (SIC) was renamed to International Financial Reporting Interpretations Committee (IFRIC),
- in 2002 finally the regulation of the European Parliament and of the Council introduced as obligatory the use of international accounting standards for listed companies which have to prepare their consolidated accounts.

The first exposure draft of the new IFRS was issued in 2001 as Exposure Draft 1 First-Time Application of International Financial Reporting Standards. In the next year followed the adoption of the first IFRS; IFRS 1-First Time Adoption of IFRS. Since 2002 eight IFRS were issued. The last one was issued in 2006. Since 2006 no standards were issued due to the announcement of IASB which proclaimed a moratorium during 2006 and 2009. IFRS are currently including:

- International Accounting Standards (IAS),
- International Financial Reporting Standards (IFRS) and
- Interpretations of International Financial Reporting Interpretations Committee (IFRIC).

The term International Financial Reporting Standards is currently applied for International Accounting Standards issued till April 2001 and Interpretations of Standing Interpretations Committee (SIC) issued till March 2002. Additionally IFRS include IFRS issued since April 2001 and Interpretations of IFRIC issued since March 2002. IFRS have become more important after 2002, after the acceptance of the regulative which requested the use of IFRS for consolidated accounts of companies which securities are admitted to trade on a regulated market of any Member State.

In continuation the paper presents the main institution connected with their development and the harmonization of standards in European Union.

## **2.1. HARMONIZATION AND INSTITUTIONS**

There have been various international institutions that had an impact on the harmonization process in European Union. The most significant impact has been made by the IASB (successor to IASC). IASC was established in 1973 by representatives of various accountancy bodies, with the aim of developing reliable standards for international use. The Board of the IASC promulgated a substantial body of Standards, Interpretations and Conceptual Framework (International Accounting Standards Committee History, 2008).

The objectives of IASC were according to the IASC Foundation Constitution (IASC Foundation Constitution, 2008):

- development of high quality, understandable and global accounting standards,
- promotion of application of those standards,
- taking into consideration the special needs of small and medium-sized entities and emerging economies and to bring about convergence of national accounting standards and IAS and IFRS to high quality solutions.

In its later years it worked with the International Organization of Securities Commissions (IOSCO) with the objective to form accounting standards that could be used on the world's stock exchanges. In April 2001 IASB took over from IASC the responsibility for setting IAS and their principal objectives to achieve and became an independent non-governmental organization. IASB was established as part of the IASC Foundation.

International Organization of Securities Commissions (IOSCO) was formed in 1983 as successor to originally formed Inter-American Conference of Securities Commission. In 1983 its name changed and it expanded over the borders of America. IOSCO looks to the IASB to develop IFRS that IOSCO members can use in their jurisdictions (The IASB and the International Organization of Securities Commissions, 2008). IOSCO supported IASC in its initial Comparability and Improvements project. In 1995 a significant agreement between bodies was made regarding the principal accounting standards for entities involved in cross-border offerings.

Another major part of the IASB's organization is its International Financial Reporting Interpretation Committee (IFRIC), which is the IASB's interpretative body. IASC is the successor of Standing Interpretations Committee (SIC), which was replaced

in March 2002. The main duty of IFRIC is to interpret the application of International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) and provide timely guidance on financial reporting issues not specifically addressed in IAS and IFRS, in the context of the IASB Framework, and undertake other tasks at the request of the IASB (The Financial Reporting Interpretation Committee, 2008). The interpretations of standards are developed by IFRIC, but they have to be approved by IASB. At first they are exposed to public comment (Draft Interpretations) and subsequently sent for the review process and approval to IASB (as Final Interpretations).

The International Federation of Accountants (IFAC) was founded in 1977 with the aim to (IFAC History, 2008):

- develop high quality international standards and support their adoption and use,
- facilitate collaboration and cooperation among its member body,
- collaborate with other international institutions and
- serving as the international spokesperson for the accountancy profession.

FEE (Federation des Experts Comptables Europeens) was formed in 1987. FEE is a non-profit association with the objective to promote and advance the interest of the European accountancy profession. FEE tends towards the harmonization and liberalization of the practice and regulation of the accountancy and financial reporting in Europe and towards promoting co-operation among the professional accountancy bodies in Europe (Federation des Experts Comptables Europeens, 2008).

European Financial Reporting Advisory Group (EFRAG) was established in 2001 to assist European Commission in the endorsement of IFRS. EFRAG is a private sector body, with the role of the technical committee for the European Commission. EFRAG has to provide advices to the Commission on all issues relating the applications of IFRS. EFRAG role is also to (European Financial Reporting Advisory Group, 2008):

- comment on proposed IFRS and IFRIC interpretations,
- IASB discussion papers,
- work closely with European National Standard Setters.

## **2.2. HARMONIZATION OF STANDARDS AND THE EUROPEAN UNION**

The harmonization process among Europe has been founded in 1957 with the Treaty establishing the European Economic Community (Treaty of Rome). In 1978 a major step towards harmonized standards was made with the Fourth Council Directive<sup>1</sup> of European Economic Community on annual accounts and the Seventh Council Directive in 1983 on consolidated accounts.

The Fourth Directive has coordinated the national provisions concerning the presentation and content of annual reports, the required disclosures and valuation techniques in use. The Seventh Directive subsequently coordinated the national legislation concerning the consolidated annual accounts. Despite the fact that annual accounts of individual countries were made in accordance with European Directives, the harmonization between countries was still not achieved. The harmonization process continued with the subsequent directives. With the growing significance of capital markets international standards were urgent.

In 2000 the European Commission published the announcement in which was proposed that all publicly traded companies members of the European Union will have to prepare their financial statements in accordance with one single set of accounting standards, not later than 2005.

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<sup>1</sup> A directive is a legislative act of the European Union which requires member states to achieve a particular result without dictating the means of achieving that result. It has to be distinguished from European Union regulations. Regulations are self-executing and do not require any implementing measures.

In 2002 the European Parliament and the Council in order to contribute to a better functioning of the internal market issued the regulation 1606/2002, which required the use of IFRS. The aim of the regulation was to ensure international standards which will be applied by the Community companies, which participate on European financial markets. Member States may permit or require the use of IFRS also for other companies. The requirement has to be prescribed in the national legislation. The rest of the companies still continue to apply national accounting standards.

IFRS lead to an increasing convergence with the ultimate objective to achieve a single set of global accounting standards. The first step towards global standards was made within Europe. In the second step the convergence between European standards and American Principles is expected.

IFRS issued by IASB are not adopted immediately. The European Commission determines their use upon European Union. They can be applied in the Community if they meet the requirements of the Council Directives.

In 2002 the Commission set up the Accounting Regulatory Committee (ARC) with the function to provide opinions on proposals to adopt IFRS. The new standards introduced new characteristics of corporate reporting. According to an unstable environment, a more dynamic accounting approach was needed.

### **2.3 CHARACTERISTICS OF CORPORATE REPORTING ACCORDING TO IFRS**

IFRS have introduced radical changes in accounting for corporate reporting. The main difference was the introduction of a more dynamic accounting approach with the implication of the fair value approach. The general principles related to the previous valuation approach were included in the Fourth Directive. As the general valuation basis was used the historical cost, although the individual national regulatory bodies could allow also the use of replacement cost or fair value.

According to IFRS the main accounting principles are the following (The Framework for the preparation and presentation of financial statements, 2008):

- the accruals basis of accounting; the effects of transactions and other events are recognized when they occur, rather than when cash or its equivalent is received or paid, and they are reported in the financial statements of the periods to which they relate,
- going concern; the financial statements presume that an enterprise will continue in operation indefinitely or, if that presumption is not valid, disclosure and a different basis of reporting are required.

According to the accruals basis of accounting users of financial statements are informed not only about the past events, but also of events that will occur. The accrual basis of accounting is the principle in use for all financial statements except the statement of cash flows. Preparers of financial statements have to follow the going concern principle as the valuation process for assets and liabilities is different if the entity will not continue its activity.

The qualitative characteristics according to IFRS have to be the following:

- understandability,
- relevance,
- reliability and
- comparability.

The first qualitative characteristic demands that information presented in financial statements have to be understandable. Additionally the information has to be relevant. The information is relevant when it can still influent economic decisions. The reliability of information is assured if it is free from material error and bias and represents events

and transactions faithfully. Comparability is attained when the information in financial statements can be comparable over time and between different entities.

As the financial statements have to present true and fair view, IFRS introduced the concept of fair value measurement. Historical value is not in use any more, but prepares of financial statements have to apply the fair value. Fair value is according to IFRS defined as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

### **3. HARMONIZATION OF IFRS AND US GAAP**

According to the development of capital markets an indispensable need for more comparable accounting standards was needed. In last decades the world leading standards had too many disharmonies, consequently investors had difficulties to compare financial accounts between companies that used different accounting standards.

European Companies which securities were admitted in US active market had to prepare their accounts also according to GAAP. Two types of annual accounts increased the reporting costs and there was only the question of time when the harmonization process will start. As expected, the leading standard setters the International Accounting Standards Board (IASB) and American Financial Accounting Standards Board (FASB) in 2002 issued a memorandum of understanding making a major step toward formalizing their commitment to the convergence.

The aim of the commitment was to adopt high-quality solutions to existing and future accounting standards. The convergence project was divided in two phases. The first one was the short-term convergence project with the object to propose changes to IFRS and Generally Accepted Accounting Principles (GAAP), that will reflect in common and harmonized solutions and eliminating or reducing remaining differences.

In February 2006 two Boards updated their convergence agreement. They published a Memorandum of Understanding that reaffirms their shared objective of developing high quality, common accounting standards for use in the world's capital markets. The Memorandum is a further elaboration of the objectives and principles first described in the Memorandum published in 2002. In the new Memorandum the goal by 2008 was to identify remaining differences and to find common solution.

In the near future we will be witnessing the elimination of major differences between IFRS and GAAP. In the second phase of the convergence project we witnessed the issuance of revised standards for Business combinations. The major differences were eliminated and the standards are almost conformable. According to the announcement of IASB no major standards will be effective before 2009. A major change in IFRS will be effective since July 2009, when the revised standards for Business Combinations (revised IFRS 3) and the standard for Consolidated and Separate Financial Statements (revised IAS 27) will become effective. Major changes in both IFRS and GAAP can be expected after the conclusion of the short-term convergence project by IASB and FASB when major changes to present standards will be identified.

Soon after the very beginning of the harmonization process between IASB and FASB, IASB started the project of IFRS for small and medium-sized entities.

### **3. IFRS FOR SMALL AND MEDIUM SIZED ENTITIES (SME)**

Soon after the formation of IASB the project of standards for SME was placed on their future agenda. In 2004 the first discussion paper regarding the Accounting Standards for Small and Medium-sized Entities was published. The discussion paper was titled: Preliminary Views on Accounting Standards for Small and Medium-sized Entities. According to numerous responses IASB proposed in 2007 a separate IFRS for

entities that were not accountable (previously called Small and Medium-sized Entities). In 2007 IASB issued an exposure draft of International Financial Reporting Standard for Small and Medium-sized Entities.

The IFRS for Small and Medium-Sized entities is intended to be used for small and medium-sized entities that (Exposure draft of a proposed IFRS for Small and Medium-sized Entities, 2007):

- do not have public accountability and
- publish general purpose financial statements for external users.

The IFRS for SME includes several differences in comparison with existing IFRS. As stated in Basis for conclusion on Exposure draft IFRS for Small and Medium-sized Entities, BC24) users of financial statements of SME may have less interest in some information in general purpose financial statement prepared in accordance with full IFRS in comparison with users of financial statements of entities whose securities are listed for trading. Users of accounts of SME are more interested in short-term cash flows, liquidity, interest coverage, balance sheet strength and not in long-term cash flow, earning and value.

The definition Small and Medium Sized does not include quantified size criteria for defining what is a small or medium entity, as the size is very relative among countries (Basis for conclusion on Exposure draft IFRS for Small and Medium-sized Entities, BC43). The size and criteria for entities which will be required to use this standard will depend of the jurisdiction that may prescribe each country.

The modification to full IFRS was made on four major types based on need of user of SME accounts (Exposure draft of a proposed IFRS for Small and Medium-sized Entities, 2007):

- topics omitted,
- only the simpler option included,
- recognition and measurement simplifications,
- disclosure reductions.

Almost parallel with the issuance of the Exposure draft the European Parliament adopted a resolution on a simplified business environment for companies in the areas of company law, accounting and auditing in response to the European Commission's communication on the subject. After the first analysis the European Commission thinks that the IFRS for SME will not simplify the activity of reporting for small and medium sized entities. The first provision for simplifying their business environment would be the exclusion of micro companies. For this kind of companies (the smallest companies) the preparation of annual accounts for general purposes is the biggest burden.

The standard is expected to be published in the first quarter of 2009. But there is still not known if the IFRS for SME will be required within the EU with the Commission's regulation or with the directive which will permit to individual member to determine if their use is obligatory or not. At the moment we can look forward to obtain three types of IFRS. The first are the existent IFRS for companies which securities are admitted to trade on an active market of EU and they have to present annual accounts to the public. The second type are almost certainly going to be IFRS for SME for companies that do not have public accountability and finally according to the resolution of European Commission there is a possibility that in a near future we will be witnessing IFRS for micro companies, which will be simpler than IFRS for SME. IFRS for SME are going to introduce radical changes in accounting for SME, as they used national standards which were simpler and did not require many requirements which will be introduced with the IFRS for SME. Although the aim of the new standards is to assure comparable financial statements for SME, they are going to intensify difficulties in financial reporting for SME. Future researches will show if the uniform standards for small and

medium sized companies were needed and if the benefits of these standards are higher than costs incurred.

#### 4. CONCLUSION

According to the process of globalization and the growing number of foreign subsidiaries, many different standards for corporate reporting were in use. Different standards lead to different results, as their recognition criteria and subsequent measurements were not always uniform. As the capital markets became more important, a growing need of more harmonized standards became apparent. In 2002, with the Directive of the European Commission IFRS became the leading standards in European Union. Since 2002 a major step towards the harmonization of accounting standards was made. In the same year IASB and FASB signed their agreement for the harmonization of IFRS and GAAP. For the first time in the history the Boards are eliminating the main differences between the world leading standards.

Few years later IASB put on its agenda the evolution of standards for SME. The project is currently about the end, but there is still not known if the IFRS for SME will be required within the EU with the Commission's regulation or with the directive which will permit to individual member to determine if their use is obligatory or not. The European Commission believes that the standards are not facilitating the corporate reporting of SME and that are redundant for the smallest entities. Future researches will demonstrate if the benefits of these standards are going to be higher than the costs incurred.

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