Faculty of Economics, University of Niš, 18 October 2013

International Scientific Conference

THE GLOBAL ECONOMIC CRISIS AND
THE FUTURE OF EUROPEAN INTEGRATION

ACCOUNTING AREAS SHAPING COMPETITIVE ABILITIES OF COMPANIES BY MEANS OF IAS APPLICATION

Oriekhova T.V. *

Ostapenko A.I.*

Abstract: *The article is devoted to the problem areas of accounting which are mainly distorted when applying IAS. The impact of its incorrect applying on company competitiveness is analyzed.*

Key words: *international standards of accounting, competitiveness.*

Problem statement. Globalization is a process of removal of barriers to the development of free trade and closer integration of national economies. [3] Along with globalization, there is an integration of international markets of goods, services and capital markets. Whereas before companies depended on financing on internal capital markets, now they are more able to attract borrowed and stock capital both within the country where business is conducted, and over the sea.

The development of market relations, the establishment of enterprises with different types of ownership, the necessity of identifying and disclosing financial results of their activities require fundamental changes in organization and methodology of accounting. The opportunities for companies to enter into international markets are directly related to the transparency and reliability of their financial data reporting which makes a basis for investor in taking decisions on feasibility and the amount of investment, and monitoring of their effective use.

These changes in market relations, their focusing on entry into international markets, attraction of added capital for raising or keeping up with other companies in a particular market segment, as well as globalization of national economies around the world have exerted a material influence on the order of presentation of financial data reporting of such companies. One of the consequences of the process was adoption and implementation of universal International Accounting Standards (IAS).

However, the application of IAS as a tool of competitive growth of the company is not always aimed at achieving clarity and transparency of its financial data reporting. This means that IAS allows manipulating of some subjective accounting rules to

* World Economy and International Economic Relations Faculty, Donetsk National University, Ukraine; tatianaorekhova@mail.ru

UDC 657

overestimate/underestimate certain rates of financial data reporting for more profitable and competitive presentation of the company.

Therefore, at the present time IAS application issues are of great importance in economics. This is due to the fact that IAS provides not only maximum transparency and reliability of financial information of the company for international markets participants, but also gives an opportunity to manipulate financial data reporting rates in order to achieve the desired effect.

Analysis of the latest research and publications. General issues related to conceptual framework of execution and presentation of financial reporting as required by IAS were outlined in research of such foreign scientists as Eugene F. Brigham, David D. VanHoose, Edvin J. Dolan, D. MacNaughton, E. Rohde, J. F Sinkey, etc.

Theoretical basis of IAS with presentation of their conceptual framework, elements, methods and principles were regarded in works of R.G. Kaspina, V.F. Paliy, M.Z. Pizengoltz, Y.V. Sokolov, O.V. Soloviyova, G.N. Shcherbakova and other researchers.

In modern native and foreign literature the problems of switching to IAS were investigated by the famous scientists H.Hruning, T.U. Druzhilovskaya, S.G. Kovaliov, T.N. Malkova, E.A. Mizikovskiy, N.P. Moshchenko, V.F. Paliy, P.S. Rose, etc.

The problems of IAS application in terms of its use as manipulation instrument in accounting regulations were researched by such scientists as Nick Antill, Kenneth Lee, B.M. Sardarov, etc. Moreover, at the present time great attention is paid to the issues of manipulation of financial reporting rates and issues of IAS treating in different economic sectors by auditing companies of Big Four, particularly by KPMG and Ernst & Young.

Research objective: to find out problem areas of accounting which complicate unique interpretation and application of IAS while preparation of financial reporting: to consider and analyze the impact of its application on company competitiveness.

Key findings. Whatever perfect can be IAS applied at the present time by the majority of international companies, which make their financial reporting on its basis; there is always space for a maneuver. Particularly, as practice shows, company management can manipulate subjective accounting rules for overestimation of company’s business current rates. That is why it is necessary to realize potential complexity of accounting information use.

Substantive areas of accounting which are considerably distorted but necessary for users for understanding of main figures of accounting used while estimation of international competitiveness of the companies are presented in Fig.1

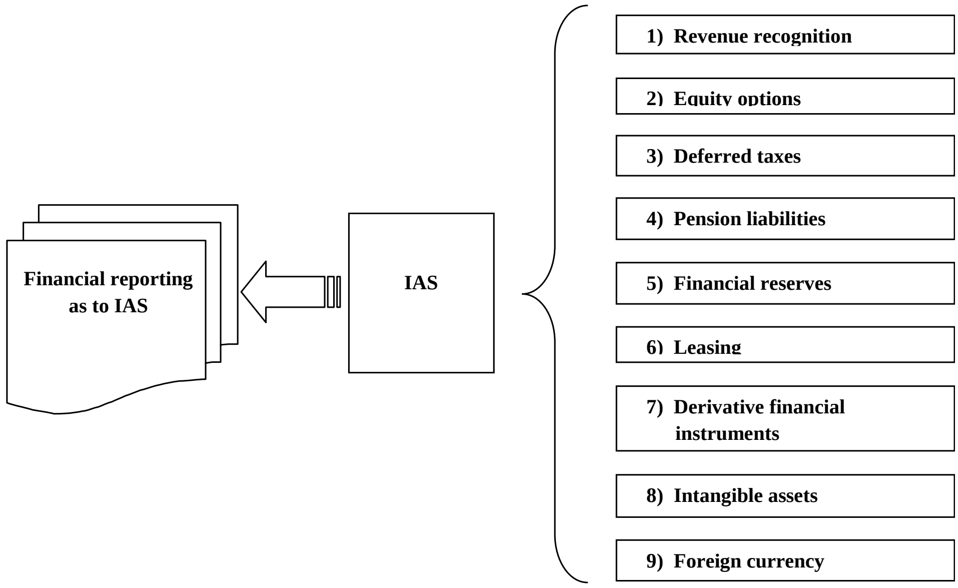

Fig. 1. Areas of accounting which are often distorted

Let us consider every component resented in Fig. 1

1) Revenue recognition.

The rules of gain (revenue) recognition in financial reporting are presented in IAS 18 "Revenue".

In practice a special interest in analysis of retrospective financial reporting is paid to revenue (benefit), as it is considered to be a principal factor of earning power and cash flow of the company. Furthermore, it should be recognized that revenue or benefit are not equal to cash flow. A company can receive substantial sums of advance money on account of future product delivery. However, it does not mean that such revenue is automatically earned and vice versa. This is why the famous EBITDA rate (Earnings before Interest, Taxation, Depreciation & Amortization) cannot be considered as cash flow measure as its components (i.e. financial reserves, accrued expenses or sales on terms of non-cash payment) may not be related to cash flow items.

Thus, accrued income, not received cash should be counted. Of course, it is connected with risks: income data accrued on company's accounts and extended incomes in predictive models can be not consistent with reality.

At the beginning of the XXIst century while telecommunication industry breakdown there were a lot of cases when companies registered large sums of income and revenue which were later declared null and void [1, p. 116].

The brilliant example is a telecommunication company WorldCom. In 2002 on the result of financial audit it was revealed that the company had overestimated its incomes for 2001 in the size of 3,8 billion USD (later the sum increased up to 11 billion). It happened due to the fact that the company was processing many everyday expenses as fixed capital expenditure. Therefore, the corporate expense was not included into the profit-and-loss report and the company seemed to be more profitable than it was in reality and more attractive to probable investors. Revealing of such mistake influenced EBITDA rate which depicts cash flow of the company. It has decreased from 10,5 to1,4 billions USD. Corporate securities have been depreciated and the company went bankrupt. [4].

That is why when using financial data reporting the important rate is the amount of real accrued income which has an impact both on the level of company competitiveness and on general real financial standing of the company. One more brilliant example of manipulating revenue recognition rules has become a scandal with Dutch trade company Ahold in 2003 [5]. Auditing company Deloitte & Touche while analysis of accounting reporting for 2002 has revealed that operating surplus in 2001-2002 was overestimated more than on 500 Mio USD, whereas in 2001the auditing company has issued a positive opinion. The company calculated in a wrong way discounts provided by the suppliers by adding into report more money than the department actually received accordingly to these discounts.

As a result of it corporate securities listed on Amsterdam Stock fell more than to 60% for one day, EBITDA rate fell more than half. Hold store network losses were more on 1 billion EURO; write off - on 3 billion EURO than was predicted by analysts. That is why historically revenue recognition is more stipulated by sectoral structure than by direct claims of accounting standards.

At the present time the most problem areas of accounting raising numerous questions related to revenue recognition are: reflection of guaranties, warrants, subscription, advertising and software profit, reflection of real estate transactions, barter transactions, accounting of non-refundable advance payments, right to compensation (refund), consignment sale, etc.

Thus, users of financial reporting should have a good understanding in revenue recognition issues in their own sector for proper understanding and appreciation both their company and competitor company.

In this case an invaluable contribution to the regarded issue solution make such auditing companies as KPMG and Ernst & Young which publish a large number of textbooks and publications related to the issues of IAS application in various branches of industry.

2) Equity options.

Principles of earning per share disclosure in financial reporting and its derivative are adjusted in IAS 33 “Earnings per Share”; the reflection of equity options - in IAS 2 “Share-based Payment”.

Earnings per share is probably one of the most widely spread rate which is used for appraisal of results of the business of the company with stock market securities. It is quite important to calculate earnings per share and disclose it in reporting as financial reporting users can use this information in order to find out ratio of company profit and market value of its shares. In this case the amount of earnings can be affected by many factors which include share purchase option.

Equity options according to IAS 2 - is an agreement which allows the owner authorize but not obliges him to subscribe for shares of the enterprise at the fixed or set price within a given time. Therefore, putting into IAS 33 words these are financial documents, which authorize the owner to buy equities.

In many economic sectors a large proportion of top management benefit consists of share purchase option. Such options provide top management and other employees with an opportunity to enlarge capital of the company.

This important component of benefit should be taken into account when estimating company business. If this data is not disclosed in profit and loss report, there can be major consequence in analysis of compared companies and in correct assessment of its profitability. Moreover, when counting margin of equity profit (relation of market value of shares to available earnings for the previous year) the user of reporting should know how the potential dilution of equity as a result of compensation via equity options affects a share revenue position.

In accordance with IAS 33, dilution is a diminution of profit per share or increase of loss per share due to the assumption that convertible instruments were converted, options or warrants have been executed, or that equity shares were issued after the stipulated conditions were fulfilled.

In other words, when estimating the company, it is important to recognize how earnings per share can change in case if equity option holder would take these options, i.e. take a position. This would mean that someone's proportionate share of ownership in a company can be reduced due to increase of total amount of outstanding shares. Thus, earnings per share would be reduced.

The disclosing of earnings per share in a company financial reporting in the absence of other financial instruments diluting assets of company, as a rule, is not a difficult issue.

Otherwise, there appear the following questions:

- What expenditures for reward should be disclosed in the profit and loss statement and what amount?
- What effect do expenditures for profit per share have in response to such dilution of equity?

Despite the probable availability of maneuver with earnings per share related to option disclosing in the report, it should be pointed out that if the company provides its employees with a large amount of options, it may reduce the attractiveness of the company to investors due to dilution of equity. Therefore, it is necessary to consider these expenditures in a profit and loss statement.

Thus, equity options can affect company value, and therefore, level of its competitiveness.

3) Deferred Taxes

Accounting procedure of income tax is determined by IAS 12 “Income Taxes”.

Taxation is the most controversial issue among accountants who prepare financial statements, and among its users. Terminology is vague and ratio is often determined by regulatory tax rules which have little in common with real economics. Nevertheless, analysts should be versed in questions of taxation. Firstly, it is the principal element of expenditures for all companies, regardless their industry. Secondly, certain tax ratio, such as tax losses can make a substantial sum. There are a lot of cases of wrong interpretation of such important elements in assessment models. Thirdly, taxes significantly affect cost of capital.

Therefore, when analyzing financial reporting of the company, it is important to distinguish current taxes and deferred ones.

As a rule, current taxation increases tax liability in balance sheet and increases tax expenses in profit and loss statement.

However, deferred taxes cause some problems. In accordance with IAS 12, these are taxes which by reference to temporary and permanent differences between tax and financial accounting should be paid or reimbursed from the budget not in current period but in future one. Hence, deferred tax assets or liabilities are disclosed in the balance sheet. It is related to the tax legislation, which allows for its own procedure of company income and loss accounting, which is different from business accounting.

For example, according to the rules of Tax Code of Ukraine, profitable companies by reference to their business activities for the year that ended are required to pay monthly advance income tax payments during 2013 in the amount of 1/12 profit calculated as of 31.12.2012. Taking into account that such advance payments should be paid in 2013, and in future they will reduce the arising tax liability, there appear the following problems with disclosing of such payments:

- in what period and in what amount such advance payments are to be disclosed in financial statements (in 2012 or 2013);
- when disclosing tax liability, liabilities side increases. Accordingly, assets should also asset, despite the fact that the asset does not meet the asset recognition criteria which allows exaggerating the balance sheet of the company.

Thus, it allows revealing both company profitability and unprofitableness for top management.

Enron Case is the example of non-accounting of losses in public financial statement which is the biggest scandal at the beginning of the XXIst century [6].

American energy corporation Enron Corporation had dumped its losses to offshore subsidiaries. As a result, corporate financial performance has significantly improved, and its share price has risen up. In fact, Enron debt still remained, but in report to shareholders and Stock Exchange the company did not disclose it because they were absorbed by its subsidiaries. All debts and expenses were provided in full to the tax office. Therefore, taking into account that balance profit and profit for tax purposes is not the same, finally the corporation was totally unprofitable for tax purposes.

In 2001, after the disclosure of the scheme, the company stock fell from 80$ to 1$, and the company went bankrupt. The auditing company Arthur Andersen, one of the largest and most prestigious accounting companies in America at that time, which issued an unqualified opinion, went into liquidation soon after Enron.

Therefore, the deferred tax makes the financial reporting useful. However, for a realistic corporate appraisal analysts must be well-oriented in tax rules of its environment for establishing amount of the actual tax burden on the company.

4) Pension liabilities.

Pension liabilities accounting is regulated by IAS 19 “Employee Benefits”.

Nowadays a great attention is paid to pension contributions. For many manufacturing companies of traditional industrial formation of pension plans a system of employee benefits has become an important component. These companies are distinguished by a high level of labor costs. Financial accounting and reporting for pension contributions is complicated by different types of pensions, change of return on assets, as well as by complexity of the legislation and accounting standards.

Pension liabilities are disclosed in profit-and-loss statement and balance sheet.

To evaluate the competitiveness of the company, pension liabilities are taken into account when calculating earnings before interest and taxes (EBIT), when net operating profit after tax (NOPAT), when analyzing of return on equity, etc.

5) Financial reserves.

Accounting procedure of reserves is determined in IAS 37 “Provisions, Contingent Liabilities and Contingent Assets”.

It is difficult to define a term ‘reservation’. ‘Reserves’ is a subjective term; it cannot always be expressed in money terms. It means that reserves can be easily manipulated.

IAS 37 defines reserves as a liability with uncertain maturity date or indefinite sum. For example, if a company was filed a legal action, and it needs to disclose the predicted loss in financial statements, this will be considered as a reserve. Taking into account the mentioned uncertainty, the reserves can be used in benefits manipulation.

In this regard, IAS 37 defines a set of requirements for the recognition of reserves, compliance with which enables companies to disclose such reserve in the financial statements.

The number of reserves includes pension contributions and deferred tax liabilities.

Thus, the aim of reserves evaluation is confirming that the figures in financial statements disclose real reserves, and not the means of adjusting the reporting indicator of company’s performance result. The use of overestimated financial reserves in a profitable period and their reduction in unprofitable one is a classical form of income smoothing.

6) Leasing.

Accounting procedure is determined in IAS 17 “Leases”.

For the majority of companies lease is the most important form of financial activity. A particular interest to it is expressed by authorities who control the accuracy of cost accounting because lease accounting causes point at issue, indeed. In addition, companies tend to use accounting tools for leverage understatement.

There are two main types of lease - financial (capital) and operating (leasing). Furthermore, accounting of such lease transactions in pure form does not cause any difficulties; difficulties arise in more complex lease agreements. These are, for example, lower lease rates at the beginning of the period, discount availability, free lease for some periods or purchase and sale suitable for leaseback.

However, all types of lease is a form of debt, this is why it is disclosed in a balance sheet, profit and loss statement and cash flow statement. In this case, the question of how the debt will be disclosed in the financial statements does not always have a definite answer. This fact provokes distortion of real transactions.

7) Derivative financial instruments.

The unique standard for derivative financial instruments is IAS 39 “Financial Instruments: Recognition and Measurement”.

Derivative financial instruments have become an integral part of all more or less large business. Its use varies, but in general, the overwhelming majority of companies use them for hedging. The hedged items can be: the future price of raw materials, foreign exchange, interest rates, etc.

The users of financial statements should understand how these instruments are disclosed in financial statements of the company in order to be able to evaluate them properly.

Officially, the derivative financial instrument is an asset which value depends on the value of an underlying asset.

All derivatives are one of four types of instruments or a combination of two or more instruments.

Forward contracts are simple derivatives. They are not for selling; these are the transactions between two parties on the informal market [1, p. 167].

Futures are forward contracts, which can be bought and sold on the organized market. They are liquid, but the conditions are standardized [1, p. 167].

Swap is a contract which presupposes an exchange of assets or liabilities in order to improve their structure [1, p. 167].

Option is a right, but not an obligation to buy or sell assets at a predetermined price [1, p. 168].

The mentioned financial instruments are estimated at fair value and disclosed in a balance sheet and a profit and loss statement.

In this case the main difficulty is caused by evaluation of derivatives in the financial statement. Moreover, there is no a generally accepted systematic approach to the analysis of benefit and loss from the use of such instruments. Some of these instruments are very complicated. Therefore, many companies do not disclose them and thus, underestimate or overestimate the financial result of the company’s business.

8) Intangible assets.

Accounting procedure and the rules of disclosure of intangible assets in financial reporting are determined in IAS 38 “Intangible Assets”.

In balance sheets of the majority of modern companies intangible assets make a significant part, i.e. assets without a material form. Evaluation of intangible assets in the balance sheet is required for making a qualitative analysis of the company's assets and return on invested capital. The lack of careful analysis in the financial statements leads to confusing and misinforming but not to disclosing of real economic ratios of the company conducting transactions with intangible assets. Tangible assets are also important for estimation of the company's competitiveness, but their accounting does not cause the similar difficulties.

The main problems which affect company value are usually connected with the Recognition and Measurement of intangible assets.

First of all, accounting and reporting of intangible assets usually do not disclose the economic matter of these assets of key importance. Therefore, in order to determine the real balance, intangible assets should be capitalized and amortized. This would have a direct impact on evaluation of profitability and return on invested capital.

Secondly, intangible assets open space for manipulation, especially when it is subject to useful lifetime. Since this decision is very subjective, the profitability can vary widely. Therefore, when evaluating it is necessary either ignore depreciation, using earnings rate (EBIT), or normalize depreciation cost used in the analyzed sector.

Thirdly, there appear difficulties in reliable determination of intangible assets value. This applies especially such specific assets as consumer loyalty to the company, the popularity of the brand, trademarks, licenses, franchises, etc.

9) Foreign currency.

In accounting and financial statements foreign currency is disclosed in accordance with IAS 21 "The Effects of Changes in Foreign Exchange Rates".

The majority of international companies have to prepare financial statements in a currency of different countries. Depending on the method of disclosing of foreign currency transactions the ratios of measures of income, equity and debt reflected in the financial statements.

Therefore, the problem of foreign currency is usually associated with the following factors. Transactional effect is one of them. If a company produces goods for the domestic market, the weakening of the national currency leads to higher incomes, on the assumption that consumer prices in local currency remain the same. The consequences will be quite opposite in case of strengthening of national currency. For example, there occurred an explosive income growth of Russian companies after the fall of Russian ruble in 1998, when their export revenues rose immediately, but the benefit was reducing from year to year [1, p. 168]

Secondly, if the currency changes not in the way the reporting currency of the companies does, there appear the effects of foreign currency transfer. Therefore, the fall of working currency of a foreign branch reflects a real fall in business valuation for shareholders.

The third reason is related to the changes in foreign currency debt. If the exchange rate of debt drops against the national currency, and all cash flows of the company are denominated in the currency of the debt, there appears non realized profit while transferring its debt in a smaller sum of the national currency. In this case revenues denominated in the national currency fall as cash flow in foreign currency debt is converted to a lesser sum in the national currency.

Therefore, when analyzing the company statements a special attention should be paid to the influence of exchange rates.

Conclusions and recommendations. Thus, considering the problem of applying IAS in the context of the impact of the application on the company competitiveness, the conclusion is the following: despite the superficial perfection of IAS, they still allow bending strict rules of accounting. Moreover, an incorrect or intentionally wrong interpretation of IAS may lead to a significant distortion of financial statements.

In addition, the proper application of IAS is affected by the complexity of business transaction, which should be disclosed in accounting records.

The biggest difficulties arise in such accounting areas as revenue recognition, equity options, deferred taxes, pension liabilities, financial reserves, leases, derivative financial instruments, intangible assets and foreign currency.

The lack of uniform accounting rules and their reflection in the financial statements, multiple options of evaluation, the emergence of new more complicated forms of contractual relationships and other issues lead to the problem of financial statements reliability, followed by the risks of manipulating both company benefits, and its general competitiveness.

References

1. Антил Н., Оценка компаний: Анализ и прогнозирование с использованием отчетности по МСФО / Ник Антил, Кеннет Ли; пер. с англ. – 2-е изд., перераб. и доп. – М.: Альпина Паблишерз, 2010. – 454 с. (Antill, N. Kenneth Lee, Company valuation under IFRS, Alpina Publishers, Moscow, 2010 (In Russian)
2. Применение МСФО = Generally Accepted Accounting Practice under International Financial Reporting Standards. В 3 ч. : пер. с англ. / М. Бонэм, А. Кович, Р. Крисп и др. ; Ernst & Young LLP. – 6-е изд., перераб. и доп – М. : Альпина Бизнес Букс, 2011. – 3280 с. (Generally Accepted Accounting Practice under International Financial Reporting Standards, Ernst & Young LLP, Alpina Business Books, Moscow, 2011 (In Russian).
3. Стиглиц, Джозеф. Глобализация: тревожные тенденции, / Джозеф Стиглиц; пер. с анг. Г.Г. Пирогова – Москва: Мысль, 2003. – 300 с. (Joseph Stiglitz, Globalization and Its Discontents, Alpina Business Books, Moscow, 2011 (In Russian).
4. www.e-reading-lib.org
5. www.spekulant.ru
6. www.roche-duffay.ru

RAČUNOVODSTVENE OBLASTI KOJE OBLIKUJU KONKURENTSKU SPOSOBNOST PREDUZEĆA PRIMENOM MRS

Rezime: *Rad je posvećen problemima računovodstva koje je uglavnom iskrivljeno prilikom primene MRS. Analizira se uticaj njihove netačne primene na konkurentnost preduzeća.*

Ključne reči: *međunarodni računovodstveni standardi, konkurentnost*