

FINANCIAL STATEMENTS UNDERSTANDABILITY BASED AN EXPLANATORY NOTES

Flavia Stoian¹
Ana Morariu²
Neluta Mitea³
Cornel Crecana⁴

ABSTRACT: The present article is the result of the observation, analyses and personal conclusions over the development of the IFRS at global level, their impact over the national and international companies all over the world and, nevertheless, the informational inputs from the Financial Statements which must be defined by the level of their transparency, relevance and comparability. The authors' intention through this article was to define the transparency of the Financial Statements imposed by the General Framework, IFRS, IAS, IFRIC, SIC, guides of interpretation, case studies and conclusions. In which way the Financial Statements could be transparent and relevant when 4 of the 5 components of the Financial Statements are flooded by numbers that have no meaning for those with no specific skills and knowledge? The answer is given by IFAC through the Accounting Policies and Explaining Notes. It's a matter of economic general knowledge and know-how concerning the IFRS area of interest and also the skills of the accounting professionals to turn the numbers into simple, comprehensive and relevant explanations, in such matter that, after the lecture of the financial statements, any user may make the best economic decisions.

Keywords: Accurate presentation, financial statements, financial position, performance, cash flows, accounting policies and explaining notes economic decisions

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Introduction

Eight years passed since the International Accounting Standards, currently International Financial Reporting Standards were adopted and applied in Romania. The globalization of the national economies and the integration of the financial markets was the strong argument in favor of IFRS application. Both investors and financial analysts should understand the financial statements of the foreign companies when they intend to buy shares in those companies. It is equally true that they are interested to be able to compare the financial statements of foreign companies and to be certain that the information included in the financial statements are high quality and certified information by the financial audit. The harmonization to IFRS has a substantial cost for all the countries which applied them, but also brings a lot of benefits both for individual, multinational companies and the respective national government, such as: relevance, high quality, comparable reporting encouraging the international investments, the access on the international capital markets, an easier control of the multinational companies. A transparent reporting system shall decrease the capital cost – both for the company and for the country itself. Furthermore, the prerequisites of the markets' stability and economic development shall be established. One investor shall not invest in countries where the financial statements are ambiguous, lack comparability or relevance. These are

¹ The Bucharest Academy of Economic Studies

² The Bucharest Academy of Economic Studies, ana.morariu@gmail.com

³ The Bucharest Academy of Economic Studies

⁴ The Bucharest Academy of Economic Studies

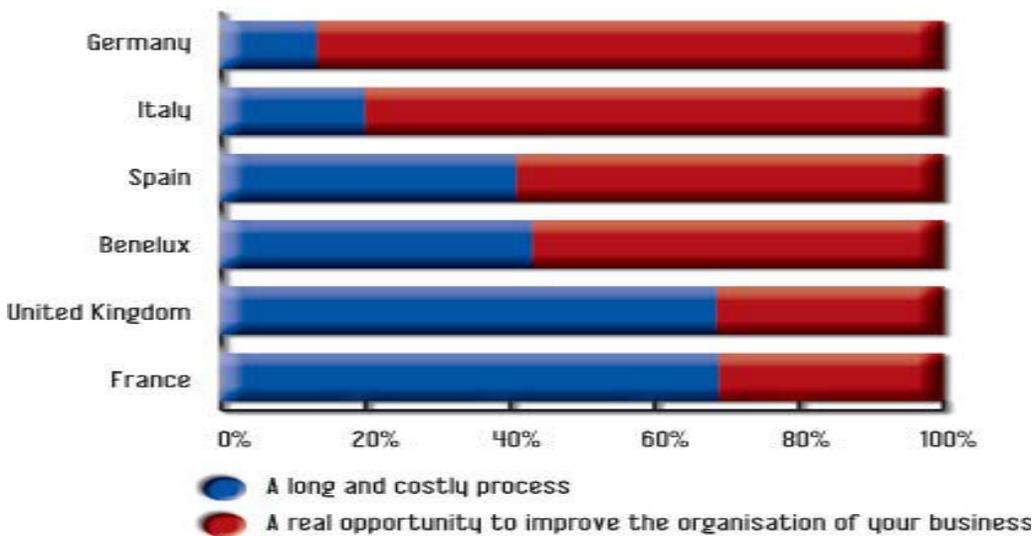
the reasons of the companies for the insistent application of IAS/IFRS in the financial reporting. An unified system of the universal accounting norms was required. As IASC, currently IASB, proved able to be represented by European expert bodies, and European experts were trained within important accounting cabinets, all these succeeded to convince the European Union that the amendment of the European directions specific to the financial reportings shall be ensured in order to comply with IFRS.

Nearly 57% of listed companies in Europe believe that the conversion process will provide them with a real opportunity to improve their internal organisation. This percentage varies across business sectors. For example, companies in Banking, Financial Services, Energy and Insurance sectors, face specific problems related to IAS 39 on Financial Instruments. This is, however, less of an issue for other sectors where there are only minor differences between their current standards and the IASIFRS and where the differences tend to be ones of presentation rather than ones of recognition or measurement of assets and liabilities. However, more than 43% of respondents perceive this changeover to be a long and costly process.

This complexity of the task faced by the companies is further complicated by the fact that the body of Standards has not yet been finalised: the IASB will still produce these texts up to the 31 March 2004 and some standards have still not been published. For a lot of companies, preparing oneself for a new regime where not all of the rules have been written seems to be attempting the impossible.

These figures also show that there is still a lot of work to do in order to convince companies that the benefits to be gained from the change will exceed the costs, especially for those working within the European market.

Figure 1. – How European countries percieve IAS-IFRS changeover.¹



Considering that in Romania the privatisation process was speeding-up, the capital market and the market economy made substantial progress and the economic globalization process increased, the continuous development of the Romanian accounting system was required. The accounting development was therefore correlated with the trends of the European and international accounting field in order to ensure a common background for the financial statements preparation and reporting for providing relevant and reliable information to the current and potential investors, financial creditors, managers, governmental institutions and other users interested in financial and accounting information.

Under these circumstances, a consistent accounting and financial auditing system at the European and international levels and its accurate practical application represent rigorous factors much required especially by the economies in transition and leading to a higher confidence of the domestic and international investors, lending institutions, insurance and re-insurance organizations and capital market as a whole, through the protection provided by the accounting information collected and audited in an appropriate manner.

IFRS application in Romania is a challenge for the accounting professional who should increase the company's value through his mind, understand the accounting operations for each transaction, go deeper into each process and event which he has to find out in the financial reports, make use of his financial thinking for choosing the best alternative whenever there are several accounting procedures available in order to show the company's clear image. The company should apply a new way of understanding the financial information by substituting the legal status by the economic facts and the historical cost by the fair value. The Romanian accounting assimilated the European free market concepts in order to achieve such a reality representation so any person aware of the global common language of the International and Financial Reporting be able to understand it.

***Case-Study – Voest Alpine ROMANIA
Monika Pitt – Manager***

“The structure of our accounts will be greatly modified”

VA Romania is currently reaching the second phase of its internal project for the changeover to IAS-IFRS. The group counts on highlighting the major effects of the changeover to IAS in their 2008 report. The financial impacts caused by the new Standards will form a specific topic within the report.

Where is VA Romania in terms of moving to IAS-IFRS?

We have set up a project which is divided up into three phases. The first phase focuses on identifying the accounting changes to financial statements. The second phase concerns the preparation for the launch of operations. This will involve a study of the impacts on the relative effects on financial information, internal procedures and organization, as well as training for the members of the "financial community" within our Group. Finally, the third phase will address any major issues which arise. The initial diagnosis phase that we launched in May/June is in the process of being completed. We have set up several working groups which include members of a team dedicated to the project and also the representatives of our major subsidiaries. In the event that this phase creates a choice between a certain number of accounting options available under IAS-IFRS we will meet with our auditors so that they can confirm that the options conform with the international system of reference.

Are there prioritized issues?

We are not at the same level of advancement in all areas. Because of the uncertainty affecting the Standards on financial instruments, we are less advanced in this area. However, in other areas, we have found relatively satisfactory solutions which limit the impact on the financial statements and on internal systems, for example, with regards to separately accounting for individual components of fixed assets which have substantially different useful economic lives. As we advance in our work, we put forward to our auditors any decisions that we envisage taking, either at the present time or in the future, with regards to changing to IASIFRS. A representative from our auditor is present; they must then work together in order to decide upon a common position with regards to the options which have been put forward by each work group.

How will the publication of your accounts be organized during the transition period?

For the 2009 report we will be in a position to describe the state of advancement regarding our preparation in light of the changeover to the IAS-IFRS. In principle, we will publish the 2009

accounts pro forma under IAS with a table of differences; this will be in the publication of the first interim accounts for the year 2011. However, we are hoping to highlight the main consequences of the changeover to IAS in the 2009 report. In any event, given the delay in the application of Standards regarding financial instruments, the first application of the new Standards will be divided into two separate dates: 2009 for all the Standards except for IAS 32 and IAS 39 and the 1st January 2010 for those two Standards. There will thus be two successive impacts on shareholders' equity.

Which strategy will you be taking for the purpose of financial communication?

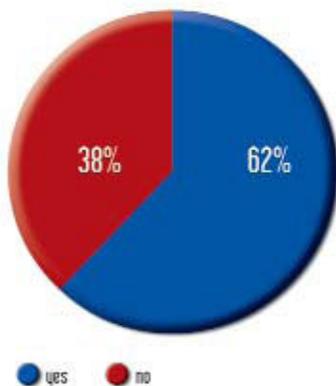
Our communication with shareholders on the financial impacts of the change to IASIFRS will take place in the second phase. At each point that we identify a financial indicator which will be affected by the new Standards, we will provide specific information. This is all the more important because we have a provision representing a large part of our balance sheet which will have to be updated when we change to the new Standards. Our balance sheet will therefore change substantially.

FINANCIAL AND ACCOUNTING IMPACT

✓ **Analysis of the differences between IAS-IFRS and the relevant local Standards**

Almost 40% of the companies interviewed have not yet tried to compare the new Standards, which they will soon have to adopt, with the Standards that they are currently using. It seems that, if certain organisational aspects are seen as more important, the real work to be done has still not been started. To be more specific, a large number of companies still have to finalise the putting into place of their internal project as they have not actually passed on to the more concrete second stage.

Figure 2ⁱⁱ - Have you carried out an active analysis of the differences between IAS-IFRS and the local standards in your country?



✓ **Simulation of accounts**

32% of companies have already taken the initiative of simulating how their accounts would look under IAS-IFRS.

✓ **Expected impacts on the volatility of results**

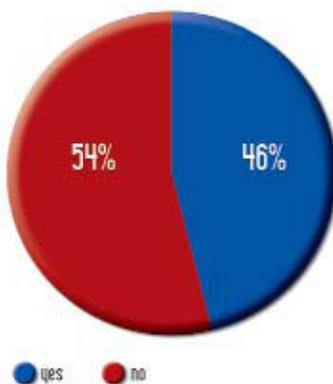
The countries surveyed are virtually in unison in thinking that the biggest impact of the new Standards will essentially be around the financial area: on financial instruments (45%), mergers and acquisitions (41%) and the valuation of assets (40%).

In fact, one of the particular features of IAS-IFRS is its use of fair values, rather than historic costs which are disconnected from reality. But the introduction of the fair values brings with it increased volatility in the reported values of assets.

✓ **Difficulties in envisaging the overall macro-economic plan**

More than half of the European companies which were interviewed (54%) think that the change towards the new standards will not have any sort of impact on the competitiveness and the growth of European companies. The companies therefore estimate that an accounting regime, however significant it may be, does not make a company either more or less successful. This result is yet to be reconciled to the one showing that the changeover of Standards is seen as an opportunity for improvement of the internal organization of the company

Figure 3ⁱⁱⁱ.- Do you think that the application of IAS-IFRS will make it possible to improve competitiveness and boost the growth of businesses in Europe?

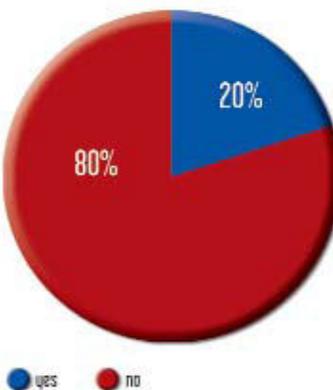


✓ **Lobbying: companies take a disorganized approach**

Only 20% of companies make use of lobbying the IASB in attempting to change certain Standards that are not suited to their business.

This unquestioning approach partly reflects the feeling that the change to IAS/IFRS is seen as being "obligatory". On the other hand, a great number of companies have not yet put into practice these new standards and are therefore unaware of the difficulties that they will cause, they are therefore not in a position to argue for changes to be made.

Figure 4^{iv} - Are you involved in lobbying the International Accounting Standards Board – IASB (either directly or through professional organizations) with a view to modifying certain standards that are not suited to your business?



However, this remark must be qualified for certain business sectors. Lobbying frequently manifests itself according to opportunity and local customs. The most important aspects of lobbying are for example undertaken by companies in the bank and insurance sectors with respect to disagreements between the professional associations which represent these companies and the IASB with regards to IAS 32 and IAS 39 on financial instruments. Furthermore, the degree to which

lobbying is carried out through intermediary professionals associations varies from country to country.

REVIEW OVER THE FINANCIAL STATEMENTS PRESENTED BY IAS/IFRS

IASB contains the 5 components of the financial statements: Balance Sheet, Profit&Loss Account, Capital Changes, Cash Flow and Explaining Notes which we can also find in OMFP 1752/2005 – New accounting regulations in accordance with the European Directions. The first 4 statements are flooded by figures and they may be understood through an intelligible 5th statement, where the accounting professional should develop, add, clearly and consistently present the items which lack or are not explained in the first 4 statements, in order to be understood by any user having basic or advanced economic knowledge. **The Explaining Notes and the accounting policies** related to the annual financial statements contain additional information which are relevant for the users' needs referring to significant items of the balance sheet, profit and loss account, capital and cash flow. They provide descriptions and details of the items contained by the 4 statements. The financial statements offer a good opportunity to the company for assessing the entity's capacity to carry on its activity. If such uncertainty is perceived, it should be recorded. The financial statements should be prepared based on the commitments' accounting, excepting the information related to the treasury flows.

Balance Sheet information

Each balance sheet item should be explained. Other balance sheet items may be shown separately based on three criteria:

- a. assets' nature and liquidity and their signification limit. This supposes a separate presentation of the commercial fund and assets resulting from the development expenses, the monetary and non-monetary assets, and the current and fixed assets as well;
- b. assets' function within the company leads to a separate presentation of the financial and operation assets, stocks, receivables, cash and cash equivalent;
- c. amount, nature and maturity of the interest-bearing and non-interest-bearing duties and provisions, which are classified in current and long term categories, capital classification in share capital classes which shall mention: number of authorized shares, number of issued and fully paid-up shares, share face value, number of shares at the beginning and the end of the year, number of shares that the company owns, associated branches or entities, shares to be issued in accordance with the option contracts and selling contracts, nature and purpose of each reserve.

The entities' shares traded on the capital market or for which the companies provide consolidated information, the **basic result per share** and the **diluted result per share** should be included in the presentation.

Each entity should emphasize and classify other items according to IFRS requirements as follows: intangible immobilizations are classified in groups in accordance with IAS 38 and tangible immobilizations are classified in accordance with IAS 16. Receivables are classified in groups such as commercial receivables, receivables within the group, receivables from associated parties, payments in advance and other amounts; stocks are classified in accordance with IAS 2.

Financial immobilizations – show how different immobilization elements move. For this purpose, increases, reductions and transfers during the financial year on the one hand, and the value cumulated adjustments at the beginning of the financial year and on the balance sheet date, on the other hand, as well as the changes made during the financial year over the value adjustments from the previous financial years are distinctly shown for each immobilization element.

Statement of receivables and debts – receivables to be collected in term of one year and over one year, and debts to be paid in term up to one year, between 1 to 5 years and over 5 years are separately shown. The following information should be included: clauses in relation with the debts' payment and the interest rate related to loans, guarantee and mortgage based debts, their value, value of liabilities covered by provisions, value of liabilities in relation with the pensions' payment.

Provisions – provide the following information:

- a) provisions' value at the beginning of the financial year;
- b) amounts added to or deducted from the provisions during the financial year;
- c) nature, source or destination of any such transfers;
- d) value of the provisions at the end of the financial year.

Profit distribution – shows separately the proposal of the net profit distribution on different destinations, such as:

- a) amounts distributed to reserves;
- b) amounts distributed for covering accounting losses from the previous years;
- c) dividends;
- d) other distributions.

Participations and funding sources

Any participation certificates, securities, convertible bonds, underwritten share capital / entity's networth; number and total value of each kind of issued share, redeemed shares, shares issued during the financial year, issued bonds should be included.

✓ **Information related to the profit and loss account.**

The performance elements are important for understanding the financial performance and the future results' expectations. The earnings and expenses classification criteria should be mentioned in accordance with their nature and their destination (function). The analysis of the operating result – show the splitting of the operating expenses according to their destination only for the operating result and provides more relevant information to the users. We should not forget that the costs' distribution to different destinations might need arbitral distributions involving the professional judgment. The income and expense elements should be separately mentioned if one situation such as the reduction of the stock accounting value up to the net realized value or the reduction of the tangible immobilizations up to the recovered value or reductions resuming appears; in case of one entity's restructuring and resuming any provisions for the restructuring costs, investments assignment, suspended operations, provisions canceled due to lack of object, the income and expense elements should be separately mentioned.

✓ **Information referring to salary costs**

The indemnities granted to the members of the administration, management and monitoring bodies;

The contractual obligations referring to the pensions' payment to ex-members of the administration, management and monitoring bodies, indicating the total commitments' value for each category;

Value of the payments in advance and loans granted to the members of the administration, management and monitoring bodies during the financial year: interest rate; main reasons for the loan granting; amount repaid until that date; future obligations such as guarantees taken upon the entity in their name;

Employees: average number and distribution on categories; paid-up salaries or salaries to be paid for the financial year; expenses with the social insurance; other expenses related to the pension contribution.

✓ **Statement of own capital changes.**

It is relevant to show the amounts distributed to the shareholders, balance of the reported results at the beginning of the period and the balance sheet date, revision and comparative analysis between the accounting value of the paid-up capital and any reserve at the beginning and at the end of the period, mentioning the changes during this period; profit or loss during this period. The result of the changes in the accounting policy and in the errors' correction recognized according to IAS 8 for each component of the own capital should be mentioned in Notes.

✓ **Cash flow statement**

Efficient in completing the limits of the commitments' accounting and in assessing the activities producing cash inflows/outflows.

Information referring to the financial statements' preparation data and the accounting policies used should be also mentioned in Notes.

Those should include the following information:

Accounting regulations applied for the annual financial statements' preparation and presentation;

Abnormalities of the accounting principles and policies, assessment methods and other provisions of the accounting regulations;

If the values shown in the annual financial statements are not comparable, the lack of comparability should be explained by relevant comments in the Explaining Notes;

The residual value set for the immobilizations if the purchase price or the manufacturing cost are not known;

The interest amount included in the cost of the immobilized and current assets with long manufacturing cycle;

In the case of the tangible immobilizations' revaluation: elements under revaluation, methods used, value of the re-assessed immobilizations at historical cost, treatment of the reassessment- resulting reserve for fiscal purpose, changes of the reassessment- resulting reserve;

If the assets make the object of exceptional value adjustments for exclusive fiscal purpose, the adjustments' amount and reasons should be included in the Explaining Notes;

If the value shown in the balance sheet and resulting from the FIFO and CMP methods' application is significantly different as compared to the value determined based on the most recent market value known before the balance sheet date, this value margin should be mentioned in the Explaining Notes. Several relevant indicators should be assessed and presented^v.

- **Liquidity ratios:**

- a) Current liquidity – it provides the guarantee of covering the current liabilities from the current assets

- Current assets

- Current liabilities

The acceptable recommended value for this ratio is around 2.

- b) Quick liquidity (acid test) – shows the capacity of paying the current liabilities from the treasury available values and from the receivables resulting at the maturity paying date

- Current assets - Stocks

- Current liabilities

If the ratio value is higher than 1, the current liabilities covering is guaranteed and if it is lower than 1, there are high difficulties in paying the debts at the maturity date.

- **Risk ratios:**

- c) Leverage ratio – it shows the long term loans (borrowed capital) in the total capital (own capital + borrowed capital)

$$\frac{\text{Borrowed capital}}{\text{Own capital}} \times 100$$

$$\frac{\text{Borrowed capital}}{\text{Total capital}} \times 100$$

- d) Interest paying ratio – it shows the number of times the entity can pay the interest expenses

$$\frac{\text{Profit before the interest and the profit tax payment}}{\text{Interest expenses}} \times 100 = \text{Number of times}$$

The lower this ratio value, the riskier the entity's position.

• **Operation ratios:**

- e) Stocks' turnover – it approximates the stocks' turnover during the financial year or the number of days the goods are stocked within the entity.

$$\frac{\text{Sales' cost}}{\text{Average stock}} = \text{Number of times}$$

$$\frac{\text{Average stock}}{\text{Sales' cost}} \times 365 = \text{Number of stocking days}$$

- f) Customers' average collection period – it determines the entity's efficiency in collecting the receivables and it shows the number of days until the debtors are paying their debts to the entity.

$$\frac{\text{Customers average balance}}{\text{Turnover}} \times 365 = \text{Number of debit days}$$

An increased value may indicate control problems in relation with the loan granted to the customers.

- g) Suppliers' average payment period – it approximates the number of credit days which the suppliers agree with the entity. Ideally it should include only the commercial creditors.

$$\frac{\text{Suppliers average balance}}{\text{Goods acquisitions, services excluded}} \times 365 = \text{Number of credit days}$$

- h) Financial immobilizations turnover – it assesses the efficiency of the immobilized assets' management through the examination of the turnover generated by a certain amount of the financial immobilizations

Turnover

Financial immobilizations

- i) Total assets turnover – it assesses the efficiency of the total assets' management through the examination of the turnover they generate

Turnover

Total assets

- **Profitability ratios:** they express the entity's efficiency in making profit by using the sources available.

- j) Total capital profitability – the profit the entity makes using the funds invested in the business.

Profit before the interest and profit tax payment

Total capital

Total capital represents the funds invested both by the shareholders and the long term creditors in the entity and it includes own capital and long term liabilities.

- k) Sales gross margin

Sales gross profit
_____ x 100
Turnover

A reduction of the percentage may emphasize that the entity is not able to control the manufacturing costs or to obtain the best selling price. Other information: entity's relationships with branches, associated entities, foreign exchange ratio for the conversion from the foreign currency into the national currency for the elements denominated in foreign currencies; information related to the profit taxation; turnover distribution on geographical markets and operation segments, presentation of the events occurred after the balance sheet date if they have such a relevance as their undisclosed might affect the capacity of the financial statements' users to make assessments and take the appropriate decisions; explanations referring to the value and nature of the extraordinary revenues and expenses, as well as the value and nature of the revenues and expenses recorded in advance if they are significant; instalments paid within a leasing contract; general description of the financial leasing contracts; commercial items discounted before maturity; probable duties and granted commitments; any details of the elements included in the annual financial statements if they are significant and relevant for the financial statements' users.

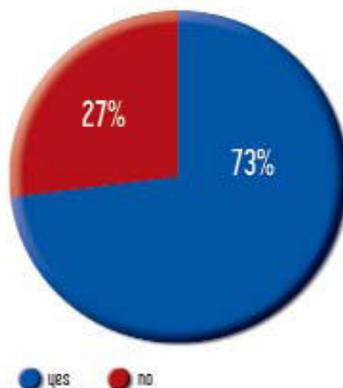
IMPACTS IN TERMS OF STRATEGIC DECISIONS

✓ **Positive effects: transparency and reliability**

73% of companies interviewed believe that IAS-IFRS will allow for a greater understanding of the financial health of companies and increase the comparability of accounts. This will happen despite the fact that some of the Standards do not allow for immediate comparability.

IAS-IFRS will bring a certain number of "off balance sheet" items onto the balance sheet. They also bring about new rules in the recognition and the valuation of assets. They will enable consolidated results by subsidiaries and by industry, an understanding of performance of companies depending on geographical zones and industry sector and will facilitate the comparison of businesses from different nationalities.

Figure 5^{vi} - Do you think transparency and reliability will be better within IAS/IFRS?



Almost 79% of respondents also believe that IAS-IFRS will contribute towards providing more reliable financial information in general.

Out of the 21 % of companies which think that this transparency will not be achieved, the following reasons have been given: the increased risk of "manipulation" interpretation of financial statements (38%), their complexity (24%) and too big a diversity amongst the companies applying IAS-IFRS which make the establishment of unique standards difficult (19%).

The fact that IAS-IFRS are similar to Anglo-Saxon concepts gives rise to a certain amount of worry because their implementation can cause misinterpretations in some countries where representation and accounting laws are codified in a regulatory way.

Also, more than 3/4 of the companies surveyed think that the process of convergence and increased comparability which will be brought about by the new Standards will favor the creation of a European financial market. 65% of them even think that the development of a unified capital market should be accompanied by the creation of a European stock market regulator.

Nevertheless, let us emphasize that more than half of respondents believe that convergence between IAS-IFRS and US GAAP is completely essential and this belief is shared by all of the countries that were involved in this survey.

It is true that the harmonization process introduced by the implementation of the IAS-IFRS ought to aim even further -coming closer to the American Standards which are already used by numerous European companies.

Only 12% of the companies interviewed believe convergence is ill-fated.

Conclusions

The objective of the financial statements in accordance with IFRS is to provide useful information to the users in order to enable them express the economic decisions. Nevertheless, the financial statements in accordance with IFRS do not include all the information which an user might need in taking efficient decisions. The Notes to the financial statements make integral part of the financial reporting process according to IFRS. These Notes include information referring to:

- **Specific accounting policies used in the financial statements' preparation**
- Lending contracts, repayment and interest conditions;
- Information referring to the leasing contracts;
- Operations' distribution on important segments;

- Assets and contingent liabilities;
- Pension plans, details, provisions.

The accounting professional is interested in assessing the entity's value or reliability, he must foresee the future cash flows, evaluate the risks related to these assessments and determine the appropriate discounting rate which should be applied to those assessments.

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ⁱⁱ Mazars Report/ 2007 – IAS/IFRS Implementing Report

ⁱⁱⁱ Mazars Report/ 2007 – IAS/IFRS Implementing Report

^{iv} Mazars Report/ 2007 – IAS/IFRS Implementing Report

^v OMFP 1752/2005 referring to the new accounting regulations harmonized with the European directions

^{vi} Mazars Report/ 2007 – IAS/IFRS Implementing Report