IMPACT OF INTERNATIONAL FINANCIAL REPORTING STANDARDS ON AN ENTITY'S FINANCIAL STATUS AND PERFORMANCE

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Abstract: *International Financial Reporting Standards - IFRS aim at harmonizing accounting principles, procedures and treatments used for the preparation and presentation of annual financial statements in order to meet the information needs of all the social partners of an entity.*

In this article the authors intend to analyze some of the regulations included in a series of international accounting standards - IAS 38 "Intangible Assets", IAS 16 "Property, Plant and Equipment", IAS 36 "Impairment of Assets"- in order to assess how their application influences the presentation of a financial status and the level and method for measuring the performance of entities.

Key Words*: accounting regulations, IAS, financial status, performance, assets, impairment.*

JEL Classification: M41

1.Introduction

The role and purpose of accounting information have led in most countries to the need for accounting normalization. **Accounting normalization** is defining *accounting principles and rules* based on a precise terminology identical for all producers and users of accounting information, as well as *practically applying them* in order to ensure comparability, relevance and credibility of accounting information. International financial reporting standards (IFRS) aim at *harmonizing* entities' accounting principles, procedures and treatments of annual accounts.

The need for accounting harmonization is based on: accelerating the globalization phenomenon; the need for unrestricted access to international capital markets; access to international funding sources; possibility for relevant performance measurement and decision-making; work and influence of multinational accounting firms and financial and tax advice firms; connection with tax authorities as users of accounting information which control the activity of multinational companies. In other words, accounting normalization involves developing a unitary conceptual model on annual financial statements.

The "Framework for Preparation and Presentation of Financial Statements" is an instrument of accounting normalization comprising the basic concepts and principles that underlie the preparation and presentation of financial statements for external users. The objective of financial reporting prescribed by IFRS is to provide accounting information about financial status, effects of transactions and other events that change the economic resources and performance of a reporting entity.

The paper herein is intended to analyze the regulations contained in a series of international accounting rules to see how their application affects the financial status, the performance level measurement manner of economic entities.

2.Content

International Standard **IAS 38 "Intangible Assets"** refers to intangible assets. These are fixed non-monetary assets, identifiable but not embodied in physical form, used in the production process; the supply of goods or services for rental or administrative purposes. Such intangible assets are: patents; brands; licenses; know-how; softwares; goodwill.

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According to the standard, the following elements are not recognized as intangible assets: entity formation costs; research costs; expenditure on advertising. These expenses are reported as running costs at the time of their occurrence.

Additionally, Standard IAS 38 requires recognition as running costs of expenses after acquisition of intangible assets, except when they are capitalized on those intangibles:

- subsequent expenses which lead to enhanced performance, higher than the initial level of intangible assets related to which they have been incurred;
- subsequent expenses can be assessed and assigned to a type of intangible asset.

Given the characteristics of intangible assets, it is often difficult to determine whether a subsequent expense maintains or increases the level of initial performance. It is also difficult to assign such expenses to a single intangible asset because division normally envisages the entire entity business.

Therefore, in practice subsequent expenditure incurred after the initial recognition of an intangible asset are reported in the balance of running.

Recognizing and measuring intangible assets as required by IAS 38 Standard and achieving the distinction between intangible assets and charges for the year is very important in terms of the implications on the financial status and economic performance of an entity:

▪ an element that does not meet the conditions for recognition of intangible assets is treated as an expense and therefore increases the running costs of a year, diminishes the result and thus reduces the performance of an entity in terms of profitability, solvency, capacity for self-financing and financial autonomy.

▪ an item that meets the conditions for recognition of intangible assets is reported as an intangible asset in the balance sheet and determines both the increase in the share of this asset category in the total balance sheet and increased expenses on depreciation, namely of running costs for the year in the profit and loss account .

The influences on economic performance of an entity by reporting as current expense in the profit and loss account or as intangible asset in the balance sheet are the same as those discussed above. One notices, however, that in practice clearly setting whether a subsequent expense maintains or increases the initial performance level of an intangible asset is subjective. Therefore, if present tax implications involve reducing taxable gross profit at the expense of economic performance, then subsequent expenses are maintained in the profit and loss account even when they could be reported in the balance sheet as an intangible asset.

International Standard IAS 16 "Property, Plant and Equipment" sets the accounting treatment of tangible assets. These are resources controlled by an entity arising from past events and generating future economic benefits for the entity, measurable in cash flows that may occur in one of the following circumstances: the use of property and equipment in the production or service flow; the use of property and equipment to extinguish a debt; the exchange of assets; etc. Tangible assets are used by an entity for a period longer than one financial year which generally means more than one year and they are intended for production, provision of services, recovery leasing, or use for purposes other than productive ones. Evaluation, depreciation and revaluation of property, plant and equipment are issues addressed in Standard IAS 16 having influence on an entity's financial status and performance.

- The **initial assessment** of tangible assets is made at the cost. Standard IAS 16 requires not including administrative costs and production preparation costs in the price of property and equipment unless they have occurred in strict connection with the acquisition or commissioning of property and equipment. In this situation, a professional accountant has little scope for information manipulation because one cannot artificially include massive administrative expenses in the cost of property and equipment, at most, one can forcefully "attach" some administrative costs to the purchasing and commissioning of property and equipment. During a first stage, it had do with increasing the value of property and equipment and subsequently with increasing annual depreciation expenses for the duration of using the property and equipment. Thus, economic performance is influenced by decreasing a year's profit and a tax implication reducing the tax base.

- **Assessment** of tangible assets incoming via **exchange of assets**. If a tangible asset given by an entity is similar in nature and value to that obtained via exchange of assets, a newly incoming tangible asset in the entity shall be accounted for at the net book value of the asset given; in this case, the entity's economic performance is not influenced. If the net book value of property and equipment transferred exceeds the net book value of the tangible asset received, accounting for shall be done at the value of new entry property and equipment; In this situation, there is a decrease in the balance sheet of tangible assets, that implicitly reduces their share in total assets. Simultaneously, in the profit and loss account there is a reduction in depreciation expense, which affects the tax base and corporate tax accordingly, that is in a positive way.
- **Subsequent expenses** after commissioning of property, plant and equipment. Standard IAS 16 recommends tangible capitalization only of those expenses which result in the reporting of economic benefits higher than initially foreseen. It is obviously difficult and subjective to delimitate of expenses that contribute only in keeping the normal production capacity of a tangible asset from expenses that may increase its performance above normal levels or extend its lifetime. Under the pretext of improving the technical and economic characteristics of property, plant and equipment, there will be in most cases the tendency to over-capitalize expenses that typically are aimed only at maintaining the production capacity of property, plant and equipment. As a result, the book value of tangible assets will increase and their share in total assets. At the same time, annual operating expenses on depreciation will increase current year expenses and reduce profit, negatively affecting the economic performance of an entity, but diminishing the tax burden by reducing the tax base.
- **Reassessment** of tangible assets. Different causes determine the initial value of a tangible asset (its cost) should no longer correspond to the current value. In such cases, one proceeds to reassessment of tangible assets. Reassessment is designed to provide information for reporting their real value in the accounts in order to eliminate large differences between the net book value and fair value (real value) of property and equipment. The need for reassessments is determined based on professional judgment, but it is recommended every 3-5 years, in order not to report large differences between the net book value of tangible assets and their fair value. It is obvious that the frequency of judgment occurrence is subjective and adapts according to the current needs of an entity and the fluctuations in market values of such property, plant and equipment regarding the increase in equity value with reassessment differences. Entities typically increase their economic performance desiring to reassess the property, plant and equipment that lead to reporting positive reassessment differences, in order to increase equity, and thus to deleveraging. Accordingly, although Standard IAS 16 recommends the simultaneous reassessment of all tangible assets that belong to the same category; in the absence of statements on the definition of "category of tangible assets", it is possible to have a selective reassessment by taking into account only tangible assets that will release positive reassessment differences and neglecting those which generate negative differences.

In practice, the reassessment of tangible assets generates positive differences in most cases leading to increasing their balance in the balance sheet and consequently to the increase in operating expenses of depreciation. Following the reassessment of tangible assets, a financial status is influenced in terms of increasing assets and simultaneously it is influenced in terms of equity increase based on positive reassessment differences. The entity receives the tax benefit of the decrease in taxable income due to the increase in operating expenses of depreciation. Whereas from tax perspective, decreased profit generates advantages, in terms of economic performance it is a disadvantage. That is why some entities try to reassess only non-depreciable tangible assets such as land in order to eliminate the disadvantage of increasing operating costs of depreciation and reducing year profit; this solution is *viable*, especially that the provisions of Standard IAS 16 are complied with, meaning that land is a distinct category of property.

- **Depreciation** of tangible assets when coming out of an entity. According to Standard IAS 16, the depreciable value of property and equipment is determined by subtracting the residual value from the initial cost representing the amount that an entity estimates to earn from the sale of property and equipment at the end of their service life, less expenses incurred by their sale. Estimating the residual value can be subjective and can serve the momentary interests of an entity. That is why, depreciation of tangible assets influences an entity's performance at least regarding the following aspects:

▪ estimating a lower residual value, that is undervaluing it, meets the principle of prudence but increases the depreciable value of property and equipment and therefore operating costs. This reduces the taxable income, yielding a tax advantage and a disadvantage on performance, except for land which cannot be depreciated. Overvaluing the residual value leads to lower annual depreciation costs and increased taxable income, thus a higher corporate tax. Higher or lower profit influences in terms of increase or decrease the profitability and solvency indicators, and the ability for self-financing.

▪ choosing the depreciation methods of tangible assets according to their technical characteristics and the specific use in an entity is marked by subjectivity. According to the criterion chosen, the depreciation duration differs and annual depreciation expenses differ, too. According to the vision of Standard IAS 16, a depreciation method should be reviewed at least at each financial year end. If the expected pace of economic advantages of an asset has experienced a significant change, the depreciation method must be changed in order to reflect the new pace.

Theory and practice recommend that a depreciation regime used should be logical and systematic. In other words, the cost of entry must not be arbitrarily assigned to years, without taking into account the manner of an asset's losing its use value over the years. The depreciation regime selected must reflect the service reduction capacity of property and equipment. When asked "*which depreciation regime is better?",* the answer is: according to an entity's objectives, an entity's "aggressiveness" when it wants to address fiscal management and, of course, according to the decision of the general meeting of shareholders or members. It is known that choosing a depreciation regime is a matter of appreciation. If an entity has a choice regarding depreciation, interest is related to investment, an interest that competes with the state's tax one. The choice of a digressive system or accelerated system is conducive for entities that are recipients or are about to become such in the first years after the investment. Since rapid depreciation is digressive, they can defer the date of payment of a tax part, thus benefiting from currency impairment. If they are deficient in terms of outcomes in the coming years, entities are able to "escape" from paying taxes permanently. Initially establishing the criterion of depreciation and its substitution following the "professional judgment" which justifies the disparity between the previously established criterion and current use of property and equipment, is a direct method of influencing an entity's performance namely decreasing or increasing it.

▪ **Tangible assets' coming out** of an entity through sale causes the generation of revenue and the year's profit growth, while their coming out through scrapping generates both expenses incurred for scrapping and revenues from recovered material recovery. If a tangible asset sold has previously been reassessed, the reassessment differences are taken directly upon reserves and increase equity, increasing the solvency ratio and the self-financing ability, but diminishing return on equity.

International Standard IAS 36 "Impairment of Assets" provides clarifications regarding the recognition and measurement of an impairment loss and specific accounting treatments. Recognition of impairment can also be treated as information in making a decision to revise the remaining life, the residual value and/or depreciation method.

According to Standard IAS 36, the book value of an asset must be brought to its recoverable amount if and only if its recoverable amount is less than its book value. This reduction represents an impairment loss and consequently it must be immediately recognized as an expense in the profit and loss account. If in following years the recoverable amount of an impaired asset has increased, the difference is scrapped by the resumption in income, except for the reassessment of assets, when it must be treated as an increase in the reassessed value; in this case, the asset value will rise to the new recoverable value, without exceeding the current net book value calculated if the asset had not been impaired in previous years.

Applying Standard IAS 36 affects the financial status and performance of an entity due to resizing the tangible assets' value. These influences are to be analyzed according to two possible scenarios: finding the loss of value of an asset and minimizing the loss of value previously found.

1) Finding the loss of value of an asset

When an asset's recoverable amount is less than the amount reported in the accounts, it results that the asset has been impaired and the entity must report the loss of value. Reporting an asset at its recoverable amount in the accounts, obviously lower than its old book value, influences the financial status by decreasing the share of tangible assets and their performance by subtracting annual depreciation expenses. Keeping the hypothesis of a depreciable tangible asset it is noted that its loss of value determines an increase in the year's expenses when it has been found, which is higher than the reduction of depreciation expense resulting only in subsequent months by dividing the new book value of a fixed asset during the remaining utility duration. As a result, in the month an impairment of depreciable assets is found, one deals with an increase in expenses which influences the monthly outcome namely decreases it and favours a lower tax burden.

In terms of revalued assets, the loss of value found is still part of the charges for the year but is deducted directly from the revaluation difference of an asset, provided it is not higher than the revaluation difference. In this case, there will be a decrease in the entity's equity due to lower revaluation differences, which will influence the entity's economic performance in a manner similar to that shown above.

2) *Minimizing an asset's loss of value*

On the occasion of reducing the loss of value of an asset, there is income reported in the profit and loss account which influences a benefit, that is increasing it. If, however, the loss of value of a revalued asset has previously been reported an expense, its minimization will be reported as income, which influences the economic performance of the entity through profit growth in a manner similar to that shown for minimizing the loss of value of an asset. Regarding a depreciable asset, after minimizing the loss of value and along with increasing its value, the depreciation expense must be rescaled namely increasing it during the remaining service life, which affects profit for the year on the downside and the economic performance of the entity on this basis, just like when finding the loss of value of an asset, previously analyzed.

3. Conclusions

Applying international financial reporting standards by economic entities involves changes in the manner of recognition, measurement, impairment, etc., in structures of financial statements. Additionally, in the practice of various countries, depending on the relationship between accounting and taxation, such changes have fiscal implications.

In pursuit of objectives, the management of an entity must apply accounting policies so that their financial statements should comply with all provisions of each applicable international accounting standard and each applicable interpretation. In the absence of an explicit standard and an interpretation, entity management appeals to professional judgment in view of developing an accounting policy that may lead to the most useful information to the users of financial information.

4. References

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