Shift from National Reporting to Reporting in Accordance with International Financial Reporting Standard for Small and Medium-sized Entities and Its Effect on Financial Management – the Case of the Czech Republic

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Abstract

The aim of this paper is to evaluate the effect of the shift from Financial Reporting under the Czech legislature (CZ GAAP) to the International Financial Reporting Standard for financial management in Small and Medium-sized Enterprises (IFRS for SMEs). The reasons for the shift and major differences between CZ GAAP and IFRS for SMEs are mentioned, as well as the changes relevant to the shift. Not only changes in accounting departments are defined but also the changes that affect a company as a whole. Furthermore, information from Financial Reporting used in Financial Management is described. Also, the effect of the changes in Financial Reporting on this information and related modifications affecting Financial Management are evaluated.

Key words: Financial Reporting, Financial Management, IFRS for SMEs, Czech Republic

1 INTRODUCTION

The harmonization of Financial Reporting is one of the key topics at the meetings of accounting experts and professional bodies. A recent step forward in harmonization of Financial Reporting of Small and Medium-sized Entities was the issuance of International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs) in July 2009 by IASB. IFRS for SMEs is supported by many worldwide institutions (World Bank, IFAC, ACCA, AICPA besides other) and as at June 2010 62 jurisdictions (including USA) have either adopted IFRS for SMEs or stated a plan to adopt it within the next three years [1]. Despite the fact, the standard setting body in the Czech Republic has not announced any adoption or convergence plans yet [3], there are companies in the Czech Republic that plan to report under IFRS for SMEs in the near future.

In this paper the effect of the change of the Financial Reporting system (from CZ GAAP to IFRS for SMEs) from the view of the Financial Manager is discussed.

Firstly, an empirical analysis with the focus on the shift in reporting system from CZ GAAP to IFRS for SMEs which represents not only changes in the accounting department but also changes in whole company is performed. Reasons, why companies would like to report under IFRS for SMEs are briefly mentioned, major differences between CZ GAAP and IFRS for SMEs are described and possible changes in the company are summarized. Furthermore, descriptive analysis of the role of the Financial Manager is performed with the main focus on the information from Financial Reporting used by the Financial Manager. The last part of the paper summarizes the changes the Financial Manager needs to do because of the Financial Reporting change.

2 SHIFT FROM CZ GAAP TO IFRS FOR SMES

2.1 Why?

Generally financial statements prepared in accordance with IFRS (both full IFRS as well as IFRS for SMEs) are considered to give better information to the users of financial statements than financial statements prepared under CZ GAAP. Two main reasons being stated are better understandability of financial statements and the better comparability of financial statements.

Understandability - IFRS is a widely used reporting system with multinational promotion done by IASC Foundation among others. On the other hand CZ GAAP is a national accounting system used only in the Czech Republic. For the users of financial statements outside Czech Republic, it is very hard to understand the financial statements prepared under CZ GAAP. The language barrier is not the only problem, but also the structure of the financial statements, the system of accounting legislation and some accounting methods, which significantly differ from widely used reporting systems like IFRS.

Comparability - Due to the differences between IFRS and CZ GAAP, financial statements prepared in line with CZ GAAP cannot be reasonably compared with financial statements based on other systems without the detailed knowledge of Czech accounting legislation. CZ GAAP is also more linked to tax and other legislation, whether IFRS is more focused on the substance of the transactions.

Because of these two facts, application of IFRS is bringing to Czech companies following opportunities – the Companies have more accurate information about the financial position of the company, they have increased possibilities of financing and finally they can have better relationship with their stakeholders.

This was confirmed by the PricewaterhouseCoopers survey of 187 fund managers across Europe, in which the investors said that IFRS is having a real impact on the way they perceive companies and consequently, on their investment decisions. Fund managers identified the key benefits of IFRS as the improved transparency and better management information, together with consistency of reporting between jurisdictions and sectors. [4]

One of the drawbacks of IFRS adoption in the Czech Republic is the complexity of full IFRS as well as lack of professionals with significant knowledge. Adoption of IFRS for SMEs is easier than application of full IFRS. Therefore it can be expected that Czech companies would prefer IFRS for SMEs if they meet the criteria of Small and Medium-sized Entity (the entity doesn't have public accountability and does publish general purpose financial statements for external users).

2.2 Major differences between CZ GAAP and IFRS for SMEs

Due to the different priorities and principles, on which both of the systems are based, there is a range of conceptual as well as specific differences.

Conceptual differences:

- CZ GAAP is based on rules but IFRS generally on principles.
- Czech tax base is still based on Czech accounting legislation. Consequently, a lot of the assumptions the management makes during the preparation of the financial statements is made with the potential tax consequences on that accounting treatment. This could (and often results) in adoption of the tax-founded point-of-view in accounting rather than of a real consideration what is the true and fair view of the transaction in its substance.
- CZ GAAP, again due to its nature, does not have a thorough conceptual framework that would describe the following:
    - the individual elements of the financial statements and their definition,
    - the conceptual discussion about the fundamental accounting concepts and methods on which the financial statements should be prepared,
    - assumptions behind the quality of neither information that the financial statements should provide not a hierarchy referring to other legislation's or accounting literature in case of non-existence of relevant rules.[7]

The most important specific differences are following [8]:

- Content of a full set of financial statements – in CZ GAAP only statement of financial position (balance sheet), income statement and Notes are mandatory for all accounting entities, in IFRS for SMEs, entities shall present (other than statement of financial position, income statement and Notes) also statement of comprehensive income, statement of changes in equity and cash flow statement.
- Revenue recognition – in CZ GAAP legal form prevails, in IFRS for SMEs the substance of the transaction is relevant. The recognition criteria have to be met in IFRS for SMEs and there is a possibility to use the percentage of completion method for booking revenues from long-term projects.
- Borrowing costs – in CZ GAAP the entity can decide if borrowing costs will be expensed or capitalized. In IFRS for SMEs all borrowing cost shall be expensed.
- Fixed assets valuation – in IFRS for SMEs unlike in CZ GAAP demolition and dismantling cost shall be part of the value of the fixed asset.
- Recognition criteria for long-term assets – in IFRS for SMEs criteria based on the economic benefits have to be met (resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity), in CZ GAAP the useful life of the asset shall be over one year and the purchase value of the asset shall be over the stated limit to recognize the asset.
- Assets held for sale – specific category in IFRS for SMEs which is included in inventories, in CZ GAAP assets held for sale are not defined and until they are sold, are included in long-term assets.

- Amortization of goodwill – in CZ GAAP goodwill is amortized over 5 or 15 years, in IFRS for SMEs goodwill shall be amortized over 10 years
- Financial lease – in CZ GAAP the assets acquired under finance lease are not presented in the financial statements. In IFRS for SMEs the leased assets are included in the financial statements as well as the liabilities and financial costs connected.
- Grants accounting – in CZ GAAP the grants for the purchase of assets lower their purchase value, in IFRS for SMEs grants are included in revenues.
- Provisions recognition – in IFRS for SMEs certain criteria have to be met to recognize the provisions (present obligation exists, it is probable that the entity will be required to transfer economic benefits in settlement and the amount of the obligation can be estimated reliably), in CZ GAAP there are some provisions that do not meet these criteria.
- Extraordinary items – extraordinary items are prohibited in IFRS for SMEs. In case of changes in the accounting policies IFRS for SMEs restates comparatives and prior-year opening retained earnings. In CZ GAAP unusual operations with regard to the normal activities of an entity and cases of random events, changes in accounting methodology and corrections of material prior-period errors are included in extraordinary items.
- Impairment rules – in IFRS for SMEs a detailed guidance for the calculation of impairment is provided. In CZ GAAP no such guidance is available.
- Reclassification – some items in the Financial Statements have to be classified in different categories in IFRS for SMEs than in CZ GAAP, e.g. activation, changes in inventory, foreign exchange differences, corporate income tax receivable or payable etc.

2.3 Changes not only in the accounting department

Implementing IFRS brings the need for change in the format of accounts, different accounting policies and more extensive disclosure requirements. In many EU countries, technical differences between local generally accepted accounting principles (GAAP) and IFRS are numerous, and the costly and resource-consuming conversion process could last up to 24 months. Many organizations are experiencing a shortage of well-trained personnel, and there are necessary IT system changes and enhancements to be made. For many, it is not a matter of just replacing one accounting system with another, but rather the addition of a new accounting system on top of the existing one still to be used for statutory purposes. [6]

Based on the experience of companies that have already implemented IFRS following steps have to be done in the implementation process, see Fig. 1.

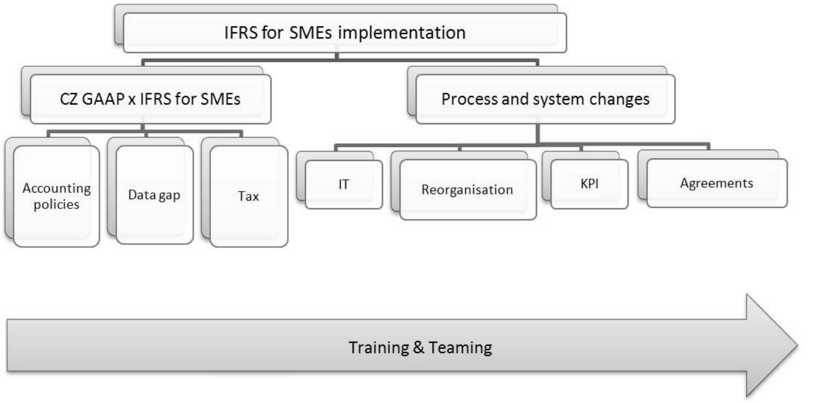

Fig. 1 – Steps in the implementation process. Source: prepared by author based on [5]

To begin with, it is necessary to understand the difference between CZ GAAP and IFRS for SMEs. Based on these differences, the change of accounting policies is essential. As an example accounting policy regarding provisions can be mentioned due to the different recognition criteria in CZ GAAP and IFRS for SMEs, another example can be accounting policy regarding fixed assets because of different approach to leasing in CZ GAAP and IFRS for SMEs. Furthermore, it is necessary to improve data collection and eliminate data gaps because the disclosure requirements are wider for the IFRS for SMEs than for CZ GAAP. It is also recommended to consider tax implications (in the Czech Republic it is not possible to use the IFRS result for the income tax calculation as of yet and therefore the company shall still remain as the statutory reporting entity).

Next step is the assessment of the process and system changes. The IFRS for SMEs implementation will need the changes IT – upgrade of accounting and information system, change of connected systems (e.g. systems used for the revenue recognition). With the changes within IT and the accounting policies the companies may use the synergy effect and the business processes can be reorganized. In line with all these changes the KPI used in the organization can be affected. Also some internal and external key agreements may be reviewed and changed in accordance with their substance.

During the whole process training and teaming is significant. Training is important for accountants to perform their job but also for other employees to understand the changes in the company. The good implementation team shall ensure that the implementation is performed with minimum constraints and problems.

3 FINANCIAL REPORTING INFORMATION USED BY A FINANCIAL MANAGER

The Financial Managers objective is to manage company funds to ensure their optimum utilization and their procurement in manner where the risk, cost and control considerations are balanced.

To achieve this objective the Financial Manager shall perform following roles:

- Forecasting and Planning
- Decision making
- Cash flow management
- Financial performance evaluation
- Financial negotiations

3.1 Forecasting and Planning

The Financial Manager shall prepare budgets for short term as well as long term purposes. In the short term working capital requirements are dealt with, in the long term the capital investments are solved. The Financial Manager shall not only prepare the budget but also regular budgetary control is very important. To achieve this goal a Financial Manager needs to have accurate information from other managers (e.g. Sales Manager, Property Manager...), and from Management Accounting as well as the information from the Financial Reporting.

The Financial Reporting information needed by Financial Manager to prepare budget are Financial Statements that shall give a fair and true view of the company's assets and liabilities. For the budgetary control the Financial Manager needs not only the Financial Statements on a monthly basis but also the detailed data from the books to explain the balances and movements.

3.2 Decision making

The Financial Manager shall make or participate in decisions relating to capital structure (whether to use external or internal sources of finance or a balanced combination of both) and investment decisions (assessment of projects using methods like payback, IRR and NPV). The Financial Manager shall also give recommendations for profit distribution (whether to keep it in the company or to pay out dividends).

The Financial Reporting information the Financial Manager uses are the Financial Statements with Notes which shall be approved by shareholders for the purposes of profit distribution, detailed data about the capital cost and detailed data about revenues and costs of the company which shall be present in the books.

3.3 Cash flow management

The Financial Manager shall ensure the supply of adequate, timely and not expensive funds to meet the requirements of individual company departments. Too- high balance of cash is also not ideal, free cash shall be invested to earn additional income. The cash flow budget shall be prepared and reviewed on a regular basis, e.g. weekly.

The Financial Reporting information the Financial Manager needs for efficient cash flow management is not only the Cash-flow statement but also details from the books (e.g. detailed subledgers of account payables and receivables).

3.4 Financial performance evaluation

The Financial Manager shall review constantly the financial performance of the company various units and the company as a whole to see if the funds have been utilized efficiently or if any improvements are needed. For the financial performance evaluating the traditional financial analysis use of ratios is applied. The importance of modern concepts to measure performance like the Economic Value Added (EVATM) is increasing as the importance of the shareholders and their wealth is more significant.

In financial analysis the Financial Manager uses company Financial Statements.

For the calculation of EVATM the Financial Manager needs to perform specific corrections to the data from the Financial Reporting to obtain data that show a company's real economic situation. As of companies doing their business in the Czech Republic the typical corrections are:

- Activation of research and development cost, marketing cost, cost of education of employees, restructuring cost
- Activation of leased assets
- Correction of goodwill amortization – goodwill shall not be amortized if not impaired
- Usage of fair values
- Assessment of reasonableness of allowances to receivables and provisions (e.g. provision for fixed assets repairs shall not be included)
- Assets that are not necessary to the operations of the company and assets not used shall be excluded from total assets
- Assets shall be further reduced by liabilities with no expense (e.g. short-term liabilities, long-term liabilities not bearing any interest or accruals and deferrals)
- Deduction of interest cost from profit
- Deduction of extraordinary and one-off costs and revenues
- Impact of the above mentioned corrections on assets and liabilities
- Correction of tax [2]

To be able to perform these corrections the Financial Manager needs to have available details about balances and movements of individual accounts. Further, the Financial Manager needs the information about cost of capital.

3.5 Financial negotiations

The Financial Manager shall communicate with financial institutions, banks, relevant parties in the Financial Markets etc. One of the purposes of such negotiations is the need to raise funds with the best conditions available. Second reason is the commitment to the capital lenders, meeting the agreements set by banks (covenants) and stock exchange rules as well as meeting the statutory rules set by the legislation.

To meet this, the Financial Manager needs to have the Financial Statements that give a fair and true view of the company's assets and liabilities as well as Notes, bringing the users of Financial Statements real and adequate information.

4 CHANGES IN FINANCIAL MANAGEMENT CAUSED BY THE SHIFT IN FINANCIAL REPORTING

For the Financial Manager the change of the Financial Reporting to Financial Reporting under IFRS for SMEs shall be positive in general. It can be expected that the Financial Statements prepared under IFRS for SMEs will give a better view of the company's assets and liabilities than Financial Statements under CZ GAAP. The full set of Financial Statements will contain the Cash Flow statement and the information presented in the Notes shall be more detailed. All these facts shall help the Financial Manager in his work as well as in communication with the external users of the Financial Statements.

On the other hand a Financial Manager will have to adjust the calculations and instruments used during his work. Major changes expected are following:

- The Financial Manager will have to adjust forecasting and planning tools to be consistent with new format of the Financial Statements.
- In his decision making Financial Manager will have to take into account changes relevant to accounting about the assets purchased with the use of the financial leasing.
- In the cash flow management the mandatory Cash flow statement shall be helpful to the Financial Manager. On the other hand the cash flow management tools shall be adjusted to the new Financial Statements format.
- For financial negotiations the Financial Manager shall be able to explain the differences in figures reported to financial institutions, banks and other parties due to the change of the Financial Reporting system and to negotiate new calculations of reported data, e. g. covenants.
- Most changes will be connected with performance evaluation and are described separately below.

4.1 Reporting packages

If the company uses the reporting packages the whole system of reporting units of the company performance will have to be adjusted. The packages have to be prepared in accordance with the data available from the Financial Reporting. The structure shall be adjusted to the new format of Financial Statements as well to better data availability. Due to the change in the reporting packages training has to be provided to the fillers of the reporting packages.

The Financial Manager shall also update the evaluating tools and has to distinguish the effect of the Financial Reporting system change from the effect of the units operations.

The performance of the units reported in the reporting packages is usually one of the factors in the evaluation of managers and as well it is used for the management decisions related to funds provided to individual units. It is necessary that the users of the information from the reporting packages have the knowledge of the effect of the shift in the Financial Reporting.

4.2 Interpretation of financial analysis ratios

For the illustration of the effect of the shift in the Financial Reporting and the impact on the financial analysis ratios I have chosen following ratios:

$$\text{EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization)} \tag{1}$$

$$\text{ROS (Return on Sales)} = \frac{EBIT}{Sales} \tag{2}$$

$$\text{ROA (Return on Assets)} = \frac{EBIT}{Assets} \tag{3}$$

$$\text{ROE (Return on Equity)} = \frac{EAT}{Equity} \tag{4}$$

$$\text{Current ratio} = \frac{Current\ assets}{Current\ liabilities} \tag{5}$$

$$\text{Debt/equity} = \frac{Debt}{Equity} \tag{6}$$

$$\text{EPS (Earning per share)} = \frac{EAT}{nr.of\ issued\ shares} \tag{7}$$

There are no rules that can be applied generally, the movements differ from company to company and depends on the actual corrections needed for transfer of CZ GAAP to IFRS for SMEs. However it can be outlined what ratios are affected by individual corrections, see Tab. 1.

Tab. 1 – Effect of CZ GAAP x IFRS for SMEs differences on selected ratios. Source: prepared by author

Differences	EBIT-DA	ROS	ROA	ROE	Current ratio	Debt/equity	EPS
Revenue recognition	X	X	X	X		X	X
Borrowing costs		X	X	X		X	X
Fixed assets valuation		X	X	X		X	X
Recognition criteria for long-term assets		X	X	X	X	X	X
Assets held for sale		X	X	X	X	X	X
Amortization of goodwill		X	X	X		X	X
Financial lease		X	X	X	X	X	X
Grants accounting	X	X	X	X		X	X
Provisions	X	X	X	X	X	X	X

Extraordinary items	X	X	X	X		X	X
Impairment rules		X	X	X	X	X	X
Reclassification		X					

In the case of EBITDA (1) revenue recognition affects sales, grants accounting affects revenues, provision recognition affects cost and extraordinary items influence the result of the company.

In the case of ROS (2) the following differences have impact on EBIT:

- Revenue recognition – affects sales
- Borrowing costs, Fixed assets valuation, Recognition criteria for long-term assets, Assets held for sale, Amortization of goodwill, Grant accounting, Financial lease, Impairment rules – affects depreciation
- Provisions, Financial lease – affects costs
- Extraordinary items – affects the result

Sales are influenced by revenue recognition and reclassification (e.g. activation, changes in inventory).

EBIT in ROA (3) is affected as described above. The assets are influenced by:

- Borrowing costs
- Fixed assets valuation
- Recognition criteria for long-term assets
- Assets held for sale
- Amortization of goodwill
- Grant accounting
- Financial lease
- Impairment rules

Equity as well as EAT in ROE (4) are influenced by all differences except reclassification.

Current ratio (5) is affected by recognition criteria for long-term assets, assets held for sale and impairment rules on the side of current assets. On the side of current liabilities the ratio is impacted by financial lease and provisions.

In Debt/equity (6) the debt is affected by financial lease, the equity by all differences except reclassification.

In EPS (7) the number of issued shares is not affected by any difference, the EAT by all differences except reclassification.

4.3 EVA calculation

In the EVA calculation there are some corrections that are no more needed or need a different approach if the Financial Reporting data used are prepared under IFRS for SMEs.

The activation of leased assets and the assessment of reasonable allowances to receivables and provisions shall already be covered by IFRS transition and no more correction shall be applied. Also the deduction of extraordinary costs shall be no more correction performed by the Financial Manager in the calculation of EVA.

In case of correction of Goodwill amortization in the IFRS for SMEs is goodwill amortized over 10 years, therefore the calculation of the correction has to be adjusted.

All other corrections in the EVA calculation shall remain the same.

5 CONCLUSION

In this paper the effect of the shift from the Financial Reporting under CZ GAAP to Financial Reporting under IFRS for SMEs on Financial Management is discussed.

First, it is mentioned why Czech companies would like to report under IFRS for SMEs, the main reasons are better understandability and comparability of Financial Statements which brings to the companies more accurate information about the financial position of the company. Companies have increased possibilities of financing and finally the companies can have a better relationship with their stakeholders. Major differences between CZ GAAP and IFRS for SMEs as of conceptual and specific differences are mentioned. The last part regarding IFRS for SMEs implementation are the changes connected to the transition. These changes can be divided into two categories, first are mentioned changes related to the differences between CZ GAAP and IFRS for SMEs and then the process and system changes.

The following part of the paper describes the role of the Financial Manager and summarizes the information from Financial Reporting used by a Financial Manager. It was described how the complete set of Financial statements including Notes, Cash Flow statement, information about the cost of capital and detailed data from the books are necessary and not only on the balance sheet presentation day but on a regular basis during the accounting period.

In the last part of the paper the changes in the Financial Management are discussed, it is stated that in general the shift to Financial Reporting under IFRS for SMEs shall be positive for the Financial Manager. On the other hand a Financial Manager will have to adjust the calculations and instruments used during his work. Specifically the effect on the reporting packages, financial analysis ratios interpretation and EVA calculation are mentioned. The reporting packages as well as the whole reporting system have to be adjusted and for the interpretation of data it has to be distinguished between the effect of the change in Financial Reporting and the operations of individual units. There are no rules that can be defined generally for the interpretation of financial analysis ratios after the shift to IFRS for SMEs, the movements differ among companies and depend on the actual corrections needed for transfer of CZ GAAP to IFRS for SMEs. However it can be outlined how ratios can be affected by individual corrections. The EVA calculation shall be a little bit easier if the Financial Manager uses data available from the Financial Reporting under IFRS for SMEs. The activation of leased assets and the assessment of reasonable allowances to receivables and provisions shall already be covered by IFRS transition and no more corrections shall be needed.

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