European Research Studies,
Volume XII, Issue (1) 2009

Transparency in Financial Statements (IAS/IFRS)

By

Gheorghe V. LEPĂDATU[1], Mironela PÎRNĂU[2]

Abstract:

The provision of transparent and useful information on market participants and their transaction is essential for an orderly and efficient market, and it is one of the most important preconditions for imposing market discipline. Left to themselves, markets may not generate sufficient levels of disclosure. Market forces would normally balance the marginal benefits and marginal costs of additional information disclosure and the end result may not be what the market participants really need.

Keywords: *financial statements, balance sheet, income statements, cash flow statement, IAS/IFRS*

JEL Classification: M41, M42, H83

1. Introduction

Financial and capital market liberalization trends of the 1980s which brought increasing volatility in financial markets increased the need for information as a means to ensure financial stability. In the 1900s, as financial and capital market liberalization increased, there has been mounting pressure for the provision of useful information in both the financial and private sectors. Disclosure requirements now dictate the quality and quantity of information that must be provided to the market participants and the general public. Because the provision of information is essential to promote the stability of the markets, regulatory authorities also view the quality of information as a high priority. Once the quality of

[1] *Ph.D., Assoc. Prof., Faculty of Finance Banking and Accountacy, "Dimitrie Cantemir" Christian University, Bucharest, Romania tel:+40.722311272, email: cilezbujor@yahoo.com*
[2] *Ph.D., Lecturer Eng., Faculty of Information Science Technology, "Titu Maiorescu"University, Bucharest, Romania, , tel:+40.723210205, email: mironelapirnau@yahoo.com*

information required by market participants and regulatory authorities is improved, entities would do well to improve their own internal information system so as to develop a reputation for providing good quality information. The public disclosure methodology normally involves publication of relevant qualitative and quantitative information in annual financial reports, which are often supplemented by financial statements and other relevant information. The provision of information involves cost: when determining disclosure requirement, its usefulness for the public must be evaluated against the cost to be born by the enterprise.

The timing of disclosure is also important; disclosure of negative information to a public is not yet sufficiently sophisticated to interpret the information and may damage the enterprise in. When information is of an inadequate quality and/or the users are not deemed capable to properly interpret the information. Public disclosure requirements should be carefully phased in and progressively tightened. In the long run, a full disclosure regime is beneficial, even if some problems are experienced in the short term, because the cost to the financial system of not being transparent is ultimately higher than the cost of being transparent.

2. Transparency and Accountability

Transparency refers to the principle of creating an environment where information on existing condition, decision and action are made accessible, visible, and understandable to all market participants.

Disclosure refers to the process and methodology of providing the information and market policy decision known through timely dissemination and openness.

Accountability refers to the need for market participants, including the authorities, to justify their actions and policies and accept responsibility for their decisions and results.

Transparency is necessary for the concept of accountability to take hold amongst the three major groups of market participants: borrowers and lenders, issuers and invertors, as well as national authorities and international financial institutions.

Transparency and accountability have become strongly debated topics in discussion of economic policy over the past decade. Regarding the policy, the market had become accustomed to secrecy. Secrecy was viewed as a necessary ingredient for the exercise of power, with an added benefit of hiding the incompetence of policy market. However, secrecy also prevents policies from having their desired effects. The world changing economy and financial flows, which brought the increasing internationalization and interdependence, have put the openness issue at the forefront of economical policy making. There is a growing recognition of national governments including central banks, that transparency (the openness of policy) improves the predictability and hence, the efficiency of policy decision. Transparency forces institutions to face up to the reality of a situation and makes officials more responsible, especially if they know they will have to justify their views, decisions and actions afterwards. Timely policy adjustments are encouraged.

The case for greater transparency and accountability rests on the need private sector agents to understand and accept policy decision that will affect their behavior. Greater transparency improves the economical decision made by other agents in the economy. Transparency is also a means of fostering accountability, internal discipline and better governance. Transparency and accountability improve the quality of decision making in policy-making institutions (whose activities should normally be required to be transparent) as well as in institutions where decisions depend on understanding and predicting the future decisions of policy-making institutions. If actions and decisions are visible and understandable, the monitoring costs are lowered. The general public is better able to monitor public sector institutions; shareholders and employees, to monitor corporate management; creditors to monitor borrows and depositors to monitor banks. Therefore, poor decision will not go unnoticed or unquestioned.

Transparency and accountability are mutually reinforcing. Transparency enhances accountability by facilitating monitoring and accountability enhances transparency by providing an incentive for agents to ensure that the reason for their actions are properly disseminated and understood. Together, transparency and accountability will:

- Impose a discipline that improves the quality of decision making in the public sector and
- Lead to more efficient policy by improving the private sector understandings of how policy-makers may react to various events in the future.

3. What Transparency Cannot Ensure

Transparency and accountability are designed to assist in increasing economic performance and may improve the working of the international financial markets by enhancing the quality of decision-making and risk management of all market participants, including official authorities. Transparency does not change the nature or risks inherent in financial systems. It may not prevent financial crises, but may moderate market participant's response to bad news.

Transparency helps market participants to anticipate and qualify bad news and lessens the probability of panic and contagion.

4. Constraints on Transparency

One must also note that there is a dichotomy between transparency and confidentially. The release of proprietary information may give competitors an unfair advantage; a fact deters market participants from full disclosure. Similarly, monitoring bodies frequently obtain confidential information from entities. The release of such information may have significant market implication. Under such circumstances, enterprises may be reluctant to provide sensitive information without the condition of client confidentiality. However, unilateral transparency and full disclosure contributes to a regime of transparency, which will ultimately

benefit all market participants, even if in the short-term, a transition to such a regime creates discomfort for individual entities.

5. Transparency in Financial Statements

The objective of financial statements is to provide information about the financial position (balance sheet), performance (income statements), and changes in financial position (cash flow statement) of an entity. The transparency of financial statements is secure though full disclosure and by providing fair presentation of useful information necessary for marking economic decision to a wide range of users. In the context of public disclosure, financial statements should be easy to interpret. While more information is better than less, the provision of information is costly. Therefore, the net benefits of providing more transparency should be carefully evaluated.

The adoption of internationally accepted accounting standards is necessary measured to facilitate transparency and proper interpretation of financial statements. The International Accounting Standards Committee (IASC) developed a *Frame-work for the Preparation and Presentation of Financial Statements,* published in 1989. This framework includes:

- List concepts: underlying the preparation and presentation of financial statements to external users;
- Guide standard-setters in developing accounting standards and
- Assists preparers, auditors and users interpreting International Accounting Standards (IAS) and dealing with issues not yet covered by such standards.

According to the international standards, financial statements are normally prepared assuming that the enterprise will continue to operate as a going concern and that events are recorded on as accrual basis. The effects to transactions and other events are recognized when they occur. Then they are reported in the financial statements of the periods to which they relate.

Qualitative characteristics represent those attributes that make the information provided in financial statements useful to its users. If comprehensive useful information is absent, even managers may neither be aware of the true financial condition of their enterprise nor may other key players be misled. The application of the principal qualitative characteristics and of appropriate accounting normally results in financial statements that give a true and fair presentation.

The key qualitative characteristics are:

- Relevance: The information is relevant when it influences the economic decisions of users by helping them evaluate past, present and future events or to confirm/correct their past evaluations. The relevance of information is affected by its nature and materiality (which is always the threshold for relevance). Overload information can obfuscate information, making it hard to sift though the relevant nuggets making interpretation difficult.

- Reliability: Information should be free from material errors and bias. The key aspects of reliability are faithful representation, priority of substance, neutrality, prudence, and completeness
- Comparability: Information should be presented in a consistent manner over time and consistence between entities to enable users to make significant comparisons.
- Understandability: Information should be readily understandable by users who are expected to have a reasonable knowledge of business, economics and accounting and willingness to study the information with reasonable diligence. The process of producing useful information includes a number of decision aspects, which may constrain the amount of information provided. These included:
- Timeliness: A delay in reporting may improve reliability at the cost of relevance.
- Benefit vs. Cost: Benefits derived from information should normally exceed the cost of providing it.
- Balancing of Qualitative Characteristics: to meet the objectives of financial statements and make them adequate for a particular environment. Providers of information must achieve an appropriate balance among qualitative characteristics.

In the context of fair presentation, it is better to disclose no information than to disclose misleading information. It is therefore not surprising that, when an enterprise does not comply with specific disclosure requirements, International Accounting Standards would normally require full disclosure of the fact and the reasons for non – compliance.

6. Transparency through Accounting Principles or Detailed Accounting Rules?

The IFRS implementation for the European Union demand clear principles, destined to serve the public interest, consolidates rules that show the manner these principles should be applied for certain situations. This approach manner promotes the firmness and transparency and helps the companies to answer properly to complex situations regarding the new evolutions of the business practice. Regarding the disadvantage of the principles based approach (the possibility of a higher level of creativity) and also the disadvantages regarding the detailed principles bases approach (the suppression of initiatives, the creation of false and harmful impression that if you follow the rules everything goes well); we consider that the exclusive approach manner, principles bases or rules based, cannot be sufficient for realizing quality works and accurate reports.

In our opinion, a correct union of the two approach manners assures a quality settlement.

7. Qualitative Characteristics of Financial Situations and Costs-Benefits Constraints

The qualitative characteristics of financial situations are: the perception, relevance, credibility and compatibility. The credibility consists of the presentation fidelity, the prevalence of the economic over the juridical, the exhaustively, neutrality and caution. The credibility suggests that all these build cost / profit constraints and that in practice there will always be compensation among these characteristics. The general frame does not include explicitly a "devoted and correct" presentation demand, but specifies that the specified qualitative characteristics application should lead to situations that present in a correct manner or which should be devoted and correct. In spite of all these the IAS 1-The presentation of financial situations – refers to the devoted and correct demand.

The transparency is to be found in the middle of the assets and debts definitions. In the IASB opinion, an asset represents "a controlled resource by the company, as a result of certain events in the past and whose future economical benefits are waited to come back to the company". A debt represents "the current obligation of the company occurred as a result of certain past events, its cancellation being waited to produce for the company resources fusions that gathers future economical benefits". The owned capital represents a residual value reached after the debts deduction from the assets. Neither the assets nor the debts are recognized in the financial situations – except the case when the have values or costs that can be credibly evaluated

8. Transparency, Fiscality and IFRS Adaptation Impact on the European Union: Companies

The effect of passing to IFRS will vary from one country to another and from company to company. The general accepted accounting principles – GAAP – from many European countries have been developed for fiscal purposes so that the principles vary from one state to another. The modification regarding the accounting principles can represent significant modifications for the profit and loss situations and the balance sheets. One of the most important effects of the imminent passing of IFRS will reflect upon the legal relations of the companies. The companies must realize the proper presentations for the interest holders in order to properly explain the modifications, the impact and the fiscal aspects connected to the transparency of the financial situations.

9. Conclusions

The transparency through IFRS applications represents a European common fiscal basis.

The main approached problems used to solve the difficult subject, built from the fiscal harmonization in Europe referred to the elucidations regarding transparency and the European fiscal basis concordance, as it follows:

- the present adaptation procedure of IFRS standards, by the member states must be complete and modified in order to provide a pattern having common fiscal objectives;

- the IFRS standards are too much orientated towards the investors' needs satisfaction to represent a starting level for the income of the calculated basis;
- the significant importance principles of the correct value contradict the fiscal principles.

Generally, the term of common tax basis received a favorable agreement, emphasizing that the IFRS standards might constitute a neutral starting level, and debates regarding the tax basis might occur.

References:

1) *Accountancy International Standards* – 2002, Ed. Economică, Bucharest.
2) Belverde E. Needles, Jr. şi colab., 2001, *Basic principles of Accountancy,* ed. a V-a, Ed. Arc. Bucharest, Romania.
3) Curtis, P., Thalassinos, J., 2005, *Equity fund raising and „creative" accounting practices: Indications from the Athens Stock Exchange for the 1999-2000 Period,* European Research Studies Journal, Vol. VIII, issue 1-2.
4) Gheorghe Lepădatu şi colaboratori, 1998, *Accountancy Law*, Ed. Tribuna Economică, Bucharest, Romania.
5) Hattingh C. P.*,"Financial Accounting Course – One Page Summaries",* Randburg: PC Finance Research CC.
6) *International Standards in Financial Reports (IFRS)™* , 2006, - including the international Standards of Accountancy (IAS)™ and their interpretations at 01.1.2006. Ed. CECCAR, Bucharest, Romania.
7) *Law № 82/1991 – The accountancy law and its updated modifications*, Romania.
8) Levis, R., Pendrill, D., "*Advanced Financial Accounting",* 40th ed. London, Pitman Publishing.
9) Lepădatu Gheorghe, Minică Boajă, 2006, *International standards of financial reports- Fundamental definitions,* Ed. CERMAPRINT, Bucharest, Romania.
10) Liliana Feleagă (Malciu), Niculae Feleagă, 2005, *Financial Accountancy – A European and International approach,* vol. 1-II, Ed. InfoMega, Bucharest, Romania.
11) *OMFP № 1752/17.12.2005, regarding the approval of accountancy regulations according to the European orders*, published in the Official Monitor № 1080 bis, part 1/30.12.2005, Romania.
12) Thalassinos, E., 2008, "Trends and Developments in the European Financial Sector", *European Financial and Accounting Journal,* vol. 3, no. 3, pp. 51-68.
13) Vorster, Q., Koen, M., Koornhof, C., 2000, *Descriptive Accounting,* 5th ed. Durban, Butterworths.
14) Wiley IFRS, 2005, *The interpretation and applications of international standards of Accountancy and Financial Reports* (Copyright, 2005, Jonh Wiley, & Sons, Inc.), BMT Publishing House, Bucharest, Romania.

APPENDIX

FIGURE 1: How transparency is secured through the IAS framework

TRANSPARENCY IN FINANCIAL STATEMENTS

OBJECTIVE OF FINANCIAL STATEMENTS

To provide a fair presentation of:

- financial position
- financial performance
- cash flow

TRANSPARENCY AND FAIR PRESENTATION

- fair presentation achieved through providing useful information (full disclosure) which would secure Transparency
- fair presentation equates Transparency

SECONDARY OBJECTIVE OF FINANCIAL STATEMENTS

To secure **transparency** through a fair presentation of **useful** information (full disclosure) for decision making purpose

ATTRIBUTES OF USEFUL INFORMATION

- **RELEVANCE**
  = nature
  = materiality
- **RELIABILITY**
  = faithful representation
  = Substance over form
  = neutrality
  = prudence
  = completeness
- **COMPARABILITY**
- **UNDERSTANDABILITY**

Timeliness

Benefit vs. Cost

Balancing the qualitative characteristics

UNDERLYING ASSUMPTIONS

Accrual basis — Going concern