Challenges of Financial Reporting

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Abstract: In this article we consider urgent challenges of financial reporting including such important issues as confidence, future, reliability and transparency. We also explore causes of these issues, review real-life examples and suggest lasting solutions.

Key words: Financial Statements • International Financial Reporting Standards • True and fair view • Predictive value • Comparability.

INTRODUCTION

Accounting and Financial Reporting are experiencing turbulent times facing multiple challenges, to a certain extent this is the consequence of the currently poor state of economy. Even though each accounting system has its own issues, the modern challenges are international and are equally acute to US GAAP, IFR or Russian accounting standards. We believe the following four issues are the most important global challenges in need of global solutions:

All four challenges are interrelated, flow from one another and require an all-inclusive approach. Under the current state of economic development, sophistication of accounting systems, communication mechanisms and information environment, i.e. under the current state of civilization, all these four challenges are unlikely to be fully resolved.

Tasks which arise from these global challenges are also not likely to be fully resolved - they can only be permanently worked on, until a principally new accounting approach is developed - “tomography of reporting entity”. We believe the modern reporting is on the verge of revolutionary change and probably within next 20-30 years it will not resemble today’s accounting.

Confidence: This challenge is the result of multiple causes. The most significant causes are highlighted below:

• Complexity of accounting rules for users hampers understating of reported numbers (how the results are calculated? which data was used in the process?). This incomprehension usually makes users doubt reporting accuracy.
• Imperfection of reporting rules results in ambiguity, lack of logic and focus and so on.
• Frequent changes of accounting rules. Even though the changes are aimed to win the users’ trust and usually improve reporting quality, they are perceived by many as a negative development - as an attempt by accounting profession to veil true state of affairs of reporting entity to hide impotency of accounting science. As Vicky Cole and Joël Branson note comparability is one the pressing issues in the changing accounting environment [1].
• Intentional distortion of numbers or disclosures in financial reporting are wide-spread internationally (unintentional distortions are primarily the consequence of three above-mentioned causes).
• Intentional and unintentional auditors’ errors. In this case both come together, since the later is perceived by users as a result of low quality audit or inability to achieve high quality of audit in principle.

The first three causes are connected with the reporting rules, the fourth - with the reporting process, the fifth - with the financial audit. Improvement of reporting rules addresses the first three causes. However this is a
Table 1: Global challenges of accounting and reporting

<table>
<thead>
<tr>
<th>Challenge Issue</th>
<th>Description</th>
<th>Task to solve</th>
<th>Possible approach</th>
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<tbody>
<tr>
<td>Confidence</td>
<td>Decline of users’ confidence in financial statements, especially following the 2008 financial crisis</td>
<td>The need to enhance (win back) users’ confidence</td>
<td>Increase in quality and extent of disclosure; Increase in quality and extent of disclosure; increase of interest of reporting entities in users’ confidence in financial reports.</td>
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<tr>
<td>Future</td>
<td>Insufficient forecasting value of financial reports. Users of financial statements expect to retrieve information useful to construct forecasts, crucial in investment decision making</td>
<td>Improve forecasting power of financial statements</td>
<td>Use of fair value and fair value models, use of estimates of expected losses rather than historic losses.</td>
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<td>Reliability</td>
<td>Inability to report the actual state of affairs of reporting entity using current accounting rules does not meet the users’ requirement for the most reliable information on the entity.</td>
<td>Constantly improve accounting rules and methods, change priority of accounting principles, introduce new methods and rules in order to bring the financial reports closer to economic substance.</td>
<td>Reinforcement of accounting principles - substance over legal form, reporting of economic substance of events.</td>
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<tr>
<td>Transparency</td>
<td>Common for many entities secrecy in financial reporting, strictly formal adherence to the regulator requirements on disclosure; tendency of regulator to minimize reporting requirement, following regulator’s expectations that entities will use all available loopholes to avoid undesired disclosure of information, considered by them as confidential.</td>
<td>Improvement of accounting rules towards greater reporting transparency. Change of public opinion in favor of transparent entities.</td>
<td>Increase of disclosure requirement. Introduction of Transparency ranking not only for reporting entities, but also for financial auditors and analytics agencies, rating agencies.</td>
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general and trivial recipe: in development of new rules (or amendment of existing rules) it is necessary to combine the incongruous:

- Simplicity, necessary for correct execution and comprehension, with complexity, flowing from the need for the most accurate reporting of substance of complex economic activity of reporting entity (Reliability);
- Durability of rules, which ensures consistency of calculations, with permanent changes - keeping up-to-date with economy, users’ expectations, accounting practices and theory;
- Conciseness of reporting, following the need to limit information volume to adequately comprehensible level with the need for many detailed explanations (inflation of reporting volume);
- The need for universal set of reporting rules with the need to address specific individual cases, which by definition is impossible to squeeze in a one-rule-for-all (see also reliability).

These are only the most obvious hurdles faced by rule-setters, there are many other obstacles.

Considering the fourth and fifth causes, one will recall well-known cases of reporting fraud by large companies. Some cases were burdened by conspiracy with auditors. There are many ways to distort financial statements. In response to new rules by regulator managers can develop new ways to bypass them. For example let’s considers a rent situation. In case a premises rental agreement has a one year term (in the case of an absence of any other lease evidences under IAS 17 “Leases” [2]) it must be reported as an operating expenditure, i.e. there are no liabilities on the tenant’s balance sheet. However every year a new rent agreement can be made to replace an expired one. Thus the tenant may occupy the premises over the most part of its economic life, i.e. be in fact in a financial lease contact, while reporting it as an operating rent. Such a case can not win trust of the reporting users’. Even though, the IFRS lease reporting rules are currently being reviewed and there is a new draft for the standard “Leasing”, it is highly likely that a walk-around for the new rules has been found already.

There must be an interest in winning users’ trust from the side of: rule-setters, reporting entities, auditors. It is also important to have government interest and involvement. For reporting entities in the Russian Federation it is especially critical to win trust of the users’ of financial statements. Moving closure to international best accounting practices helps increase strength of local capital markets as demonstrated by Daniel Zeghal and Karim Mhedhbi, in their research [3].

Future: Some researchers note historic accounting as the main issue of reporting [4]. In our opinion, this issue largely has already been addressed, at least to the extent possible in the current state of civilization. It is already impossible to define financial reporting as retrospective, since it incorporates information on the future and seriously attempts to report on the future. Even though, especially following 2008 financial crisis, there is continuous flow of criticism for accounting in general and accounting rule-setters in particular. For example, L Karaseva [5] noted that on “IFRS Foundation
In June 2012 in Germany there were critical speeches by financial analysts, who asserted that current accounting rules had not contributed to forecasting function of financial reporting. Possibly, there are issues not only with accounting, but also with analysts’ approach: analysts’ perception of accounting rules and adjustment of analysis to recent economic and accounting developments. Statement of Total Comprehensive Income and Other Comprehensive Income have been around in IFRS for over 4 years, obviously these measures have not been used by analysts to the full extent. However, attempts are being made to evaluate their use in forecasting (see research by M. Humayun Kabir and Fawzi Laswad) [6]. In many facets, future is based on the past; modern accounting rules use the past events as the basis to make forecasts for the future of reporting entity. Although, universal uncertainty in general and uncertainty of the World’s economy in particular do not allow for perfect forecasts; one would agree that in case if all accounting rules are adhered to by reporting entity, the future could be seen in every reported number and even more so in every reported disclosure.

This comes out in the following two important aspects: (1) reported numbers disclose the future of the reporting entity; (2) reported number are arrived at using information on the future.

Using several examples let’s trace how historic accounting transforms into perspective accounting.

Statement of Assets, Liabilities and Equity (Balance Sheet) - future forecasts appear in expected inflows and outflows of economic benefits (e.g. cash inflows and outflows). Categorization of assets and liabilities into short-term and long-term provides users with understanding of timeframe for the benefits flows: which flows are expected within one-year period and afterwards. In some cases, additional disclosure gives even more detailed understanding of timing of expected flows.

Separation of different types of assets and liabilities allows to understand the types of transactions which will result in expected inflows and outflows of economic benefits. For instance, balancesheet value of fixed assets is arrived at using expected period of economic usage - which is an estimates of the future, this is a common approach in accounting. The wide-spread use of fair value and gradual decline of historic values - these are steps in transformation of historic accounting into future-based reporting. The commonly recognized feature of management accounting - forecast-orientation has been becoming a unifying force for financial and management accounting.

The Draft of IFRS concepts [7] sets “relevance” as one of the fundamental principals of financial reporting. Relevance is achieved if new forecasts are made and past forecasts are confirmed. This premise guides changes in existing rules as serves as a basis for new IFRS reporting rules.

Yet another example of the future orientation, is the transition of valuation rules for financial instruments from the actual losses basis to the model of expected losses. If in the actual losses model is based on past events, for the expected losses models past events are not necessary. The future based financial reporting improves management practices, since not only it requires development of plans and forecasts, but also requires constant monitoring of all changes. In some cases, future based reporting demands a thorough approach to information gathering and methods selection, demands a consensus decision making.

Reliability: It is virtually impossible report the 100% true state of affairs of a reporting entity using current accounting methods, we can only expect to get as close as possible to the reality. The level of achieved proximity to reality depends on both rules and standards and correctness of application of these rules. One of simple examples of the current IFRS trend of moving closer to substance is the renaming of Balance Sheet Statement into Statement of Financial Position. Yet another more obvious example is the change from the Income Statement to Statement of Comprehensive Income, i.e. introduction of new result measurement - total income, which is the sum of realized and unrealized profits and losses under all accounting methods. This example could be considered in the context of the issue of the “Future” discussed above. Comprehensive Income, which includes unrealized gains, assists on one hand to forecast expected future, on the other hand, discloses fully financial results for the reporting period.

The next example - recognition of control for consolidation purposes in accordance with IFRS 10 “Consolidated Financial Statements” [8]. Rather than rely on formal attributes, IFRS 10 sets the rules in a way that facilitates recognition of the real situation with control, since the financial reporting users’ for the purposes of their own decision making are seeking to understand the real structure of reporting group. The new IFRS 10 “Consolidated Financial Statements” is an attempt by IASB to redirect accounting rules towards greater recognition of economic substance.
Thus we can now define the dilemma: Financial Reporting is either “objective” numbers, which do not uncover the reality, or “subjective” data, which gives insight into economic substance. Since it is impossible to report on all diversity of economic activity using universal set of rules, it is necessary to employ professional judgment to account for individual features, however judgment is subjective by definition. Therefore, the way to enhance reliability of financial reporting lies in extension of the use of professional judgment and introduction of a framework for application of professional judgment. We believe a special accounting standard is required to thoroughly guide exercise of professional judgment and provide corresponding disclosure. Professional judgment rules will probably narrow the level of subjectivity thus increasing objectivity of financial reporting. In addition, education for accountants, economists and financers must be adjusted in order to instill professional judgment skills. Thus, naturally subjective professional judgment will contribute to realism of reported financial position financial results.

Transparency: There is an obvious trend towards greater transparency in economics and society in general. Both businesses and governments are under pressure to meet transparency demands. The idea of greater transparency is increasingly becoming the main axis of modern civilization, through the rapid development of mass-media, mass-communication and greater access to retail investors. As Mohsen Souissi and Hichem Elhifi demonstrate in their research the high transparency level reduces cost of equity [9].

In the wake of the transparency trend, managers are in search for new ways for qualitative and quantitative improvements in financial reporting and disclosure. At the same time investors and other users of financial reports are increasingly considering transparency is an expected attribute, rather than an unexpected exception, thus pushing secretive entities either to follow the new trend or to yield the way (surrender their market place) in favor of more transparent competitors. We believe transparent financial reporting should be based on the following principles: accessibility, voluntariness (motivation), timeliness, efficiency, consistency, reliability, audit ability, flexibility, materiality, standardization, mutual trust. In our opinion, areas for immediate improvement of financial reporting transparency are: quality and extent of accompanying disclosures (now applicable to many reporting entities, including small and medium enterprises in IFRS; increase in disclosure requirement in national accounting systems); adaptation of existing accounting rules for greater transparency; increase in transparency of the process of financial reporting. As noted by Sheraz Ahmed, users’ perception of lack of transparency in Russia significantly reduces potential to attract investors [10].

All four financial reporting issues considered above (confidence, future, reliability, transparency) are acute globally. They are especially important for Russia, due to their natural connection to greater economic problems - improvement of investment climate, improvement of competitiveness of Russian enterprises.

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