The Impact of International Accounting Standards on Firms

Marjan Petreski

Abstract

The aim of this paper is to provide some arguments for the effects of the adoption of the International Accounting Standards on firms. Therefore, IAS impact on firms' management and financial statements are analysed. Provided financial statements intend to support or reject findings in the literature for IAS effects on them.

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Introduction

International Accounting is a field of academic interests which has significantly risen in the last couple of years. As such, it triggered heated debate among economists for putting forward different issues arising from the still vague boundaries of this scientific and practical area. The latter becomes important especially in emphasized conditions of international integration of firms, which in turn, provides them with more opportunities to approach new markets and therefore to increase their sales, and, of course, to obtain financing from the multinational financial markets. The last is accompanied with many obstacles. From the view of the accounting, outrunning those impediments calls for harmonization of international accounting (Combarros, 2000). Rudhede and Wahlberg (2003) accentuate the lack of accounting synchronization and relate this with the investors' and companies' difficulties in understanding the variety of accounting principles among countries.

Hence, a supranational entity is needed to be titled for preparing, issuing and interpreting internationally accepted rules for the accounting practice. Such body is The International Accounting Standards Board, which is "*committed to developing, in the public interest, a single set of high quality, global accounting standards that require transparent and comparable information in general purpose financial statements.*" (IASB, 2002, p.1). International Accounting Standards, though, create a common language for defining, interpreting and publication of financial statements in the whole world (Blanc, 2003). Furthermore, their aim is "to provide a standardized and coherent sight of the companies to the shareholders and investors" (p.4).

Establishing International Accounting Standards should enhance firms' performance in many ways. Houston and Reinstein (2001) point out that international accounting harmonization will trim down the costs of doing business, especially across national borders, than will contribute towards greater efficiency of the market regulations and will reduce the costs for conducting financial statements analysis and investments in international context.

For the purposes of this paper, the effects of International Accounting Standards' (IAS) adoption on firms are considered in two directions: their impact on the firms' management and their influence on financial statements. Hence, the remainder of the paper is organized as follows: firstly, the IAS effects on management and decision making process are examined referring to the available literature and an interview with a financial manager. Than, IAS impact on financial statements is discussed in general; and, in the last section

Balance sheet and Income statement before and after adoption are presented and main changes under IAS are discussed.

IAS adoption effects on firms' management and decision making processes

Even though the main objective of the IAS is achieving convergence in presenting fair picture for the businesses through their financial statements (which aspect is analysed later), however, accepting IAS has broader impact on firms. For instance, Karamanou and Nishiotis (2005) found that adopting IAS, because of the higher disclosure required, is associated with viewing the firm as entity with high value. Moreover, this is considered as reputation building effect (Karamanou and Nishiotis, 2005). Wilson (2001; cited in Rudhede and Wahlberg, 2003) emphasizes the improved market communication of the firm which has adopted IAS, because every disclosure should be further explained by the management. Deepening the last conclusion, it infers that by adopting IAS, management becomes more accountable for running the business and its results.

Following this line of thinking, on the other hand, IAS adoption could be considered in regards to the management and decision making processes in the firm itself. I asked Mr. Boseski, a financial manager in a company which has adopted IAS some years before, to compare management and decision making process in the firm which he works for, before and after IAS adoption. According to him, the main advantage of accepting IAS for the firm's management process is the availability of relevant, crucial and accurate information, which in turn are the platform for making good and accurate decisions. Indeed, compliance to IAS in the firm provided "more understandable, comparable, unified and valid information for the assets, liabilities, equity, revenues and costs", said Mr. Boseski, and therefore enabled solid basis for acquiring valid information for the firm. Moreover, according to him, this further afforded investors to make more reliable estimations for the firm when they attempted investing in it last year. Literature also (Dumontier and Raffouriner, 1998) supports this view, emphasizing that the IAS-complied firm supplies superior information, which in turn helps in attaining better financing conditions.

"Another important area where IAS adoption was effectuated in our case was the opportunity of other firms – our business partners, which have adopted IAS also, to precisely

assess our company, in regards to the potential risk in the business relations, but also in regard to the possibility of eventual further mergers and making our business activity broader in the future" – says Mr. Boseski. Moreover, the IAS adoption facilitated the firm in making comparisons with the competitors on a sustainable basis; this further evoked confident information for its position in the branch.

In the above line of thinking, some articles (Karamanou and Nishiotis, 2005; Easley and O'Hara, 2004 and Gebhardt et al, 2001) found that greater disclosure under IAS decreases the cost of capital. For instance, Easley and O'Hara (2004, cited in Karamanou and Nishiotis, 2005) state that firms that applied IAS have the opportunity to impinge on their cost of capital, through the IAS selection and the adopted policies of corporate disclosure. Furthermore, Gebhardt et al (2001) confirmed that firms with accurate information provided on IAS basis, "enjoy a lower implied cost of capital" (p.6).

At the end of the interview, Mr. Boseski agreed that IAS adoption added value to the firm, but the main implications of IAS adoption, according to him, are better firm's financial reporting and decreased cost for financial statements' preparation. Barth et al (2005) supports the view that adopting IAS improves financial reporting. In fact, all above discussion has its root in the firm's financial statements' preparing and reporting. Thus, much more attention in the following sections is devoted to the IAS impacts on financial statements.

IAS adoption effects on financial statements

Theoretical aspect

Although IAS adoption effects could be considered in many ways, the core IAS influence on a firm which has accepted and implemented them, is to its financial statements. "Examining financial statement implications is important because, while IAS adoption might lead to indirect economic consequences … the only direct effects … are changed financial statements …" (Hung and Subramanyan, 2004, p.4). Indeed, many companies, accepting IAS, face with the facility to implement new accounting definitions and valorization principles and procedures, than to acquire more exhaustive and detailed reporting for their operations and activities and finally, to satisfy the needs for a variety of financial statements' users (Blanc, 2003). Besides these facilities, by not allowing the creation of hidden reserves, IAS make financial statements more credible (Dumontier and Raffouriner, 1998).

Some articles (Hung and Subramanyan, 2004 and Barth et al, 2005) have examined the effects of adopting IAS on financial statements, particularly on some accounting measures and financial ratios. For that purpose, for instance, Hung and Subramanyan (2004) have used a sample of 80 firms in Germany that have adopted IAS for the first time and found some significant results. Specifically, they found that the total assets and the book value of equity are considerably higher under IAS and that the latter plays more significant, while the former less significant "valuation role under IAS" (Hung and Subramanyan, 2004, p.36). Finally, they have concluded that "IAS emphasizes fair values and balance sheet valuation" (p.36).

In the same line of thinking, Barth et al (2005) found that companies that have adopted IAS experience more volatility in net income. Further, they found that these firms "evidence less earnings management, more timely loss recognition and more value relevance of accounting amounts" (p.5), compared with firms that haven't adopted IAS.

Due to the lack of available literature for this topic, further a case study is examined, where implications of certain IAS on financial statements' figures are pointed out.

Case study: Saint-Gobain Key Impacts of the IAS application

In order to see the impact of adopting IAS on financial statements, in this section a case study is analysed. For that purpose, Saint-Gobain Group is chosen. Saint-Gobain Group is a world-wide producer of high-tech products and comprises more than 1200 consolidated companies all over the world (Saint-Gobain Group web site). Operating in various countries and various accounting environments, this group needed compliance with IAS (IFRS) in order to achieve more reliable picture for its world-wide business. Therefore, IAS were applied retroactively on the opening financial statements at the date of adoption – 1st January, 2004 (Saint-Gobain Group, 2005). Restated financial statements' figures are shown in the appendices. They are obtained from the Annual Report 2004 for Saint-Gobain Group. Further, changes under concrete IAS that mostly influenced them are analyzed.

Impacts on the Balance Sheet

The main impact on Group's financial statements of switching to IFRS is on the opening Balance Sheet. As it can be seen from the Appendix-1, the key changes are (Saint-Gobain Group, 2005):

- Decrease in shareholders' equity for 7,6%;
- Increase in debt for 11,7%; and therefore
- Increase in gearing ratio, from 46,5% under GAAP to 57% under IFRS.

Further analysing these effects of adopting IFRS, the following could be inferred. The main impacts of accepting IAS on opening Balance Sheet, besides IFRS-1, are:

- Decrease in goodwill under IFRS-3, which is due to the re-measuring the foreign operations according to IAS-21 and also, the negative goodwill cancellation;
- Increase in property, plant and equipment, which, when applied IAS-16 comes up with a greater figure, mainly reflecting the retrospective increase in the useful lives of these assets and also the resulting write-back of depreciation. Here, the Group has applied the depreciated cost method (Saint-Gobain Group, 2005) set out in IAS-16, which directly results in an increase in the net book value of PPE at 1st January;
- Further, under IAS-38 – Intangible assets, retail brands are recognized as indefinite-lived intangible assets;
- Employee benefits recognized under IAS-19 - a decrease which is due to the "full recognition of cumulative actuarial gains and losses at 1st January, 2004" (p.105). Under this IAS, the Group passed on including the interest cost referring to pensions, which previously was included in operating items. The latter corresponds with reduction in shareholders' equity;
- Increase in deferred tax under IAS-12 which reflects all above restatements under the other applied IAS, but the main impact comes from the pension and post-retirement benefits under IAS-19; also the change is due to "a recognition of additional deferred tax on certain acquired retail brands, benefiting from a reduced tax rate" (p.108);
- Finally, in order to achieve more comparative figures, the Group decided on applying IAS-32 and 39 of financial instruments, which has resulted in certain-item increase.

All in all, a couple of standards have had *material impact* on Saint-Gobein's financial statements: IFRS-1 – First-time adoption of IFRS, IFRS-3 – Business combinations, IAS-16 – Property, plant and equipment, IAS-38 – Intangible assets, IAS-19 – Employee benefits, IAS-12 – Income taxes and IAS-32&39 – Financial instruments. All mentioned standards contributed for shareholders' equity decrease, shown in Appendix-1. The last is not convergent with the theoretical aspect discussed above.

All above IASs had certain impact on the net debt too. Not citing the specific reasons for such change, it could be inferred that the net debt has increased for 11,7%, resulting in *increase in gearing ratio*.

Impacts on the Income Statement

Main IAS-adoption impacts on Income Statement (shown in Appendix-2) are:

- Increase in sales and operating income and therefore increase in operating margin from 8,2 to 8,5%;
- Increase in net income for 14,4% (Saint-Gobain Group, 2005).

Operating income increases primarily reflecting the impact of IAS-19 and IAS-16: the former's influence is through the reclassification under financial income a portion of the pension cost, while the latter's influence is through the decrease in related depreciation charge because of the adjusted useful lives of PPE under IAS-16. Hence, the decrease in net financial income item in Appendix-2 is due to above mentioned reason (IAS-19). Furthermore, net income increases because of the elimination of goodwill amortization under IFRS 3. Indeed, this confirms what Barth et al (2005) found, that under IAS net income experiences considerable fluctuations.

This is the way of analyzing the general impacts of IAS on financial statements. It can be inferred that several (but not all) standards have significant impact on certain financial statements (here presented through Balance Sheet and Income Statement), which in turn, depends on firms' type, production, environment etc. Deepen analysis is needed to specifically quantify the effects of applying every single standard on firm's financial statements and management, of course.

Conclusion

Several conclusions could be derived from the above supplied arguments. First and the most direct effect of applying IAS is that on financial statements. The last section has shown that figures must be restated under IAS. Further, deepen analysis is needed to explore every impact that certain-standard adoption has on the financial statements. Every company could be significantly influenced from a couple of standards and hence these effects should be taken in consideration.

But, as stated above, not only direct, but adopting IAS has a lot of indirect consequences on firms. In this line of thinking, their effects on management and decision making process could be considered as important, than their impact on the cost of capital, on the availability of relevant and crucial information, on the management's accountability etc.

To sum up, the effects of adopting IAS on firms are multiple, positive and noteworthy. The very adopting process is accompanied with many obstacles, but than, IAS-complied accounting supplies more reliable picture for the business, and therefore contributes for a higher value of the firm.

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Interview

Mr. Dimitrija Boseski, Manager of Finance and Accounting, Printing House "11 Oktomvri" – Prilep, FYROM. Interview obtained on 05/12/2005

Appendices

Appendix 1: Overview of the impacts of IFRS (audited figures) on the Balance Sheet at 1st January and 31st December, 2004 (in EUR millions)

Item	January 1, 2004			December 31, 2004		
	French GAAP	**IFRS**	**Impact**	**French GAAP**	**IFRS**	**Impact**
Goodwill	49002	4755	(147)	5170	5203	33
Other intangible assets, net	1836	1756	(80)	1883	1804	(79)
Property, plant and equipment	8686	9085	399	8939	9367	428
Investments in associates	75	78	3	61	64	3
Available for sale and other securities	217	248	31	87	92	5
Other non-current assets	1521	346	1175	1375	252	(1123)
Non-current assets	**17237**	**16268**	**(969)**	**17515**	**16782**	**(733)**
Inventories	4509	4483	(26)	4838	4817	(21)
Trade accounts receivable	4240	4539	299	4467	4789	322
Other accounts receivable	1035	1030	(5)	1099	1070	(29)
Short-term loans	160	160	0	69	69	0
Cash and cash equivalents	2914	2913	(1)	2899	2898	(1)
Current assets	**12858**	**13125**	**267**	**13372**	**13643**	**271**
Total assets	**30095**	**29393**	**(702)**	**30887**	**30425**	**(462)**
Shareholders' equity and minority interests	11,310	10,214	(1,096)	11,806	10,910	(896)
Non-voting participating securities	170	0	(170)	170	0	(170)
Pensions and other post-retirement benefits	2,305	2,839	534	2,249	2,750	501
Deferred tax liability	599	249	(350)	548	238	(310)
Other liabilities	1,032	959	(73)	954	901	(53)
Long-term debt	6,518	6,680	162	5,396	5,629	233
Non-current liabilities	**10,624**	**10,727**	**103**	**9,317**	**9,518**	**201**
Trade accounts payable	3,592	3,570	(22)	3,967	3,954	(13)
Other payables and accrued expenses	2,356	2,290	(66)	2,659	2,556	(103)
Short-term debt	2,213	2,592	379	3,138	3,487	349
Current liabilities	**8,161**	**8,452**	**291**	**9,764**	**9,997**	**233**
Total liabilities and shareholders' equity	**30,095**	**29,393**	**(702)**	**30,887**	**30,425**	**(462)**
Net debt under French GAAP	(5,657)			(5,566)		
Net debt under IFRS		(6,359)	(702)		(6,218)	(652)

SOURCE: Saint-Gobain Annual report 2004

Appendix 2: Overview of the impact of IFRS (audited figures) on the 2004 Statement of income (in EUR millions)

Item	**2004**		
	French GAAP	**IFRS**	**Impact**
Sales and ancillary revenue	32,025	32,172	147
Operating income	2,632	2,743	111
Dividends from non-consolidated subsidiaries	3	3	0
Non-operating costs	(280)	(271)	9
Profit/(loss) on sales of assets and asset write-downs	(44)	(63)	(19)
Amortization of goodwill	(155)	6	161
Business income	2,156	2,418	262
Net financial income/(loss)	**(441)**	**(535)**	**(94)**
Income taxes	(603)	(616)	(13)
Shares in net income of equity investees	8	8	0
Net income before minority interests	1,120	1,275	155
Minority interests	(37)	(36)	1
Net income	**1,083**	**1,239**	**156**
EPS (in EUR)	3.18	3.63	0.45
EPS excluding treasury stock (in EUR)	3.23	3.70	0.47
Net income excluding capital gains	1,122	1,289	167
EPS excluding capital gains and losses (in EUR)	3.29	3.78	0.49
EPS excluding capital gains and losses and treasury stock (in EUR)	3.35	3.85	0.50

SOURCE: Saint-Gobain Annual report 2004