Financial Securies' Reporting: IFRS 7 Requirements Are Quite Strange… Are We Prepared? (From Czech Perspective)

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Financial instruments as such raise emotions and will continue to do so in future, as well. The accounting attitude toward the reporting of financial instruments according to IFRS is to a great extent connected with the fair or, in more specific terms, present values of these instruments. This is due to the fact that the standard issuing authorities aim at providing investors with the most up-to-date data at the moment of issuing the financial statements, with a reference to the actual development of the values of the company's assets on the market.

Since 2005 (due to E.U. Regulation 1606/2002), companies whose shares are traded on the public market are obliged to make reports pursuant to the IFRS in whole EU. This paper provides the analysis of the current situation with reporting of financial instruments under IFRS standards in the Czech Republic and stress the attention on reporting under fair value concept at not such active market...

Field of Research: Transitional Economies, Financial Reporting, Financial Instruments

1. Introduction

In 2002, the Council of the European Union issued an order imposing an obligation on companies listed on European stock exchanges to structure their consolidated final accounts according to the IFRS starting from the year 2005 at the latest. If it was not for these uniform accounting standards, there would be 27 different methods of accounting reporting by listed companies in the EU at present (Whittington, 2005, p. 129). Brown & Tarca (2005, p. 201) anticipate that the future of the IASB will definitely be connected with the successful introduction of the IFRS in Europe.
Though the IFRS are not considered as an equivalent method of structuring statements in the Czech Republic, the Accountancy Act establishes a legal obligation for certain accounting units to use the IFRS within the framework of financial statements. This exception applies to consolidating accounting units issuing stocks registered on a regulated securities market in the EU member states. Other consolidating accounting units are given the option to structure their financial statements pursuant to either the Czech standards or the IFRS.

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2. Literature Review

Research in the field of accounting harmonization has focused primarily on two basic aspects – the reliability and the correctness of the evaluation (e.g. Aisbitt, 2001; Emenyonu & Grey, 1992 and 1996; Herman and Thomas, 1995). According to Alexander & Nobes (2004), the following factors affecting the development of accountancy in a given country can be defined: colonial and external influences, impact of capital providers, character of the legal system, impact of taxation, impact of the accounting profession. The reasons why IFRSs are considered beneficial are as follows: facilitated access to foreign capital markets, improved credibility of supranational corporations on domestic capital markets, global comparability of accounting data, improved transparency, improved comprehensibility thanks to a "common accounting language", easier regulation on capital markets, reduced vulnerability of accounting standards to political pressures.

Before the IFRS standards were adopted in the EU, it was stock exchanges in particular which required that listed entities submit final accounts in compliance with the IFRS or US GAAP. The previous research dealing with the degree of disclosure (Cooke, 1992; Meek et al., 1995), or the probability of using supranational standards (El-Gazzar et al., 1999; Murphy, 1999; Ashbaugh, 2001; Dumontier and Raffournier, 1998; Leuz and Verrecchia, 2000; Leuz, 2003) indicate a positive correlation between the listing of accounting units on foreign markets and the degree of disclosure and use of supranational standards as the basis for accounting reporting.

The standards most widely discussed in terms of their practical implementation include namely: IAS 32 Financial Instruments: Presentation, IFRS 7 Financial Instruments: Disclosures, and IAS 39 Financial Instruments: Recognition and Measurement. The greatest benefit of the standard IAS 39 is considered to be the wide application of the fair value method to the measurement of financial instruments. It is true that for a long time, it was the historical costs which were considered as the principal basis of measurement and were also used in the field of reporting of financial instruments. Nevertheless, the importance and volume of derivative transactions, whose value would be zero if the historical costs model were applied, have been on the rise recently. Whittington (2005) therefore emphasises that it is much more appropriate to measure derivatives according to their present values reflected in the fair value through the application of the standard IAS 39.

Numerous studies have also dealt with the use of fair values in banks' investment portfolios. For instance, Riffe (1993) and McAnally (1995) analysed the information potential of the requirements of the US standard SFAS 105 for bank entities. Riffe (1993) proved that there was an important causal interaction between the values of off-balance sheet items and the value of the company's equity capital. Other studies aimed directly at the use of fair values for reporting of financial instruments. Barth et al. (1995) tested how the financial reporting at fair values influenced the volatility of the economic result and how it influenced the price of shares. They demonstrated that the revenues, as well as the amount of equity capital based on reporting at fair values were more volatile than in the event of accounting on the basis of historical costs, and that the price of the shares was significantly influenced by such added volatility.

Pirchegger (2006) is concerned with the fact that accounting units tend to note primarily the high level of disclosure obligations in relation to hedge accounting and the costs related thereto. On the other hand, the primary goal of the standard-issuing authority is the incontestable effort to provide investors with highly relevant information. The fact that the information on hedge accounting should form an indivisible part of the financial statements is motivated by the effort to assure investors that the criteria applicable to the field of hedge accounting were applied correctly rather than by the fact that the information on hedge accounting causes considerable additional costs to accounting units.

3. Methodology of Research

Some experts, however, express their concerns regarding the fact that the application of the IAS 39 leads to a certain degree of volatility within the framework of economic results and equity capital, and such volatility may differ from the real economic volatility. Previous studies (e.g. Leftwich, 1981), however, indicate that the application of different accounting rules is not usually connected with any movements of prices of financial instruments unless the application of such rules has further economic consequences.

Numerous studies in our professional practice have dealt with the bond between the economic and the accounting concept of hedging. Melumad et al. (1999), for instance, indicates that the application of hedge accounting in compliance with the US standard SFAS 133 leads to deviations from optimum hedging in the economic sense. However, Barnes (2001) draws attention to the fact that these deviations from economic hedging are the very consequence of the set hedge accounting model, pointing out that hedge accounting may motivate poorly performing companies to speculate and influence their economic results on a short-term basis.

Several studies have dealt with the information and control effects of hedge accounting (e.g. Jorgensen, 1997; Hughes et al., 2002). The most interesting finding lies in the fact that the voluntary application of hedge accounting leads to a deviation from the optimum hedging strategy (as opposed to the exclusive application of economic hedging without the application of the principles of hedge accounting).

4. Findings in the Way of Reporting under Czech GAAP

Similar rules apply to reporting equity securities, either realizable or intended for transactions, both in the Czech Republic and in the system of reporting according to the IFRS. The impacts on the balance are therefore identical as regards the Held for Trading and Available for Sales portfolios. The principal reason, however, lies in the fact that the IFRS information requirements are much more exacting. The illustrations of reporting long-term bonds (investor's position) indicate that the most important difference lies in the technique of discharging the remainders between the nominal value and the purchasing price of the bond (i.e. amortization of the discount or premium on securities). While the Czech accounting units give a strong preference to the linear distribution of these costs or revenues in time (often motivated by tax relations), the IFRS require definitely that the amortization be based on the effective interest rates. The principal differences in the reported economic results and accounting values of bonds in the respective years are also based on this fact.

This anticipation is certainly correct; nevertheless, the backbone of its applicability is a functional and highly transparent market, which seems not to be the case with the Czech market. It is true that the fair value is one of the evaluation bases in the Czech Republic; however, its determination is usually based on pricing models, not the market price. When comparing the evaluation bases of the IFRS and the Czech conditions, it should also be noted that long-term receivables may not be priced in current values (and, subsequently, amortized costs) pursuant to the Czech regulations, with not only short-term receivables and short-term obligations, but also those with a period of maturity exceeding one year having to be priced and reported in their nominal values by companies operating on the Czech market in compliance with the applicable regulations. The complete ignorance of the time value of money may therefore significantly affect (though in perfect compliance with the statutory requirements) the accounting statements and, eventually, misinform potential investors in the process of making investment decisions.

4.1 Shares

The Czech regulations require that accounting units re-valuate equity securities and ownership shares as at the balance date, applying either the method of equivalence or the fair value, depending on the type of portfolio in which the same are included. The fair value of the given instrument is always considered the optimum information; should it be impossible to determine it, the accounting unit uses an expert evaluation on the basis of an evaluation model. Unfortunately, the optimum situation, i.e. the derivation of the fair value from the market price, seldom occurs in the environment of the poorly transparent Czech stock market, and that is why other models usually have to be employed. The disadvantages of evaluation on the basis of net value include the differences in evaluation bases used in accountancy, as well as the fact that the application of the principle of precaution is preferred among Czech companies, and the impossibility of re-valuation of certain types of property to higher values (as distinct from the IFRS).

Deriving the information on the fair value from the P/E ratio seems to be a good method. Nevertheless, it should be stated that this model fails if the company shows a loss. Besides that, the indicator is hardly available to accounting units in the environment of the Czech market. The principal disadvantage of the dividend discount model lies in the presumption of a constant rate of growth of dividends, which is almost inapplicable in practice. Nevertheless, this presumption is applicable for the calculation of the expected dividend in the course of no more than two subsequent periods; on the other hand, this model fails if the accounting unit concerned does not pay dividends or shows a loss.

Accounting units in the Czech Republic may report equity shares in balance sheets in compliance with their purchase prices if it is impossible to determine the fair value in a reliable manner. Czech companies often opt not to use the equivalence method (to which the right of choice applies) to report capital participations with a significant or decisive influence, reporting them in compliance with their respective purchasing prices (applying adjusting entries if necessary). In the past, when the costs of re-valuating equity securities were allowable for tax purposes only to the amount equal to the revenues from such re-valuations, accounting units often criticised this system, clearly preferring the capital method of re-valuation.As the re-valuation of short-term equity securities has no impact on the tax assessment base at present, this problem has ceased to arise.

4.2 Bonds

The accounting reporting of bonds with a maturity period of less than one year does not show any significant discrepancies with the requirements of the IFRS standards. On the other hand, we should look with a critical eye at the fact that the reporting of these instruments with maturity periods exceeding one year is not consistent with the IFRS. The purchasing costs of investments in bonds increase uniformly with the discount/premium amortization; from the viewpoint of the issuer, however, it should be noted that these contracts are reported in their nominal, not current values. Accounting reports presented by listed and non-listed companies are not comparable in the field of reporting long-term investments in bonds. Accounting units might prefer the application of Article 7 of the Czech Accounting Act (563/1991) specifying true and fair view; nevertheless, the tax aspects play their role, too.

4.3 Derivative Contracts

The most serious problems in the field of reporting derivative contracts by entrepreneurs manifest themselves in determining the fair values of these instruments, as well as the fair values of off-balance sheet receivables and off-balance sheet payables. The fair value is considered (and defined) as the amount for which the asset could be exchanged or an obligation settled in a transaction between well-informed and willing parties under standard conditions. Nevertheless, the negotiation of derivative financial instruments has entailed and, as can be reasonably feared, will entail an information asymmetry between the enterprise and the company with whom the contract is negotiated. The overwhelming majority of entrepreneurs is unable to determine the fair values of their derivative contracts, fully relying on the information supplied by financial institutions with whom such contracts are negotiated. Unfortunately, in practice, companies often have only information on the fair values of such instruments, lacking any information on the fair values of off-balance sheet receivables and off-balance sheet payables arising from the negotiated derivative contract.

German and Austrian regulations, for instance, do not require the reporting of derivatives in the balance sheet, the reason being that these derivative contracts are considered by these regulations as uncertain transactions and therefore they are reported in the balance sheet only in the event of any imminent losses from such transactions. On the other hand, accounting units are required to specify the type and scope of financial derivatives held by them, and their fair values and methods of measurement. In relation to the accounting reporting and disclosure of information on derivative contracts, the following aspects should be mentioned: insufficient information disclosed, inconsistent approaches of companies to disclosing information – this applies not only to financial reports of various companies, but even to annual reports of single companies. Thus the comparison and analysis of the disclosed information is made very complicated.

The respective pieces of information on the structure of derivatives, their nominal and fair values, types of derivative instruments, their duration, development etc. are usually scattered throughout the annual report. The levels of detail differ, and every company reports data in a different form. For instance, the nominal value is reported with every type of derivative instrument, however, the fair value is reported in summary according to the risk hedged by the derivative concerned. Most accounting units in the Czech Republic declare in their financial statements that they do not use derivatives for speculative reasons. The problem of insufficient information on derivatives persists, carrying with it the risk of making it impossible to differentiate between speculative and hedging transactions, and enabling the misinterpretation of reports. The detailed description of the structure of derivatives allows for an improved detection of the purpose of derivatives. In this respect, it can be said that accounting units in the Czech Republic would find it very problematic to meet the requirements of the IAS 39 and IFRS 7 standards in the field of disclosing information on derivative contracts and their structure.

4.4 Problems Connected with the Facultative Application of Hedge Accounting

The greatest risk connected with hedge accounting, however, seems to lie in the field of testing the efficiency of hedging relations. Not only is the majority of companies practically unable to test their hedge relations, but they also fear (not without reason) that the given efficiency test will show that hedge accounting is not beneficial; in other words, the test result will not match the requested interval of <-80 %; -125 %>. It is undeniable that even if the fair-value option was applicable to a greater extent in the Czech Republic, companies would hedge only cash flows. This particular rule questions the long-term perspective of hedging the fair value, with the accounting units applying the fair-value option allowed to re-valuate an automatically hedged item (if it is a financial instrument) without having to meet the demanding conditions of hedge accounting.

As regards the accounting reporting of hedge relations, unfortunately, it must be said that the overwhelming majority of companies does not disclose detailed information on hedge accounting. The investor therefore usually lacks any information on the volumes of derivative transactions relating to the hedging of the fair value and the cash flow, respectively. Information on the method of measuring the efficiency of hedging relations and on the values of such efficiency is practically always unavailable. In addition, external users of accounting reports often find it unclear what part of the hedged nominal values was ineffective and how many hedge relations had to be terminated as a result of their ineffectiveness.

5. Conclusion

The accounting reporting of unlisted companies in the field of financial instruments is to a certain extent affected by requirements compliant with the IFRS international accounting reporting standards. In the field of equity securities, there are identical requirements for the initial recording of purchasing prices; nevertheless, the subsequent re-valuations are carried out in a different manner, depending on the comparability of the assignment of the individual tools to the respective portfolios. The adoption of portfolios applicable in international standards (HFT, AFS) and the subsequent application of identical requirements to them would be beneficial in the field of investments in equity securities in the Czech Republic.

In the field of reporting bonds, however, the level of compatibility between the IFRS requirements and Czech regulations is not significant. The issue of amortization of the reminders between the nominal values of bonds and their subscription prices is treated particularly inappropriately (though the solution is relatively elegant in terms of taxation). That is why the introduction of the Held to Maturity portfolio would be beneficial in the Czech Republic on condition that the tax consequences are resolved at the same time, i.e. that the premium amortization is fully allowable for tax purposes from the viewpoint of the investor purchasing a bond. Derivative contracts are recorded in the accounting system in compliance with the IFRS requirements. In this respect, a relatively significant problem lies in the fact that companies negotiating derivative contracts lack the appropriate information and knowledge, as well as in the fact that the amount of disclosed information on such contracts is insufficient.

Hedge accounting has become more popular in the Czech Republic lately. Primarily, such efforts are motivated by tax aspects, with the Income Tax Act establishing that the costs of derivatives negotiated for the purpose of hedging are fully allowable for tax purposes. Long debates in this field were evoked by the fact that it was unclear whether the provision of the law concerned meant the economic or the accounting concept of hedging. Thanks to that provision in particular, companies introduced the application of the concept of hedge accounting. The future of hedge accounting in the Czech Republic is connected to a great extent with the possibility of a wide application of the fair-value option. Accounting units in the Czech Republic clearly prefer the capital approach to re-valuating such hedge relations, which is also the reason of the great popularity of cash flows. The major problem of hedge accounting in the Czech Republic remains its practical implementation by accounting units, which are often unable to execute the hedge documentation, let alone measure the efficiency of their hedging transactions. This seems to be one of the grounds of the companies' unwillingness to disclose information on their hedging strategies and the respective hedging relations.

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