Impact of IFRS for SMEs Adoption on Performance of Czech Companies

PŘEMYSL PÁLKA, BOHUMILA SVITÁKOVÁ
Department of Finance and Accounting
Tomas Bata University in Zlín
5139 Mostní, 760 01 Zlín
CZECH REPUBLIC
ppalka@fame.utb.cz, svitakova@fame.utb.cz

Abstract: Paper deals with topic of international harmonization processes in accounting field. The main aim of a paper is to suggest convenient system for comparison of the results of chosen financial ratios which were calculated according to the rules of IFRS for SMEs and Czech Accounting Standards (CAS). Comparative study is presented and based on real data of a selected Czech company. There is also described the methodology for ratio calculation and comparison is described. The impact of a transfer of the Czech accounting statements on financial statements according to the IFRS for SMEs is analysed.

Key-Words: IFRS for SMEs; statements analysis; pyramidal breakdown; performance; DuPont analysis; comparative analysis

1 Introduction and Literature Review
Based on differences between IFRS and national accounting standards is evident that it is very important to build in these conditions to the system of financial analysis which needs to be adjusted to the new informational environment [6]. We strive to aim our research on key areas of accounting transformational process towards to the successful implementation of IFRS for SMEs, which are estimated to account in the future for over 95 per cent of all companies around the world.

In July 2009 the International Accounting Standards Board (IASB) issued IFRS for SMEs. The new standard is result of five years effort when the IASB was trying to adapt the “full IFRS” (primarily designed to the publicly traded companies) to other businesses. The final version of the standard is mostly based on the working draft that was released to the professional public to comments in February 2007. The result of pursuit is an independent and separate standard from the “full IFRS”. The main differences of IFRS for SMEs comparing to the “full IFRS” consist in the simplification of certain rules, skipping of the irrelevant rules for SMEs and reducing the requirements for disclosure of notes to the financial statements [4, 5, 9].

The procedure for the preparation of financial statements in accordance with IFRS for SMEs is as follows:

• recognize all assets and liabilities whose recognition is required by IFRS for SMEs;
• don’t report items such as assets or liabilities if IFRS for SMEs, do not allow them;
• reclassify assets and liabilities which were recognized under the previous financial reporting systems as one type of asset or liability in line with IFRS for SMEs;
• apply this standard for evaluating of all recognized assets and liabilities.

According to [7] SMEs sector plays a very important role in economy; it is a driving force of business, of growth, innovations as well as competitiveness. The biggest obstacle is the existence of 27 different systems of accounting within the European Union, which have to be harmonized [5, 11, 12]. Financial statements prepared in compliance with international standards may provide a high level of transparency and comparability [9, 10]. [6, 7, 8, 9] already pointed out the importance of harmonization and discussed the possible impacts to the performance indicators. [8] performed empirical analysis concerning reporting for financial instruments and documented the existence of a high similarity degree among IFRS and Czech Regulation.

One of the main objectives of financial analysis is to ensure the comparability of analyzed data. Despite all the efforts it is very difficult to achieve this objective, particularly at international level, where the legislation, economic environment, accounting policies and many other factors differ. Important sense of the world’s leading IFRS is to
compare statements prepared in conformity with IFRS rather than statements drawn up in accordance with the national accounting regulations of the country. IFRS provides users in many cases with quite a lot of freedom, e.g. choice of several correct options of accounting transaction and therefore, differences might arise in the same items of financial statements of different companies. Ensuring full comparability among similar companies is therefore never possible, even if the world recognized IFRS seeks the greatest possible comparability [6].

2 Problem Formulation

Assets should be increased with items that are not included in the Czech balance sheet and companies recognize it only within their sub-ledger records (usually concerning financial lease and other tangible and intangible assets). On the other hand we have to deal with the liabilities related to financial lease (long and short termed) as well. Changes will have relevant impacts upon revenues and costs that will affect profit created and accumulated.

2.1 Identification of Key Data of Transition to IFRS for SMEs

The primary sources of data are driven from the financial statements prepared according to the Czech accounting standards: the balance sheet and income statement. Based on these reports we strived to create the most appropriate way of transition that would facilitate the conversion process from Czech to IFRS for SMEs. Our first phase of research has already been done in field of identification of important (key) differences between both accounting systems. The key areas (see figure 1) of distinctions and primary data interpretation (from collected questioners) are shown as following:

Fig. 1 Essential areas of accounting defined within 115 Czech SMEs (30 – production, 29 – Trade, 56 – Services)

2.2 Selection of Appropriate Financial Measure

Accounting provides analyst with a statements that are primary informational input for their analysis. Selection of correct measures that would be used for analysis depends on several criteria, but mainly on following two:

- who is intended as a fundamental user of a results (targeted group);
- what is an essential goal of performed analysis?

The IASB has a long-running project on reporting financial performance that was proved to be very controversial, and the project is now part of a joint FASB project, Presentation of Financial Statements. The main original aim of the project was to improve the presentation of the income statement to include a comprehensive income measure, sometimes referred to as ‘clean-surplus’ income [3]. [1] examines the benefits and economic consequences of mandatory implementation of IFRS reporting and presents that there is an evidence of decrease in firm’s cost of capital and an increase in equity valuations.

Our selection accepts the shareholder point of view. Same as [2] we will concentrate on closer analysis of profit from the owner perspective. Detailed discussion and causes of variation in the measure as well as consequences are contained in publication [2] who proclaimed that the "quality" of earnings is a function of the firm's fundamental performance.

We analyse the value (in shareholder meaning) creation through the adopted and extended DuPont pyramidal breakdown of ROE (Return On Equity) ration. For our purpose when having two concepts of data processing seemed pyramidal breakdown of ROE, also known as the strategic profit model or the DuPont formula the most convenient. It represents a common way how to break down ROE into the
three important components (net margin, asset turnover and financial leverage). Splitting return on equity into three or more parts makes it easier to further analyze and understand changes in the top ratio (ROE). Priority is given to the owner’s perspective (shareholder value concept). That is mainly because of level of simplicity, which rapidly decreases with the more sophisticated models such as e.g. Economic Value Added which is registered trademark of Stern Steward & CO.

In the financial statements are presented the absolute values of each item. In order to analyze the interactions and connections between indicators, we put different absolute values into the mutual relationships. This logic creates the ratios that basically allow the comparison with other business or with industry averages, respectively competitors or accounting system (Czech regulation towards IFRS for SMEs). Thousands of slightly different financial ratios can be found in a variety of sources, some of which differ in only minor modifications and added to ROE pyramidal breakdown. However practical usage selected a group of generally accepted indicators, which allow creating a basic understanding of the financial situation of the enterprise.

3 Comparative Analysis

Comparative analysis is based on structure of pyramidal breakdown that is derived partially from the recommendation of Ministry of Industry and Trade of the Czech Republic and can be seen of the following figure 2.

**Fig. 2** Used structure of ROE pyramidal breakdown

![ROE Pyramidal Breakdown Diagram](image)

Source: authors’ analysis

Figure 2 describes the mathematical relations between each single indicator. The way of each computation is shown on table 1. Each ratio is numbered and the table 1 describes the ratios in order from 1 to 19. Calculation procedure shown on figure 2 arises from the structure and items of Czech financial statements. Unfortunately there are many differences in structure of IFRS’s statements. In order to be able to compare the results of both systems is needed to prepare common methodology for our analysis. We will now concentrate our mind on only the items that are directly required for our designed ROE break-down. Following table 1 summarizes the items under the Czech Accounting Standards and table no. 2 deals with the IFRS for SMEs accounting system.

### Table 1. Methodology for data inputs from statements according to the CAS

<table>
<thead>
<tr>
<th>Ratios</th>
<th>Symbol description</th>
</tr>
</thead>
</table>
| EAT Equity   | Net profit (loss) for the financial period (***)
|              | Equity (Total Liabilities and Equity site of the statement, section A.) |
| EAT Revenues | Content already described |
| Revenues     | Content already described |
| Assets       | Total Assets (Asset site of the statement, section A. + B. + C. + D.I.) |
| Equity       | Content already described |
| EBT          | Content already described |
| Revenues     | Content already described |
| Fixed Assets | Content already described |
| Assets       | Content already described |
| Total Liabilities | Content already described |
| Equity       | Total Liabilities (Total Liabilities and Equity site of the statement, section B.) |
| Financial Assets | Short-term Financial Assets (Asset site of the statement, section C.IV.) |
| Short-term Liabilities | Short-term Liabilities (Total Liabilities and Equity site of the statement, section B.III. + B.IV.2. + B.IV.3.) |
| Short-term Liabilities | Content already described |
| Total Liabilities | Content already described |
| Financial Assets | Content already described |
| Assets       | Content already described |
| Revenues     | Content already described |
| Revenues     | Content already described |
When comparing the two tables many differences resulting from different requirements of both systems can be found. The most important of which are described in more detail. Revenues Recognition – the Czech accounting proceeds strictly according to legal status, while for the IFRS for SMEs is important to meet the defined criteria. Within the IFRS for SMEs is also possible to report income according to the degree of long-term project completion. IFRS for SMEs distinguishes between "revenues" and "gains". Revenues are incomes that arise in the course of the ordinary activities of an entity and are referred to by a variety of names including sales, fees, interest, dividends, royalties and rent. While gains represent other items that are not included in revenues, but meet the definition of income.

The recognition criteria for intangible and tangible assets – in the IFRS for SMEs are crucial economic benefits, while in the Czech legislation is crucial if they match the list of conditions defined by law, the expected lifetime and the valuation has to be higher than the specified amount. For tangible assets is necessary that are held for use in the production or supply of goods or services. So, tangible asset has to be already put into commission. Other definitions of Property, Plant and Equipment (PP&E) are more or less identical to Czech accounting standards. The most problematic items to express and use for ROE-break-down under the IFRS are Cost of Goods and Interest Expense. Both of these items are not allocated separately in the statements. Cost of Goods is included in Income statement under the Cost of Sales and Interest Expense included in Finance Costs.

3.1 Calculations methodology description
Calculations according to the figure 1 with the data equivalent for CAS and IFRS for SMEs were done and each ratio is represented now with two results. We performed mathematical and statistical analysis on calculated ratios. Desirable structure of final data is as follows:

<table>
<thead>
<tr>
<th>Symbol</th>
<th>Ratio no. 1 - 19</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>In accordance with CAS</td>
</tr>
<tr>
<td>B</td>
<td>In accordance with IFRS for SMEs</td>
</tr>
<tr>
<td>C</td>
<td>Difference between CAS and IFRS for SMEs</td>
</tr>
<tr>
<td>D</td>
<td>Discrete yield</td>
</tr>
<tr>
<td>----</td>
<td>----------------</td>
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<td></td>
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</tr>
</tbody>
</table>

Methodology how to substitute values according to the CAS and IFRS for SMEs was already presented. Difference between both systems was calculated as its simple absolute difference.

\[ C = A - B \]  

(1)

Discrete yield was calculated according to the following formula:

\[ D = B / A - 1 \]  

(2)

For „E“ calculation we had to apply one of the methods of influence quantification on selected profitability ratio. Influence quantification analysis was made by applying functional method. Influences of individual indicators on basic ratio was calculated and compared.

Functional method can be introduced on the demonstrative multiplication of just only two ratios \( A_1 \) and \( A_2 \). Implementation of the method to our case was done analogically to the following:

\[ X = A_1 \times A_2 \]  

(3)

\[ \Delta x_{A_1} = \frac{1}{R_x} \left( R_{A_1} + \frac{1}{2} R_{A_1} R_{A_2} \right) \Delta y_x \]  

(4)

\[ \Delta x_{A_2} = \frac{1}{R_x} \left( R_{A_2} + \frac{1}{2} R_{A_2} R_{A_1} \right) \Delta y_x \]  

(5)

where:

\[ R_x = \frac{\Delta x}{x_0} \]  

(6)

\[ R_{A_i} = \frac{\Delta A_i}{A_{i,0}} \]  

(7)

\( R_x \) is discrete yield of \( x \)-ratio, and \( R_{A_i} \) is discrete yield of ratio \( A_i \).

4 Conclusion

Based on the proposed methodology and its application (in case study) to specific business conditions was proved that the conversion of the statements from CAS to IFRS for SMEs affects the results of financial ratios.

Main ratio “ROE” decreased by 0.74%. In terms of other indicators, 7 ratios were decreased and 12 indicators increased.

When examining the proportion of the difference to the ratio’s results is the average value of 1.29%, i.e. the average deviation is below 1.5% of the value of indicators. These differences can be then considered as insignificant. The examination was performed on a particular company.

In this case study we didn’t find significant differences between CAS and the application of IFRS for SMEs. There was proposed possible methodology for transition that would facilitate the conversion process from Czech to IFRS for SMEs. The main aim was to present convenient methodology for relevant comparison of both accounting systems which is done through the ROE pyramidal breakdown and influence quantification analysis that is well described.

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References:


