

THE ROLE OF FINANCIAL REPORTING FOR THE DEVELOPMENT OF BUSINESS: EVIDENCE FROM LATVIA

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Abstract. It is well known that the financial statement is the basic source of the financial information on the companies' activities in the business world. Not casually, Accounting is often said to be the 'language' of business. The purpose of the financial reporting is presentation of objective and useful information on activity of the company to the broad audience of users. To what extent the information contained in the financial statements is objective and useful is determined by two factors: regulation and presentation of statements. The given paper reveals the problems of preparation of financial statements by Latvian companies, which occur because of regulatory legislation's imperfection and its differences with international standards, and also because of its accounting practices. The aim of this paper is to provide recommendations on financial statement quality improvements, which would ensure adequacy of financial information disclosure on Latvian companies' activities and comparability of indicators of the financial reporting for international users. The qualitatively prepared financial statement, including the Intellectual Capital Report, the author considers as a factor, which ensures the strengthening of investment attractiveness of Latvian companies and development of Latvian business in the European market.

Keywords: Financial statement, International Financial Accounting Standards, Fair value, Report on Intellectual Capital.

1. Introduction

The introduction of the international accounting and financial reporting rules to practice of the Latvian companies took place on 1 January 1993 and was connected to the adoption of two Latvian laws, i.e. the Law 'On Accounting' and the 'Annual Accounts Law'. Since then the development of the Latvian accounting system has been influenced by the legislation of the European countries.

From 2005 all listed EU companies (including banks and insurance companies) must prepare their consolidated financial statements in strict accordance with international accounting standards (IFRS). Application of IFRS lets the companies to work with partners and investors without regard to their geographical location. IFRS are necessary not only for large companies but can also help medium and small businesses to present their financial reports in a standardized way that is accessible to international markets. Currently, in Latvia there are nine standards of accounting, which are based on the IFRS.

The interest in studying international accounting systems and IFRS in Latvia intensifies with each year, not only among the accountants and financial executives of large companies, but also from the representatives of small and medium businesses. As information technology, products and services are spread around the world the accountant becomes involved into the process, because the company that employs him is also a participant in it.

The process of introducing international standards of financial reporting in practices of Latvian companies is not simple and remains controversial, because the rules on financial reporting in Latvia differ from IFRS. In addition, many accountants and financial executives do not understand the role and the meaning of the accounting standards, believing that there is no great necessity to apply them in practice.

Therefore, there are real problems with the practical implementation of IFRS, which are related both to the accounting and tax legislation as well as the level of professional training for accountants and financial professionals.

The circumstances outlined above have motivated the author to undertake the research with the aim to receive the answers to the following questions:

What does the transparency of financial information ensure for users?

What hampers the financial statement to be transparent?

How to make the financial statement more useful for the users and how to make the company more attractive for the investors?

2. Latvian Accounting and Reporting System and IFRS

Latvian accounting and reporting system is characterized by the following features:

The laws on accounting

Governmental rules and directives

- Tax legislation
- National plan of accounts
- Latvian accounting standards.
- Company's accounting policy
- Methodology of determining of financial results.

The Latvian accounting system is based on the macroeconomic's approach; it is greatly influenced by the tax legislation and state directives, which results in the strict regulation of the accounting procedures.

The system of regulating accounting practices in Latvia was shaped under the influence of the legislation of European countries. The minimum level of correspondence across the financial reports in European Union is provided via directives, which lay the foundation for Latvian accounting laws: Latvian Law 'Annual Accounts Law' is based on the fourth EU directive on businesses' annual reports; Latvian Law 'On Consolidated Accounts' corresponds to the seventh EU directive on consolidated reports; Latvian Law 'On Sworn Auditors' is issued based on the eighth directive on persons responsible for the legally mandated verification of accounting documentation.

The consequences of tax legislation influence on the development of Latvian accounting sphere in general and accountant's profession in particular, will be analyzed further in the text.

Current Latvian legislation determines only the most important aspects of preparing of financial statements. In international practice financial reporting standards are guidelines for applying accounting legislation and directives. Standards contain several alternative solutions and their application is voluntary. If the legislation that regulates accounting practices in Latvia cannot provide comprehensive guidelines for a particular accounting question, it is suggested that one use International Financial Reporting Standards (IFRS), on condition that they do not contradict Latvian laws.

Analysis of current accounting legislation and IFRS allows determining the main differences between Latvian legislation and IFRS:

- 1) Latvian accounting laws are approximately 50-60 pages in volume, the volume of IFRS is more than a 2000 pages; Latvian and International Accounting Standards differ in the amount of information they contain.
- 2) The most significant difference is in the fact that financial reports that are prepared according to IFRS are based on 'fair' value; whereas Latvian legislation primarily concentrates on the fact that transactions should be reflected at their 'historical' value, that is at the acquisition value;
- 3) Accepted Latvian accounting standards have more of a legislative power; the application of IFRS is voluntary and the IFRS by themselves are recommendations.
- 4) There are also differences in accounting for company acquisitions or sales; transactions among related partners, and contracts with derivatives.

After analyzing legislation that regulates accounting practices in Latvia, one can point out the following characteristic features:

1) Tax legislation dominates accounting practices. Significant influence of tax legislation on accounting is proved by the fact, that calculation of financial result (profit or loss) is tied to calculating income tax from businesses. In formats of income statements that are recommended by the law one of the most important analytical indicators – ‘operating profit’ is absent.

2) The ‘Annual Accounts Law’ does not sufficiently develop the meaning of conceptual foundation of accounting practices for preparing financial reports. In Chapter 5 ‘Rules of Valuation (article 25) the law only briefly mentions the necessity to observe basic accounting concepts and principles while valuing final accounts positions. The annual report shall be prepared in accordance with the following principles (2):

- Going concern assumption
- Consistent use of the same valuation methods from year to year
- Items shall be valued in accordance with the principles of prudence
- All income gained and expenses incurred during the reporting year have to be taken into consideration irrespective of the date the invoice was issued or received; expenses shall match the revenues for the reporting period
- Assets and liabilities must be valued separately
- The annual report must be prepared in Latvian; the monetary unit of the Republic of Latvia shall be used as a measure of value.

3) Accounting legislation does not take into account the particularities of preparing annual reports for individual entrepreneurs, partnerships and publicly owned companies.

4) Accounting legislation uses the term *inspection* to designate verification of financial reports as opposed to the word ”audit”, which is commonly accepted internationally. Latvian legislature does not pay enough attention to the questions of terminology. However, it is precisely the word *inspection* that has a powerful psychological impact on the accountant, who perceives *inspection* as a method for finding mistakes and punish those responsible for it. Afraid of mistakes, the accountant believes that one's main job is to calculate taxes correctly. There are thus no resources for analytical, creative work.

Summarizing the abovementioned, author can make the following conclusions:

- There is currently no precise understanding of the purpose of preparing financial reports in Latvian accounting practice.
- Accounting procedures and financial reports in most cases reflect primarily the interests of one group of users – government tax agencies.
- Latvia's accession into the EU as well as the expansion of international economic and financial links, necessitate preparing financial reports in the interests of investors and creditors.
- Preparing financial reports in the interests of investors and creditors demands standardizing financial reporting, which, to a significant extent, is ensured by the international standards of financial reporting and Latvian accounting standards that are based on those.

The role of International Accounting Standards is to minimize the differences between financial reports in different countries and provide, on that basis, comparability and reliability of information, for users, who rely on financial reports as the main source of information about the company.

Applying IFRS ensures:

- The methodological basis for accounting and financial reports.

- Clearness of financial information for a wide variety of users, which makes reports ‘transparent’.
- Unification of national accounting systems, creating conditions for the successful integration of Latvian accounting system into the European one.

The major concepts of IFRS are:

- The Fair value concept
- Priority of economic content over legal form
- Transparency of financial information.

Fair value is an exchange price for the assets or liability in a transaction between a knowledgeable, willing parties and financially independent persons (5). The arguments for and against Fair value are shown in the Table 1.

The introduction of the International Financial Reporting Standards into practice of the Latvian companies increase prominence of Fair value as a basis for a true and fair view of companies’ financial performance and position.

Table 1. The arguments for and against Fair value

The argument for:	The argument against:
- Fair value provides a more solid and accurate base for future cash flows comparing to historical costs, because it reflects current market value of these cash flows.	- There is a need for an active market with relevant valuation objects and a necessity in qualified professional valuers.
- It ensures transparency of financial information; reduces accounting risk.	- For many assets and liabilities that are measured at fair value, no market value is available
- The analytical role of financial information for users enhances	- There are problem by regarding a mathematical calculation of a hypothetical market price as a “fair value”

3. What hampers the financial statement to be transparent?

In order to study the opinions of the accountants and financial executives of Latvian companies about the necessity and possibility of practically applying IFRS, the author had disseminated a questionnaire among the graduates of the course ‘International Financial Reporting Standards’. 112 accountants in Riga were questioned in March 2007.

The basic part of the questionnaire had eight questions included related to IFRS and Fair value, as well as five questions characterizing the size of the enterprise, where respondent is employed, main industry of the enterprise and the type of enterprise.

The survey of the respondents’ characteristics revealed the following features of the accountants:

- 71.0 per cent of accountants are employed by the companies with less than 50 total people employed (small business); 18.0 per cent are employed in companies, whose staff does not exceed 250 people (medium business) and 11.0 per cent - are employed in companies whose staff exceeds 250 people (large business).
- A significant part of respondents (42.9 per cent) are employed by companies where annual turnover exceeds 1 million LVL.
- More than 80 per cent of accountants are employed by limited liability companies. This type of enterprise has historically been very popular in Latvia. The necessary initial capital upon the registration of company is merely 2000 LVL. Business partnership is the least popular enterprise form.
- 75.0 per cent of accountants represent companies that do not have subsidiaries. 17.9 per cent - represent subsidiary companies of various conglomerates and 7.1 per cent are representatives of conglomerates or holding companies.

- The distribution of respondents by the types of business is as follows: 43.9 per cent represent retail business; 16.8 per cent - the service sector; 21.4 per cent - the manufacturing sector; 7 per cent - construction; and financial business – 10.8 per cent.

The distribution of the participants of the questionnaire confirms overall tendencies in the development of Latvian companies (4):

- Enterprises employing up to 50 people comprised 93 per cent of the total number of enterprises in Latvia;
- The most popular sphere of enterprises is trade (43.0 per cent);
- Limited liability companies (Ltd.) take the largest ratio in the companies' structure (64.9 per cent).

4. An overview of survey results

More than 80 per cent of accountants have given a positive answer to the first question on the questionnaire – ‘Do you find the application of IFRS useful in a company where you work?’ Accountants, who worked in holding companies and financial and banking industries, have indicated complete confidence in applying IFRS in practice.

The Table 2 presented below shows the distribution of respondent's answer to the question: ‘Do you apply some of IFRS in practice?’ and find out the relationship between the main field of company's operations and practical application of IFRS. More than a half of the respondents apply some of IFRS in practice. IFRS is very important in the banking and financial sectors, as well as in the service sector of industry. Trading companies use IFRS the least. For instance, about 24 per cent of retail companies do not use IFRS at all and about 40 per cent are not certain if they do. IFRS is not used by one third of the companies involved in production and construction.

Generally a large number of companies in each industry sector use particular IFRS in practice.

Table 2. The distribution of respondent's answers to the question ‘Do you apply some of IFRS in practice?’

Industry / Answers	Yes %	No %	Don't know %	Total %
Retail trade	38.1	23.8	38.1	100
Wholesale trade	42.9	35.7	21.4	100
Services	78.9	15.8	5.3	100
Construction	50.0	25.0	25.0	100
Manufacturing	41.7	33.3	25.0	100
Financial services	100.0	-	-	100
Real estate	66.7	33.3	-	100
Others	60.0	20.0	20.0	100
Total	55.4	25.0	19.6	100

The third question was asked in order to clarify, whether the respondents are familiar with the notion of *fair value* and whether they use it while evaluating company assets.

In spite of the fact that all accountants in Latvia perform revaluation of company's assets and liabilities in foreign currency at the date of preparing financial reports, many of them (more than 55 per cent) do not understand the essence of valuation based on *fair value*.

The answers of the respondents to the fourth question highlight those areas of accounting where the application of IFRS is the most prevalent. The following objects of accounting are named among those: capital assets, financial investments, traded securities and inventories.

Factors that have influenced the responses the most are the size of business and industry membership. For example, for companies, whose annual turnover exceeds 1 million LVL, the most important objects of accounting are financial investments, fixed assets and short-term liabilities.

One of the most widely discussed themes among academics and practitioners of accounting in Latvia is the definition of the *company's accounting policy*. Latvian legislature and theory are not yet clear in explaining the term *accounting policy*. Practitioners, however, believe that accounting policy is the 'system of implementing accounting at a particular business'.

The author of this paper believes that under the accounting policy of the company, one should understand the methodology of preparing financial reports, which is based on the fundamental concepts and principles of accounting.

The system of accounting encompasses all the aspects of organization and maintenance of bookkeeping, which is managed by a separate department (functional unit) within a company. The author treats accounting policy in this context as one of the elements of the accounting system within an enterprise.

The responses to the fifth *discussion* question (do you apply IFRS in developing company's accounting policy?) were ambiguous. 69.6 per cent of responses were positive. Obviously, those accountants who use IFRS in practice have included in their company's accounting policy, the corresponding methodology of recognizing and valuing the objects of accounting according to the IFRS. 30.1 per cent of respondents do not use IFRS when developing accounting policy it is most likely that in companies that they represent the accounting policy is absent.

75 per cent of respondents have expressed doubts about the readiness of Latvian companies to transition to IFRS. That was the response of accountants to the sixth question 'Are Latvian companies ready to make a transition to IFRS?' Only one eighth of the respondents (12.5 per cent) have expressed readiness to prepare financial reports on the basis of IFRS in 2006 already, and, several of them, as has been mentioned above, have used particular standards when preparing financial reports for the year 2005.

'What is the benefit of applying IFRS in practice?' - this was the seventh question that was addressed to respondents, who use IFRS in their work. The possible answer choices were distributed as follows (per cent):

- The basis for developing company's accounting policy - 73.2;
- "Transparency" of financial reports for users - 58.9;
- Harmonization of financial reports - 55.4;
- Access to capital markets - 17.9;
- Wider access to cheaper loans and investment - 8.9;
- Others - 3.6;
- Don't see any benefits - 1.8.

The responses to the eighth question 'What *hampers* the progress of application of IFRS in practice?' are summarized below (per cent):

- Incomplete legal framework (uncertainty of state policy towards IFRS) - 67.9;
- **Lack of professional knowledge about IFRS - 66.1;**
- Psychologically not ready - 19.6;
- There are no obstacles - 10.7;
- There is no practical necessity - 7.1.

The Table 3 shows the distribution of respondent's answers to this question, depending on the industry of the business:

Table 3. The distribution of respondent's answers to the question 'What hampers the progress of application of IFRS in practice?'

Industry	Lack of knowledge %	Psychologically not ready %	Incomplete legal framework %	Nothing prevents %	No practical necessity %
Retail trade	71.4	28.6	66.7	9.5	9.5
Wholesale trade	64.3	21.4	71.4	0.0	14.3
Services	73.7	10.5	68.4	0.0	5.3
Construction	75.0	25.0	75.0	25.0	25.0
Manufacturing	66.7	16.7	75.0	8.3	0.0
Financial services	66.7	0.0	66.7	33.3	0.0
Real estate	33.3	0.0	33.3	33.3	33.3
Others	40.0	20.0	60.0	20.0	0.0
Total	66.1	19.6	67.9	10.7	7.1

These tables indicate that accountants, who work in different branches of the economy, are unified in their opinion about the factors that constrain active application of IFRS in practical work. On the basis of the survey results, a number of general conclusions can be drawn.

Responses to the questionnaire reflect the reality, that has formed on the level of the state, private enterprise and professionals and which is typical for the current stage of the development of Latvian accounting system.

A large part of the respondents, who have participated in the questionnaire, work in companies, among which the companies with the following characteristics are prevalent:

The amount of staff employed – up to 50 people.

Net annual turnover – up to 500,000 LVL.

Type of business – Limited Liability Company.

Independent company.

The results of the research confirm that most of the respondents understand the purpose and objectives of IFRS, and, overall, consider this question pertinent to Latvian accounting practice. At the same time, one should note that there are ambiguous and contradicting answers that indicate a certain lack of confidence from the respondents in this opinion.

5. How to make the financial statement more useful?

With occurrence in scientific area of concepts 'New Economy', 'Knowledge Economy', the role of such accounting category as an 'Intangible Assets' raises. In economical literature intangible assets is defined as an 'Intellectual Capital' or 'Intellectual Assets', which becomes the most important type of assets for many companies, because it influences their value-added potential in the market economy. Intellectual capital, involved in process of creation customer and stockholder value, it is considered through a prism of strategy of the company.

The term *Intellectual Capital* illustrates the new usage of accounting term *Intangible Assets* as the object of Management of the company. The main focus of the management role in this context is the increase of the share value of the company by involvement of underused resources: knowledge, competences, organizational structure, information technologies, customer satisfaction, etc. Supplementing the annual report with this information, we have increased transparency. The company's strong and weak areas are exposed and this provides stakeholders with a better understanding of the company's potential and consequently increasing stakeholders' trust.

Reports on Intellectual Capital prepared and published by some companies are supplementary to traditional financial reports. Report on intellectual capital is considered as a

tool for its measurement, its management and enhancement of company attractiveness for investors.

The system of indicators describes the company's value creation process. Indicators can be both financial and non financial. All indicators must be verifiable even when not purposely audited. IC is highly specific to each company, therefore the contents of such a report of a separate company is individual. Many companies when preparing IC report are guided by the scheme, suggested by MERITUM Guidelines.

List of possible measuring indicators for all Intangibles, which are typical for Knowledge-based companies, are shown in the Table 4. *Knowledge-based company*, such as educational or consultancies institutions, have knowledge as the only outcome of their transformation processes.

Table 4. Intellectual Assets Report (6)

Components of Intellectual Capital	Indicators	Type of indicator
HUMAN CAPITAL		
Human resources (Staff structure)	Number of staff	NFI
	Percentage of full-time employees	NFI
Training and Education	Total days training per employee (annual average)	NFI
	Expenses for training and education per employee (LVL)	FI
Employee Survey	Average satisfaction of the employees with training activities	NFI
	Cost of survey	FI
STRUCTURAL CAPITAL		
Processes and equipment	IT expenditure per employee (LVL)	FI
	Reliability of hardware and software	NFI
Quality management of study process	Cost of quality management system (LVL)	FI
	Number of employees involved in quality management system	NFI
R & D and Innovation	Internal R&D expenditure	FI
RELATIONAL CAPITAL		
Project cooperation and Network	Number of new program categories	NFI
	Project revenues from customer projects (LVL)	FI
Conferences and publications	Number of international meetings hosted by organization	NFI
Customers	Number of international students	NFI
	Number of students of ERASMUS exchange programs Customer satisfaction (feedback results)	NFI

6. Conclusions

IFRS are becoming an integral element of the Latvian accounting system. The study and application of IFRS in practice will let Latvian companies create financial reports that are reliable and useful to their users. 'Transparency' of financial reports will ensure the attractiveness of Latvian companies for foreign investors.

The process of transferring to the IFRS will require new knowledge from accountants and financial professionals as well as the creation of a system of preparing accountants that responds to the demands of the changing current situation. The results of the accountant survey, which has been mentioned above, have also clarified the reasons preventing active application of IFRS in practice. About 70% of accountants mentioned the lack of professional knowledge in the field of international accounting and IFRS as one of the main problems.

The concept of Fair value ensures the valuation of the financial situation of the company and its operating results based on current market conditions. Such evaluation allows answer

the question: “How much my business is worth today?” The concept of Fair value allows to reduce the accounting risk and to improve a quality of the financial statement from the point of view of financial management.

Intangibles are the major ‘driver’ of company growth. In an economy where innovation, information and communication technologies, networks and alliances, as well as the quality of human resources and the way in which they are organized, intangibles will continue to be vital to companies. Current financial statement provides very little information about Intangible Assets. Intellectual capital report is supplementary to traditional financial reports. Intellectual capital (IC) report seems to have a fundamental function of self-analysis for the company. These reports are vitally important for the proprietors and investors as they allow measure the activity of the company and its prospects.

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