Implications of the enforcement of the international accounting standards over the financial and economic information of the Spanish companies

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Abstract: Accounting information has to be useful to enable different end-users (mainly investors and shareholders) to make informed decisions. It is for this reason that the analysis through ratios linking the balance sheet and the profit and loss accounts is a key tool for studying the economic and financial situation of companies. As a result, a clear objective of the International Financial Reporting Standards (henceforth IFRS) is to *establish parameters of recognition, measurement, and representation of the financial information that improve the usefulness of these indicators. This paper demonstrates how the process of harmonization of the accounting rules has affected the results of Spanish companies and whether the regulatory changes have influenced the companies' performance. We revisit IFRS accounting principles related to assets and liabilities of the balance sheets (in particular, related to tangible and intangible fixed assets, leases, and financial instruments) in order to ascertain if the changes have an impact on key management accounting ratios, such as capital adequacy ratio, liquidity ratio, debt ratio, return on assets (ROA), or return on equity (ROE). We assess the major implications of the enforcement of international standards on the Spanish accounting system in general, and on management ratios in particular. The main conclusion is that the requirement to use of fair value in financial instruments with mandatory accounting revaluations, caused solvency to move in the same direction as the change in valuation. In addition, the application of the amortized cost for debts improves the company's autonomy by reducing its indebtedness because deferred interest are not considered as debt. Concerning the other assets, the international regulation moves the 'non-current assets held for sale' from non-current assets to current assets, thereby improving the companies' solvency and liquidity. Although there are no significant changes in valuations applied to 'financial lease', because of the principle of 'substance over form', certain contracts that should have been considered as operational (and recorded in the profit and loss account) must now be treated as a 'financial lease', while the non-current asset and short and long term debt are recorded in the accounting. This change in turn worsens the solvency situation. In sum, regulatory change that affects the concept of result and the valuation assumptions based on fair value will have a significant and positive impact on the image of the company, thus improving the ROA and ROE indicators.*

Keywords: International Standars;ROA; ROE; liquid; solvency

1 Introduction

The analysis of the financial statements of a company is aimed at assessing its current situation and forecasting its future, so that it is possible to correct the weak points of the company, take advantage of strong points [10], and help economic actors in their resource allocation decisions, such as investment and credit decisions [3].

The analysis of the accounting information helps both internal and external agents associated with the activity. The former will use the analysis to guide their management decisions, while the latter will take it as a basis for taking decisions on the appropriateness of committing resources to the firm. Nevertheless, financial statements are not the only source of information for making judgments; they must be complemented by an analysis of the business environment and strategy. By examining this information, analysts will be able to draw conclusions about the company's historical development, as well as extrapolate it into the future to make a valuation.

Garcia Lorenzo et al. [10] distinguish two basic types of analysis: economic analysis and financial analysis. The financial analysis aims to know the financial structure in order to determine the relationship between investment and financing and study the level and quality of indebtedness. This is often referred to as verifying the company's ability to meet its debts. The economic analysis tries to look at the company’s results to make judgments in terms of productivity, profitability, performance, margin and profits.

The amount of an account or an asset considered in isolation provides little information on the position of the firm or on the management carried out. It is therefore necessary to implement a methodology to compare the information both with other benchmark companies and with the own data presented by the company in its historical evolution. According to Archel Domench et al. [3], the analysis through ratios transforms accounting information so that it become comparable.

In view of the foregoing, the aims of this work are:

– Knowing the implications of the application of international accounting standards in Spain, through the adaptation of the Spanish General Accounting Plan (henceforth Spanish GAAP).
– Reviewing the changes in both the main accounting items and valuation standards as well as the effect of these changes on the main ratios (solvency, liquidity, indebtedness, return on equity, and return on assets), according to the definition of ratios of Amat [2], Aching Guzman [1], Archel Domench et al. [3], and Gonzalez Gomez [12].

This work is structured as follows:

– After reviewing the legislative developments, section 2.1 presents the changes in annual accounts and their impact on solvency and indebtedness.
– Sections 2.2 and 2.3 show the changes in fixed assets and intangible assets, together with the concept of fair value and its effect on indebtedness and autonomy.
– Section 2. 4 details the changes in the profitability of companies resulting from the introduction of the valuation of financial instruments at amortized cost.

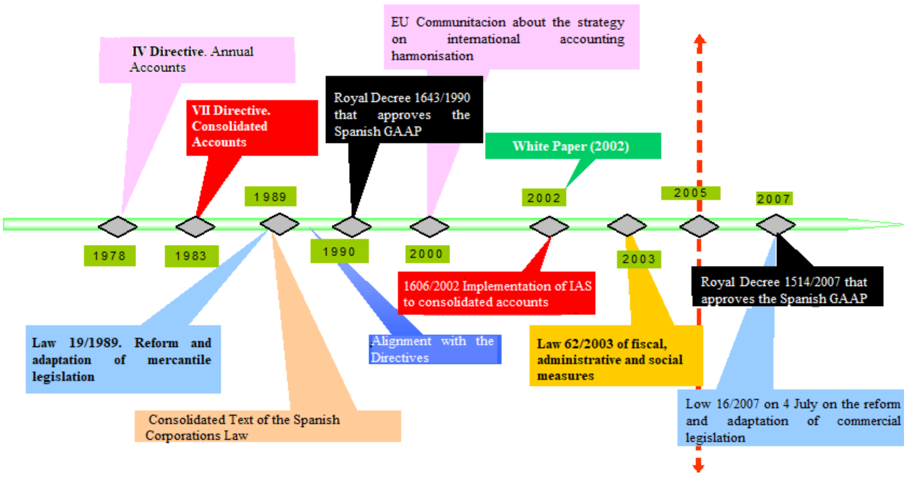
- Point 2. 5 reviews the effects on corporate profits induced by changes in the valuation of inventories.
- Sections 2.6 and 2.7 are reserved for two new elements: the valuation of corporate risks in the provisions and the valuation of the events occurring after the end of the financial year.
- Finally, the conclusions underline the idea that including the statement of cash flows and the statement of changes in equity improve the accounting information, because a more complete vision is offered and new risks are reported. Two main ideas stand out with regard to the valuation standards: on the one hand, the valuation of liabilities is more prudent than before, since the financial cost is not included in the company's debt, which implies an improvement in results; on the other hand, when valuing assets there is the possibility of revaluing them since the fair value can be included.

2 Effects on the balance-sheet assets and liabilities arising from applying international regulation

The European Union (EU) has led a process of accounting harmonization that seeks to achieve higher quality in the available financial information and to help investors in decision-making, and all of this to the benefit of achieving markets that operate more efficiently.

As a result of this process, shown in figure 1, the consolidated accounts of listed companies must be drawn up since 1 January in accordance with IAS/IFRS and in the case of the other companies (the non-listed ones), the Spanish regulator decided to modify the GAAP that was passed into law by the Royal Decree 1614/2007.

Figure 1. Process of harmonization of accounting standards in Spain



Source: prepared by the authors

1606/2002 Implementation of IAS to consolidated accounts

Law 62/2003 of fiscal, administrative and social measures

Before adapting the international accounting standards, a report was commissioned in 2002 on the situation of the Spanish accounting at that time and the basic lines for tackling its reform (known as the White Paper and published by ICAC Instituto de Contabilidad and Auditoria de Cuentas, 2002) [13]. This document included proposals drawn up by a group of experts to tackle the reform. It also included the recommendation on standardizing the calculation of the ratios, although it has not yet been implemented.

In the following we present a summary list, while not exhaustive, of the main modifications that the GAAP has caused in the balance-sheet assets and liabilities (further information can be found in the handbooks of Fernandez Rodriguez and Sanchez Fernandez [8][9] and Centro de Estudios Financieros[7], which serve as practical guides for the adaptation).

2.1 Annual accounts

As a result of the reform of the accounting system, the balance-sheet becomes the fundamental figure of the annual accounts [10] and the total equity is highlighted. Total equity is a broader concept than shareholder’s equity (it is made up of shareholder’s equity, revaluations and subsidies).

The biggest difference is on “the right side of the balance-sheet" which goes from having five blocks to only three (figure 2).

Figure 2: Items on the right-hand side of the balance-sheet

GAAP 1990
Shareholder’s equity
Deferred income
Provisions for liabilities and charges
Long term creditors
Short term creditors

GAAP 2007
Total equity
Non-current liabilities
Current liabilities

Source: prepared by the authors

Basically the deferred income disappears, with the exception of subsidies that pass to total equity: the non-refundable capital subsidies are directly recorded as an income in total equity, while the subsidies received from partners or owners do not generate income and they are recognized in the shareholder’s' equity. In the balance-sheet, subsidies and revaluations appear as net quantities of its related tax effect. This must be taken into consideration when calculating the autonomy of society.

Provisions become liabilities and, depending on the term, they will be considered as current or non-current liabilities.

Concerning the assets and rights of the company, the criterion used for differentiating between current and non-current assets is no longer always considering a year, it can also be the operating cycle provided that it is longer than a year. This is also another change that has a great influence on the calculation of solvency.

The extraordinary income disappears from the profit and loss account, which in the GAAP 2007 is presented as a list in which the results are classified by their nature. As a result of this disappearance, all the results arising from sales of fixed assets become part of the operating income, modifying the profitability in the same way. In other words, if the company has had a profit from the sale of a fixed asset, ROA increases irrespective of margin. Something similar happens with ROE that capture in the numerator the net profit and the results arising from the concept “discontinued operations".

Two new financial statements are included in the Spanish GAAP, the statement of cash flows (SCF) and the statement of changes in equity (SCE), that until this moment were not taken into account in the business analysis [18][19][6][11],. Studies conducted by authors such as Vila Biglieri [20], Carcasona and Jimenez [5] or Rodriguez-Vilariño Pastor [17], Villanueva Villar et al. [21]: have shown that cash flows are usually better indicators of a company's solvency than traditional ratios, taking as a point of departure the idea that obtaining a profit figure of more than zero, an ample working capital, and a positive self-financing capacity does not guarantee that cash flows are sufficient to meet payments.

Moreover, the viability of a company would be guaranteed if cash flows come mainly from ordinary operations. In this light, authors such as Arnold et al. [4], Mills and Yamamura [16] and Maseda Garcia and Iturralde Jainaga [14] have verified that the most representative ratios for studying the liquidity and solvency should be based on the magnitude of operating cash flows, which in the SCF would be represented by flows from operating activities.

2.2 Tangible fixed assets

One of the major novelties in the Spanish GAAP is the differentiation between tangible fixed assets, investment property and non-current assets held for sale. We therefore move from a single category within the balance-sheet, the “tangible fixed assets”, to having at least three possible locations for the company's tangible assets:

- Tangible Fixed Assets (Standards 3 and 3): this category is aligned with its classical definition, and includes all the fixed assets that are to be used in the normal or usual production process of the company.
- Investment property (Standard 4): this new category addresses the need of locating the buildings that are not intended for the usual activity of the company, although they are a means to generate income or capital gains, i.e. the income generated by this kind of investment arises without relying on the activity of the company.
- Held-for-sale assets (Standard 7): this is also a new category in balance-sheet, included within the “current assets", that arises when the company’s managers have a plan to sell fixed assets in the short term and, therefore, investments should be recovered via the sale, not via their use in the company. Even though the previous use and the characteristics of the good fitted into a tangible fixed asset, it becomes a current asset (readily converted to cash) after the new business decision to sell.

The first two categories are placed in non-current asset, while the held-for-sale assets are placed together with the inventories in the current asset. This has a direct effect on solvency ratios, in which these assets are considered as a liability. In addition, these assets are not depreciated. Therefore, the expenses decrease and the profit increases and this would affect both ROE and ROA.

One of the most relevant changes in tangible fixed assets is the disappearance of the former group 20 of the GAAP of 1990 (“amortizable expenses”), which can be recorded as: 1) expenses for the financial year, if they are cost of firstestablishment or 2) less equity, if they are related to the incorporation costs. This means that newly created companies reduce their financial autonomy, because of a decline in these expenses in reserves, and/or their profitability, because the profit is lower.

Other changes that increase non-current assets are, for example:

- The new regulation of trade swaps that could generate profit (because they are no longer valued at net book value but become registered at fair value).
- The valuation of non-cash contributions at fair value.
- The activation on the acquisition price of the present value of the costs related to certain decommissioning provisions and the reduction of all sorts of discounts on the acquisition price (including cash discount for prompt payment).
- The obligation to activate financial expenses (associated with fixed assets) if the asset takes more than one year to be into operating condition.

In all these changes, the initial value of non-current assets is increased when they enters the company, thus reinforcing the company's autonomy.

Concerning the subsequent value, once the asset is accounted for in the company, there is no change because the Spanish GAAP regulates impairments and depreciations in a similar way as it was done before.

Spanish GAAP does not include the great innovation of international regulations, which is the possible subsequent valuation of non-current assets at their fair value. This would have a major effect on ratios because if revaluation is taken to the profit and loss account then ROA will decrease, and if it was recorded as a reserve then the financial autonomy of the company will improve. Figure 3 shows a comparison between the fair value treatment in international regulations and in the Spanish GAAP.

Figure 3: Fair value in International Accounting Standards (IAS) vs. Spanish GAAP

REGULATION		ELEMENT	DIFFERENCE POSTING
IFRS	MANDATORY	Financial instruments held for trading, including derivatives	Results
		Financial instruments available-for-sale	Net/Results
		Biological assets and agricultural products	Results
	OPTIONAL	Tangible fixed assets	Net
		Intangible assets	Net
		Investment properties	Results
SPAIN	MANDATORY	Financial instruments held for trading, including derivatives	Results
		Financial instruments available-for-sale	Net
	OPTIONAL	The obligation to measure at fair value the patrimonial elements other than financial instruments may be established, as long as such elements are measured uniquely in accordance with this criterion in the Regulations of the European Union (Reform Law, art. 38. 5 of the Commercial Code).	

Source: prepared by the authors

2.3 Intangible assets (former inmaterial assets)

In order to recognize an intangible asset, it has to be "separable". Moreover, brands or other internally generated intangible assets cannot be recognized.

The recording of the financial leasing as a fixed asset (former “rights on leased assets” account) disappears and the asset is directly recognized according to its nature. Debt is recognized at the present value of the payments and not at the redemption value. This means the disappearance of “deferred interest" and that finance charges are taken to the profit and loss account according to accrual criteria. This involves estimating the effective interest rate of the transaction and updating the values at every moment, in order to know the amortized cost of the debt, applied to both short-term and long-term debt.

2.4 Financial instruments

The great innovation is the classification of financial assets and liabilities according to how the company expects to recover or cancel the debt, knowing that, in general, they will be valued at the time of acquisition at their fair value [15].

In subsequent measurement, financial assets must be measured at fair value, giving rise to differences according to their classification. The changes arising from the recognition of held-for-trading assets at fair value are taken to the profit and loss account and this has consequences on ROA and ROE. The changes arising from the recognition of held-for-sale assets at fair value are directly taken to equity and this has consequences on the company's indebtedness and autonomy. Finally, trading in own shares is recorded by decreasing the figure of total equity.

2.5 Inventories

There are no major innovations in this area in the recognition or in the initial valuation of goods, except for the disappearance of the inventory valuation systems known as LIFO and Standard Cost, which generally reduced the closing stock values. The valuation system used is of particular importance in the solvency of the company.

It is possible to recognize the cost of stocks incorporated in services, which involves improving the solvency of service-companies working on a multiannual project.

In the sales revenue standard disappears the differentiation between volume discounts (or sales rebate) and financial discounts, since all discounts will reduce the amount of the sale. This implies a reduction in turnover that has an impact on economic profitability (ROA).

Finally, and similar to that mentioned in the case of fixed assets, income arising from deferrals is taken to the profit and loss account as a financial income as the accrual occurs (income to be distributed in several years disappears), which means a reduction in own funds and autonomy.

2.6 Provisions

Provisions, understood as uncertain liabilities with respect to their amount and/or their cancellation date, are greatly reduced and directly included in the company's liability. Provisions for extraordinary repairs and reversible assets disappear. The valuation of them is made by the best estimate of its present value. This has a negative impact on indebtedness, liquidity and solvency.

Contingencies appear. They are not recorded, but they should be reported in the Annual Report.

In the case of liabilities linked to long-term staff payments, a distinction is made between: 1) defined contribution plans, in which no actuarial or investment risk is assumed, so they are recorded as a period expense and this has consequences on results and profitability, and 2) defined benefit plans, in which there are actuarial and investment risk, so a provision (liability) is recognized for the committed remunerations and this has consequences on indebtedness and solvency.

2.7 Changes and subsequent events

The changes in accounting criteria or error handling (if significant) must be booked retrospectively in equity, affecting the ROE. Changes in accounting estimates will be booked prospectively, according to their nature, in equity or in the profit and loss account, as appropriate. They also must be reported in the Annual Report.

Relevant events that existed at the end of the financial year, but which become apparent at a later time, must be taken into account when preparing the annual accounts (if they have not yet been prepared) or when reformulating them (if they have already been prepared). They will originate an adjustment or entry in the Annual Report. Relevant events that occur after the end of the financial year do not give rise to any adjustments, but it is necessary to report them in the Annual Report.

3 Conclusions

Spain has modified its GAAP to align its regulations with the process of international accounting harmonization. These changes, as has been shown, have a direct impact on the different balance-sheet items that make up the annual accounts and serve as the basis for economic and financial analysis. In particular, the autonomy of companies improves as the equity increases due to the effect of revaluations credited to reserves.

In addition, there will be changes in the liquidity and solvency ratios with different signs, depending in each case on how they are affected.

This first exploratory work encourages us to carry out an empirical investigation that allows us to quantify these effects on the companies listed on the Spanish Stock Exchange.

Moreover, it would be interesting to know how the accounting systems of other countries have been adapted in order to be able to determine whether the effects on the performance of companies vary according to the accounting criteria applied.

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