

## INFLUENCE OF INTERNATIONAL FINANCIAL REPORTING STANDARDS ON AN ENTITY'S FINANCIAL STATUS AND PERFORMANCE

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**Abstract:** *International Financial Reporting Standards - IFRS aim at harmonizing accounting principles, procedures and treatments used for the preparation and presentation of annual financial statements in order to meet the information needs of all the social partners of an entity. In this article the authors intend to analyze some of the regulations included in a international accounting standard - IAS 2 "Stocks", - in order to assess how this application influences the presentation of a financial status and the level and method for measuring the performance of entities.*

**Key words:** *accounting regulations, IAS, financial status, performance, assets, impairment.*

**JEL Classification:** *M41.*

### 1. Introduction

International financial reporting standards (IFRS) aim at harmonizing entities' accounting principles, procedures and treatments of annual accounts.

The objective of financial reporting prescribed by IFRS is to provide accounting information about financial status, effects of transactions and other events that change the economic resources and performance of a reporting entity.

The paper herein is intended to analyze the regulations contained in international accounting standard - IAS 2 "Inventories", to see how its application affects the financial status, the level and measurement manner of economic entities' performance.

### 2. Content

Standard IAS 2 "Inventories" regulates the accounting treatment applicable to inventories under the principle of applying the historical cost principle. The standard provides guidance on the recognition of inventories' value on balance sheet date, determination of inventories' cost and recognition of inventory-related costs, considering any record at its net realizable value. Additionally, the standard provides guidance on the practical procedures for determining the cost of inventories.

According to IAS 2, inventories are elements of current assets which in terms of their intended destination meet at least one of the following conditions:

- are held for sale during the current activity of an entity;
- are currently being produced for subsequent sale;
- are raw materials, auxiliary materials which are intended for consumption in the production process or service rendering.

It results from this definition that standard IAS 2 does not apply to the following inventories:

- financial instruments handled by standard IAS 32 "Financial Instruments: Presentation and IFRS 9 Financial Instruments";
- biological assets related to agricultural activity and agricultural production at the time of harvesting treated by standard IAS 41 "Agriculture."

One can notice that: the definition includes a list of users, so the nature of elements is not sufficient to regard them as inventories; the standard does not specify an upper limit value or a maximum useful life.

This way of defining inventories is based on their destination rather than nature, and hence, depending on an entity's object of activity, the elements that are inventories to an entity may not be such to another.

If one uses the nature of inventories as a classification criterion, one can identify the following categories:

- goods stocks subject to marketing in exactly the same form in which they have been purchased. They are found mainly in the current assets of trade entities;
- raw material stocks that are used in the production of goods or in rendering services. They are found in entities whose object of activity are the production of goods or rendering services;
- finished product stocks resulting from the completion of the production process;
- goods or services in progress which are in one of the intermediate stages in the production process or service rendering and not yet completed.

As well as any assets, inventories are recognized when the recognition criteria under the Framework for the Preparation and Presentation of Financial Statements are met:

- it is possible for any economic benefit associated with an item to enter or exit from an entity;
- an item has a cost or value that can be reliably measured.

The first criterion refers to the uncertainty in achieving future economic benefits embodied in assets, representing the potential to contribute directly or indirectly in the cash flow and cash equivalents to an entity and the other criterion in assessing credibility.

Inventory assessment is done according to the rules of evaluation:

- in accordance with the accounting standards of our country laid down in Order of the Minister of Public Finance 1802/2014 "Order of the Minister of Public Finance for approval of accounting regulations on annual individual and consolidated financial statements";
- in accordance with international standards laid down in: IAS 2 "Inventories" and IAS 36 "Impairment of Assets".

Standard IAS 2 "Inventories" requires the measurement of inventories at the lower value between cost and net realizable value. The cost of inventories is made up of: acquisition cost; cost of conversion; other costs necessary to bring the inventories to the location and condition they are in.

1) The acquisition cost of inventories must include the purchase price; import duties and other taxes; shipping and handling costs; other costs directly attributable to the acquisition of finished goods, materials and services.

The cost of inventories is influenced by price discounts representing trade discounts which a supplier may provide under certain conditions.

The other category of discounts namely financial discounts are granted by a supplier to customers who have prepaid bills and it does not affect the cost of inventories.

Discounts are granted either at the time of invoicing goods or afterwards by a discount invoice. Discounts are given in the following order: trade discounts; financial discounts. From the commercial point of view, discounts are given in the following order: rebates; draws; drawbacks.

In terms of performance, relating a customer there is optimization of supplier relationships and/or operating with increased efficiency the same volume of financial resources for the acquisition of a high amount of inventories. At supplier level, there is increasing turnovers to the rise in freight volumes sold and/or on improving the flow of receipts related to the relationship with a specific client and/or strengthening contractual relationship with a client. Keeping the approach in terms of performance and referring to

the Romanian accounting system, the authors intend to analyze the influences of IAS 2 regulations concerning discounts on inventories' reflection in accounting.

Trade discounts are not reported separately in accounting. The time of granting price cuts directly influences the amount of inventories reported in customer accounts and the sales related revenues made by the supplier. Trade discounts granted upon delivery of inventories and invoiced together will reduce the cost of inventories delivered so that they will be reported in customer accounts at an acquisition cost reduced by the trade discounts received. If there is subsequent granting of trade discounts, as applicable rebates, one will find that:

- in the supplier's accounts there is a decrease in revenue from the sale of goods;
- in the client's accounts there is a decrease in the acquisition cost of an inventory.

Unlike trade discounts, financial cuts, both granted when invoicing goods and those granted subsequently, are reported separately in accounting as expenses in the supplier's accounting, namely as financial revenues in the client's accounting.

Inventories are reported in the beneficiary's accounting at the acquisition cost undiminished by financial cuts which makes it possible that there are no variations in inventories caused by financial cuts.

2) Conversion cost includes direct costs related to units produced or services rendered (e.g., labour) and some indirect production costs, fixed and variable costs, due to the conversion of raw materials into finished products. Hence, one can deduce the mandatory inclusion in the inventory cost structure of part of fixed costs, consisting primarily of depreciation and production capacity maintenance costs. It results that the value of inventories cannot only be determined at the expense of variable costs, because it might not reflect reality and inventories could be undervalued.

The allocation of fixed production costs at conversion costs per unit of inventory is based on normal production capacity or average production capacity expected to be achieved over a number of financial years. Unit cost of production is influenced by the amount of units produced: the more production units are made, the less the unit cost of production becomes, since a part of it, namely fixed costs, is reduced by assigning a number of products; reciprocally, the less production volume is, the lower the unit cost is because fixed costs are borne by fewer product units made.

In practice, the inclusion of fixed costs in the cost of inventories is done during the periods when production volume remains below the level regarded as normal or average and therefore taken as the baseline, by weighting them with the result of comparing the actual production volume to average production volume. Via this method, one can get a unit cost of production independent of activity volume.

The method described above cannot be applied, however, in periods when the actual production volume exceeds the average production volume taken as reference for the IAS 2 standard requires inventories should not be valued at a cost superior to their size. Therefore, during these periods, inventories will be valued at their actual costs without resorting to the share of production costs according to the average volume of production.

3) Other costs are included in the cost of inventories only to the extent that they represent costs incurred in bringing the inventories to the form and place in which they are at present. For example, it may be appropriate to include in the cost of inventories the time-work and the cost of designing products for specific customers. The cost does not include: general administrative expenses; costs of disposal; losses of raw materials over the normally permitted limits; storage costs unless they are linked to production prior to passing into a new stage.

Inventory assessment based on their costs raises the question of forms of costing. The cost of inventories that are not ordinarily interchangeable and of goods or services

produced and intended for separate orders shall be determined by specific identification of individual costs.

Specific identification cannot be used in cases where inventories include a large number of items that are ordinarily interchangeable. In these cases, the method to select those items that remain in inventories is the “first in-first out” (FIFO) or the method of weighted average method costing (WAC).

Alternative accounting treatment, namely the “last in, first-out” (LIFO) method is not permitted by the new version of IAS 2.

- The FIFO method assumes that inventories are consumed in the order of their establishment, that is the items coming first into the inventory are consumed first and the remaining products are those made or purchased last.

- The method of weighted average costing (WAC) calculated after each input (or before each output) or monthly. Weighted average costing takes into account all inputs in and all outputs from inventories.

$$WAC = \frac{\text{Amount of initial inventory} + \text{Amount of inputs}}{\text{Quantity of initial inventory} + \text{Incoming quantity}}$$

$$\text{Amount of outputs} = WAC \times \text{Outgoing quantity}$$

Applying either of the assessment methods generates changes in the level of entity's expenditures, and therefore influences performance and has tax implications. Additionally, the choice of either inventory assessment methods mentioned influences the amount held in current assets and the level of liquidity indicators.

Applying the IAS 2 standard allows influence over an entity's performance at least in the following ways:

- a) using either of the FIFO or WAC methods for assessing inventory outputs must be analyzed by rising prices and entity's accounting policy as the same quantitative outputs assessed by different methods lead to different values of the accounting result and inventory size (different information in the balance sheet and income statement).

Price developments which may change from one input to another of the same inventory because of inflation or simply because of supply and demand make conventional methods possible to apply in the problem of assessing inventory outputs. Regarding several variants, an entity will choose the “best” method. The criteria underlying the determination of the assessment procedure of outgoing inventories, fiscal impact can be significant.

Example: In May the year N, an entity reports the following operations related to goods inventory:

- 01.05.N initial inventory of 100 kg x 30 lei/kg;
- 03.05.N purchase of 150 kg x 32 lei/kg;
- 15.05. N sale of 160 kg;
- 20.05.N purchase of 200 kg x 36 lei/kg;
- 21.05.N sale of 200 kg;
- 25.05.N purchase of 100 kg x 40 lei/kg;
- 28.05.N sale of 100 kg.

**Table no.1. Incidence of various assessment methods upon inventories**

Date	Transactions	FIRST IN-FIRST OUT METHOD (FIFO)			WEIGHTED AVERAGE COSTING METHOD (WAC)	
		INPUTS	OUTPUTS	FINAL INVENTORY	OUTPUTS	FINAL INVENTORY
1.05.N	Initial inventory	100 kg x 30lei/kg = 3000 lei		100 kg x 30lei/kg = 3000 lei		100 kg x 30lei/kg = 3000 lei
3.05.N	Purchase	150 kg x 32 lei/kg = 4800 lei		100 kg 30lei/kg = 3000 lei 150kg x 32 lei/kg = 4800 lei		250kgx31.2 lei/kg = 7800 lei
15.05. N	Sale		100kg x 30 lei/kg = 3000 lei 60 kg x 32 lei/kg = 1920 lei	90 kg x32 lei/kg = 2880 lei	160kgx 31.2lei/kg = 4992 lei	90kg x 31.2 lei/kg = 2808 lei
20.05.N	Purchase	200 kg x 36 lei/kg = 7200 lei		90 kg x 32 lei/kg = 2880 lei 200 kg x 36 lei/kg = 7200 lei		290kgx34.51lei/kg = 10007,9 lei
21.05.N	Sale		90 kg x 32 lei/kg = 2880 lei 110 kg x 36 lei/kg = 3960 lei	90 kg x 36 lei/kg = 3240 lei	200kgx34.51lei/kg = 6902 lei	90kgx 34.51lei/kg = 3105.9 lei
25.05.N	Purchase	100 kg x 40 lei/kg = 4000 lei		90 kg x 36lei/kg = 3240 lei 100 kg x 40 lei/kg = 4000 lei		190kgx7.4lei/kg = 7106 lei
28.05.N	Sale		90 kg x 36 lei/kg = 3240 lei 10 kg x 40 lei/kg = 4000 lei	90 kg x 40lei/kg = 3600 lei	100kgx37.4lei/kg = 3740 lei	90kgx37.4lei/kg = 3366 lei
31.05.N	Final inventory			90kg x 40lei/kg = 3600 lei		90kgx37.4 lei/kg = 3366 lei

**Table no. 2. Effects upon profit after adopting various inventory assessment methods**

	FIFO	WAC
Sales	27.600	27.600
Initial inventory	3.000	3.000
Purchases	16.000	16.000
Final inventory	3.600	3.366
Cost of goods sold	15.400	15.634
Gross profit	12.200	11.966

**Table no. 3. Comparative analysis of inventory assessment methods**

Method	Advantages	Disadvantages
"first in-first out "	<ul style="list-style-type: none"> <li>- pursues physical movement of inventories;</li> <li>- inventory amount is current;</li> <li>- easy to calculate.</li> </ul>	<ul style="list-style-type: none"> <li>- prices can be over-assessed at certain times;</li> <li>- comparisons regarding various orders, activities, tasks are hard to perform;</li> </ul>
"weighted average costing"	<ul style="list-style-type: none"> <li>- levels profits;</li> <li>- easy to calculate;</li> <li>- allows comparisons.</li> </ul>	<ul style="list-style-type: none"> <li>- deformation of costs in certain periods;</li> <li>- result accuracy must be checked.</li> </ul>

Usually, when out of an inventory or discharging from administration, there is a cost (or a reduction of income) with direct effects on the accounting result. From a tax perspective, the higher an expense is as per a given amount of inventories sold or rendered for consumption, the lower the profit and income tax will be. Thus, there is postponement of some of the tax burden. This reasoning leads one to believe that the best method is the one that allows assessment of inventory outputs at the highest value.

One believes this is the most important influence that the application of the IAS 2 standard has on the performance of an entity.

b) separation of direct and indirect expenses and distinction between production overheads and administrative expenses is subjective, since it depend snot only on the nature of the business, but also on correct accounting records. The manner of such allocation of overhead expenses and the way some of them are considered to be related to inventory items or conversely only to administrative expenditure is always questionable. In other words, they are likely to be distributed in a certain limit as administrative expenses which do not relate to building up inventories in the fixed costs associated with the production of such inventories. In this case, the entity's performance is reduced in terms of production cost efficiency because they are inflated in order to obscure oversized administrative expenses. Therefore, the profit margin per unit is decreased unless trade price increases occur.

c) subjective assessment of the value of indirect fixed costs to be entered in the cost of inventories. There is in this case also the possibility of distorting the performance reported related to cost effectiveness, by over-assessing the cost of inventories. As in the previous case, the effect is to reduce the unit profit margin and artificially reduce fixed indirect costs.

d) keeping provisions at the minimum necessary level, where one aims to mirror the high result of a year or, conversely, reporting provisions abundantly to reduce earnings and lower income tax subsequent to the application of an overly cautious "professional judgment" about possible sales of slow moving inventories or about the possibility of trading them at prices above costs.

It clearly results regarding inventory assessment that an entity has some opportunities of embellishing its reported performance either improving it artificially, often at the cost of increasing the tax burden or decreasing it in order to hide administrative expenses and reduce income tax. The possibilities of handling non-economic results through accounting processing of inventories are limited in time, as in accounting there is the principle of acquisition of closing balances of accounts at the end of the previous year as opening balances at the beginning of the current year.

From the above, one can see that a high level of financial performance of economic entities requires inherent fiscal costs.

### **3. Conclusions**

Applying international financial reporting standards by economic entities involves changes in the manner of recognition, measurement, impairment, etc., in structures of financial statements. Additionally, in the practice of various countries, depending on the relationship between accounting and taxation, such changes have fiscal implications.

In pursuit of objectives, the management of an entity must apply accounting policies so that their financial statements should comply with all provisions of each applicable international accounting standard and each applicable interpretation. In the absence of an explicit standard and an interpretation, entity management should appeal to professional judgment in view of developing an accounting policy that may lead to the most useful information to the users of financial information.

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