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Latvian Financial Reporting and International Harmonisation

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The content of the given paper reveals specifics of the Latvian accounting system which are typical for the contemporary development stage of accounting. The author of the article believes that introduction of IFRS into the practice of Latvian companies and application of international experience in accountant preparation is the cornerstone for the success of integration of Latvian acconting system into European.

International System of Accounting and Financial Reports

Latvia's accession into the European Union leads to the *necessity of integration* of Latvian accounting system into the European international system of accounting and reporting.

In every country the system of financial accounting and reporting is created under the influence of certain factors. Among the factors that exert significant influence on the creation and functioning of the national accounting systems are:

- traditions of national schools of accounting;
- sources of financing;
- tax policy;
- the influence of professional organizations and leading experts;
- national peculiarities;
- overall economic situation in the country;
- influence of other countries, etc.

The overall questions of the dialectic of accounting systems are considered in the significant amount of works by foreign authors (E. S. Hendriksen, G. G. Mueller, V. I. Tkatch, S. J. Gray). The majority of the definitions of the concept of an accounting system understand it as “a certain set of logic”, formed on the basis of the company plan of accounts, which summarizes all of the economic processes on the micro and macro levels and provides for the management of the company directed towards an adequate measurement of the results of the company's and its divisions' operation.

A particular feature of the accounting system in highly developed countries is the lack of stringent specification for its procedural side. The lack of the national plan of accounts, the stream of instruction materials, a single methodological centre, whose directions are mandatory for implementation, significantly heighten the role of the ethical professional aspects of any accountant's work. This is one of the most significant features of the organization of accounting in highly developed countries.

In order to determine the similarities and differences between countries, there are attempts at classifying national systems of accounting. These classifications are founded on certain principles. The reasons for the creation of such classifications of accounting systems include the following:

- Classification helps to determine the similarities and differences between the countries more precisely.
- Classification can aid in the creation of the accounting profession in the country and in choosing the system that is most appropriate for a given country.
- Classification is an excellent instrument of investigation that allows for the creation of the accounting and reporting system of a particular kind.

- For the accounting experts, classification becomes a point of reference, allowing them to predict problems that a country, in which a similar accounting system is operating, can encounter.

Nobes classification system is generally widely known:

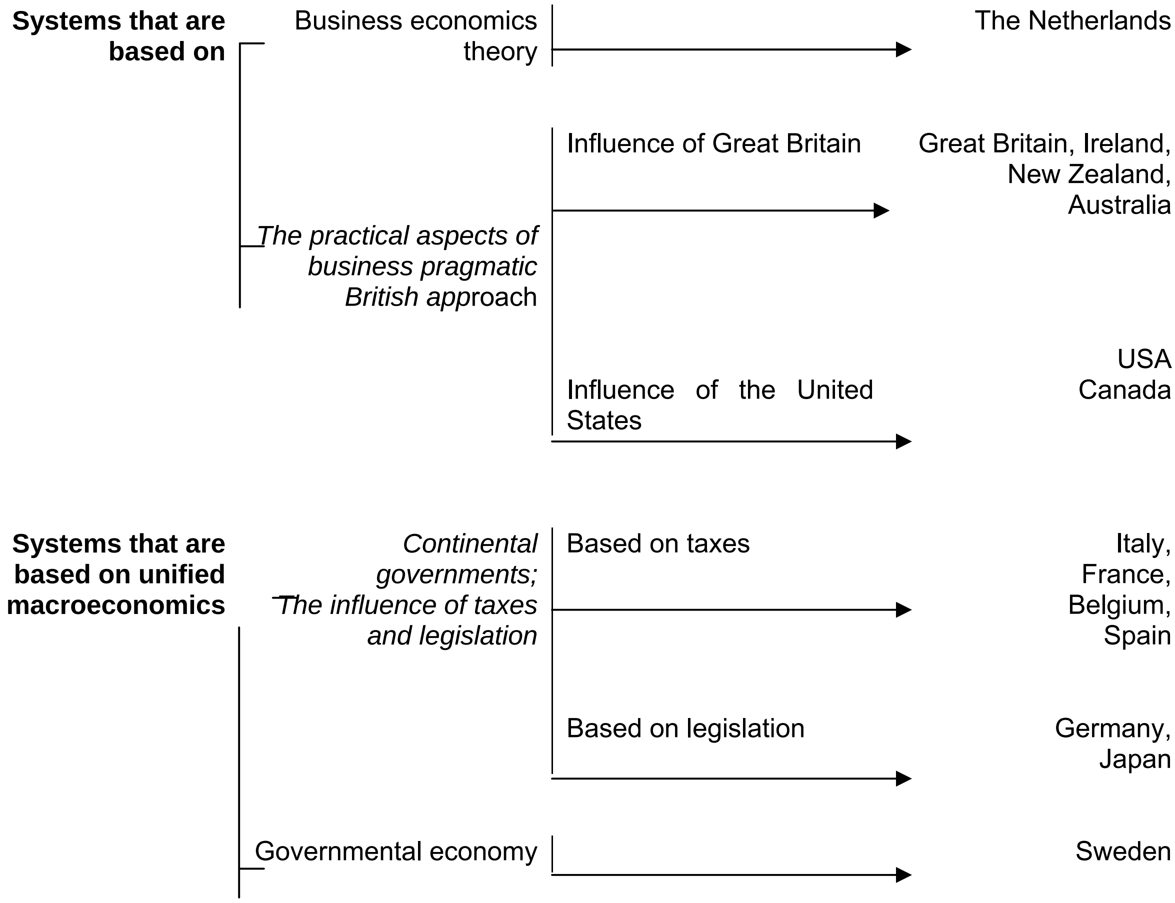

Diagram 1. The view of Nobe's classification [Blake, 1997]

However, even the systems of accounting and reporting in different countries that belong to a common classification group have significant differences, chiefly in the questions of methodology of preparing financial reports.

The differences in the accounting practices of particular countries and the degree of their influence can be evaluated in several ways. The example shown below allows seeing how the profit of the company changes, depending on the different practices of accounting for goodwill amortization using different accounting systems in some European countries.

British company S&S, while purchasing company ABC, has paid 151.5 thousand pounds more than the pure asset valuation of the latter company. Thus goodwill was created in the process of purchasing company ABC. Depending on which country is the company ABC located in, English shareholders will receive different dividends. That can be explained by the different rules for depreciating goodwill that are in operation.

Goodwill accounting rules that are working in practice:

- Great Britain – amortisation in 20 years;

- Belgium – amortisation in 5 years;
- France – amortisation in 20 years;
- The Netherlands – amortisation in 10 years;

In the **Table 1** below one can find the results of depreciating goodwill and their influence on the profit for the shareholders (in thousands of pounds).

Table 1: Goodwill Depreciation Methods and Their Impact on the Profit

	Belgium	France	The Netherlands	U.K.
Shareholder's profit, calculated according to the British accounting system	69,6	69,6	69,6	69,6
Adjustments for amortisation of goodwill	30,3	7,6	15,2	7,6
Shareholder's profit after adjustments for amortisation	39,3	62,0	54,4	62,0
Profit per share (in pence)	25,9	40,9	35,9	40,9

Note. This example is given in the book 'European Accounting' (Blake, 1997), but numbers for Great Britain were changed according to UK FRS 10.

British shareholders would get the highest dividend at home and in France.

Another example demonstrates differing approaches to accounting for operations in foreign currency (Plotkin, 2003).

Table 2: Accounting for Operations in Foreign Currency

Country	Denmark	Belgium	Italy	Germany, Latvia
Method of valuing operations	At the exchange rate at the date of operation	At the exchange rate at the date of operation	At the exchange rate at the date of operation	At the exchange rate at the date of operation
Method of valuing monetary positions	At the exchange rate on the date on «closing the account»	At the exchange rate on the date on «closing the account»	At the average rate of the last month of the given reporting period	*Debtors* – at the *lower* rate from the one on the date of the operation or valuation on the date of "closing the account": *Creditors* – at the *higher* rate from the one on the date of the operation or valuation on the date of "closing the account":
Method of reporting exchange rate differences	*All exchange rate profits or losses* are reflected in the income statement.	*Exchange rate profits* are shown in the balance statement as deferred income. *Exchange rate losses* first are mutually cancelled with the deferred income; any differences that are not cancelled are reported in the bottom line result of the reporting period. *Realized differences* for completed deals are shown in the income statement for the reporting period.	*Exchange rate profits* are shown in the balance statement as deferred income. *Exchange rate losses* first are mutually cancelled with the deferred income; any differences that are not cancelled are reported in the bottom line result of the reporting period. *Realized differences* for completed deals are shown in the income statement for the reporting period.	*Any* methods of reporting exchange rate differences are allowed, but one method has to be followed during the accounting period.

Using different methods of valuation influences the indicators of financial reports and causes difficulties in their application and comprehension by the users from other countries. The necessity to unify approaches to the organization of accounting and preparing financial statements of European companies is one of the main questions in the development of European accounting.

Currently two approaches to the solution of the problem of unifying accounting practices are the most popular:

- harmonisation of different systems of accounting within European community;
- standardization of accounting procedures as a part of unifying accounting practices that is done by the Council on International Financial Reporting Standards that is developing international financial reporting standards (IFRS).

The Role of International Accounting Standards

International financial reporting standards (IFRS) have appeared due to the international integration of the economy as well as an intensive development of the financial and investment markets. Providing for investor' demands, easing the operation of transnational corporations, the ability to reuse accounting knowledge, interests of international statistics and a search for the alternative to US dominance all necessitated the development of IFRS.

International financial reporting standards have already made and continue to make a significant contribution to the improvement and harmonization of financial reporting on a global scale.

The role of IFRS is to minimize the differences in financial reporting in different countries and on that basis to provide comparability and reliability of financial information for the users.

Every standard contains the following information:

- the object of accounting (identifying objects and concepts related to the object);
- recognizing an object (description of relating the object of accounting to different elements of financial reports);
- object valuation (possible valuation methods).

IFRS provide:

- a methodological basis for accounting and preparation financial reports;
- clarity of financial information for a wide variety of users; IFRS makes reports «transparent»;
- unification of national accounting systems.

Currently in the EU two systems of financial reporting are used: GAAP USA and IFRS. Both systems are oriented towards investors and provide a similar level of their interest protection. In 1998 210 companies in the countries of European Union provided their reports according to the IFRS and 235 companies according to GAAP USA. The last statistical data published by the IFRS committee account for 275 companies in the EU countries that currently apply IFRS (13).

IFRS committee has published the results of the opinion survey amount 717 financial directors in 16 European done by the „Pricewaterhouse Coopers" company in the end of 2000. More than half of the respondents prefer IFRS to the GAAP USA, believing that GAAP is more stringent and does not always reflect European conditions. 79% of the respondents supported the suggestion of European Commission to make IFRS mandatory rules towards the end of 2005 (13).

Globalization of the economy, new possibilities to attract capital on the markets all across the world demand standardization of financial reports. 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.

The specifics of Latvian accounting system

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

- the laws on accounting;
- governmental rules and directives;
- tax legislation;
- national plan of accounts;
- Latvian standards of financial reports;
- the system of organizing accounting on the level of a company, including company's accounting policy;
- methodology of determining financial results.

The system of regulation in Latvian accounting has formed under the influence of legislation of European countries. A minimal level of correspondence between financial reports in the European Union is provided via directives, which form the foundation between Latvian accounting laws: Latvian law “On Annual Reports” is based on the 4th EU directive on annual company reports; Latvian law “On Consolidated Annual Reports” is related to the 7th EU directive on consolidated report; Latvian law “On certified auditors“ is issued on the basis of 8th directive on persons who are responsible for the verification of accounting documents mandated by the law.

Current Latvian legislation determines only the most important aspects of creating financial reports. In international practice financial reporting standards are guidelines for applying accounting legislation and directives. Standards contain several alternative solutions and their application is voluntary.
Analysis of current accounting legislation and IFRS allows determining the main differences between Latvian legislation and IFRS:

- Latvian accounting laws are approximately 30-40 pages in volume, the volume of IFRS is more than a 1000 pages; Latvian and international standards differ in the amount of information they contain;
- 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 purchase value;
- accepted Latvian accounting standards have more of a legislative power; the application of IFRS is voluntary and the IFRS by themselves are recommendations;
- there are also differences in accounting for company acquisitions or sales; transactions among related parties, and contracts with derivatives.

Analyzing legislation that regulates accounting practices in Latvia, one can outline the following characteristic features:

- 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.
- Accounting procedures and financial reports in most cases reflect primarily the interests of one group of users – government tax agencies.
- The Law 'On the Annual Accounts of Undertaking' 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.
- Accounting legislation does not take into account the particularities of preparing annual reports for individual entrepreneurs, partnerships and publicly owned companies.
- 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.
- There is currently no precise understanding of the purpose of preparing financial reports in Latvian accounting practice.

According to the EU directives, from January 1st, 2005, IFRS became mandatory for the companies whose shares are traded on European stock exchanges. This requirement concerns those Latvian companies, whose mother companies trade shares on European markets. These subsidiaries of these companies that are registered in Latvia will have to use IFRS to prepare financial reports for mother companies.

For other Latvian companies IFRS application will remain voluntary, however, those, who plan to attract foreign investors, loans from banks abroad or establish partnerships with other European companies, will have to adhere to the IFRS.

Are Latvian companies ready to apply IFRS in practice? Below are certain results of the survey of opinion of accountants and financiers, conducted by the author of this article in the Spring of this year and published in the article «Key issues of IFRS application in the practice of Latvian enterprises» (9):

- Most of the respondents understand the purpose and objectives of IFRS, and, overall, consider this question pertinent to Latvian accounting practice: 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?'
- 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: 75 per cent of respondents have expressed doubts about the readiness of Latvian companies to transition to IFRS.

When looking for objective reasons for such lack of confidence in accountants, one can name the following (9):

- Latvian accountants currently do not have clear understanding of the purpose of preparing financial reports, because accounting and financial reporting in Latvia has traditionally been performed in the interests of primarily one group of users – state tax agencies.
- The strong influence of tax legislation on accounting practices determines strict adherence of accountants to the requirements of Latvian accounting and tax legislation. Latvian accountant has gotten accustomed to work in strict conformity to instructions. At the same time a characteristic of IFRS is the fact that is possible to choose alternative methods of accounting and valuation, this means that the accountant has the right to choose one or another method. Any choice means making a decision, and thus accepting responsibility. An accountant facing a choice as a rule is indecisive, because it's easier to follow the '*letter*' of the law than to make decisions by themselves. This factor is the cause of lack of confidence in the responses to the questionnaire.

Using the International Experience

The process of transferring to the IFRS will require new knowledge from accountants and finance professionals as well as the creation of a system of preparing accountants that responds to the demands of the changing current situation.

In Latvia accounting practice has typically had a dominating influence on developing accounting profession and the system of preparing professional accountants is absent as such.

The strong influence of the practical application has led to undervaluing the significance of accounting theory. As a result a "vacuum" of knowledge of the basic principles of accounting, where the essence and application of fundamental concepts of accounting are explained, has been created. The lack of knowledge and understanding of the principles of accounting leads to undervaluing the role of IFRS, whose purpose is indeed in showing how to use different accounting and valuation methods and implement these basic principles that provide reliability and comparability of financial information for the users. An accountant, who did not master the methodology of accounting, cannot explain the essence of the transactions he or she conducts; instead the transaction is booked automatically, without ever questioning the reason behind it. 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 author's cooperation with the International Association of Book-Keepers (IAB) of the United Kingdom and teaching accounting programs for international qualifications (GAAP, U.K.) to Latvian accountants and finance professionals allowed the author of this article to see the strengths of the accounting system in the United Kingdom.

In the UK, there exists a multilevel system of professional accountant preparation that includes study programs for the following qualification levels:

- Basic
- Intermediate
- Final
- Management Accounting level.

Study programs of all qualification levels are directed towards mastering conceptual basics of accounting and are based on the international financial reporting standards. The content of the study programs reveals the particulars of accounting and financial reporting in different types of companies. In such an approach, the accountant masters the methodology of preparing final accounts of different organisations: sole traders, partnerships, limited companies, public limited companies, non-profit organisations.

Among the strong sides of the accounting system in Great Britain, one can also name the following:

- the objective of preparing financial reports is clearly defined: accounting is conducted in the interests of investors and lenders;
- financial year is not attached to calendar year;
- some accounting procedures are significantly simplified, thus cash method, is used to account for expenditures that assumes payment correction at the end of the year.
- Financial and tax accounting are related, however, the functions of financial accountant creating financial reports and tax accountant are separate; this lets accountant to have time to perform the most important function of accounting – the analytical one.

Conclusions

IFRS are becoming an integral element of the Latvian accounting system. The study and application of IFRS in practice will let Latvian companies prepare financial reports that are reliable and clear to their users. «Transparency» of financial reports will ensure the attractiveness of Latvian companies for foreign investors. Utilizing the experience of well developed countries in relation to preparing specialists in the field of accounting will let the level of accounting culture in Latvia grow, that will undoubtedly increase the creativity and the authority of accounting profession.

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