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TRANSFORMATION OF COMPANIES' FINANCIAL STATEMENTS TO INTERNATIONAL STANDARDS

Abstract. During the process of Initial public offering management of the company should perform number of transformation steps in order to comply with requirements of Stock exchange on which it plans to go public. One of the main steps is to prepare financial information for investor under recognised international standards. In the article analysis of methods of financial statements transformation from national accounting standards to international was performed. The three main ways were identified. Among them are transformation, automation and parallel accounting. Each of these methods has both pros and cons and use is determined by factors related to frequency of reporting, access to financial information at any point in time, users of financial statement, business need, etc. Advantages and disadvantages were analysed for all transition method. Main complexity issues to implement international standards were identified during the research.

Keywords: initial public offering; international capital market; stock exchange; financial statements; international standards; IFRS; generally accepted accounting principles; transformation.

In times of economic instability and unfavourable market conditions for Ukrainian companies usually quite difficult to overcome all the factors that prevent recognition among international investors. It is difficult to attract financial resources other than bank credits which are quite expensive and may not cover the financial need of the company. However, for some of the companies there is a way to go public and propose its shares on foreign capital markets. Usually there are a number of factors that prevent Ukrainian companies to access such markets. Among others the most significant is the way Ukrainian business is operating. It is normal for Ukraine to overcome the shadow business practices, which is based on a creation and implementation of the company tax avoidance schemes, redirecting cash flows to shadow, conducting illegal operations, misrepresentation of the company's financial statements and other financial information by management of the company to "optimize" the business and make it look pretty. It should also be noted that in Ukraine there is no clearly defined legislation to protect the investor rights. All these factors avoid investors to put money into development business in Ukraine or purchase shares of Ukrainian companies. Investor may not be sure of the quality of shares he buy and have no guarantees to receive a dividend on their ownership.

In order to find out the way how to attract investors and to bring back their trust a number of improvements should be done in all directions – national financial system, business, social and other spheres. If talking about business one of the first improvements must be transparency and openness of companies. The most effective method to return the interest to Ukrainian companies is to initiate financial and organizational transformation of enterprises from national to international standards which must be guaranteed by annual audit.

The main principles of transformation are transparency of management and organizational structure and correctness of financial information prepared based on International financial reporting Standards (IFRS). Usually transformation of enterprises can take quite a long period of time, since it requires significant quality changes of all business processes.

Transformation of the company may include the following stages and steps, depending on the goals:

- development and implementation of accounting policies that would meet international standards;
- implementation of financial and organizational control systems at all levels of company management, which minimize the risk of misconduct by the individuals involved in the business processes;
- assessment and determination of financial information and accounting data;
- involvement of auditors for confirmation of financial statements;
- develop transformation of the financial statements of the company from national to international standards;

- the research business environments and determine the characteristic features of the company and related information required for calculating the transformation adjustments;
- mapping of accounts in accordance with International Financial Reporting Standards and tables of compliance with the Ukrainian chart of accounts;
- clustering and classification of financial statements captions in accordance with international standards;
- definition of all company’s related parties, the operations with which must be disclosed in the disclosures to the financial statements prepared in accordance with international financial reporting standards;
- disclosure of subsidiaries to be included in notes to financial statements;
- preparation of final financial statements according to international standards and the release of the final financial statements that will correctly reflect the financial position and give investors accurate information about its condition.

Ukrainian companies are stepping up working in this area due to the increasing integration of Ukraine into the international economic environment and the desire to attract foreign capital and investors. During the last years the growth of local markets and development of successful Ukrainian companies into large businesses groups lead management to the question about search for alternative ways of attracting financial resources. Among those ways are cooperation with international financial institutions and investors and access to international capital markets through private placements or IPO. These actions require from management among many other transformational actions reporting based on the International Financial Reporting Standards. This process is more active in large enterprises, such as the steel and engineering industries. Although there are some difficulties: the output of companies operating in these sectors requires perhaps a little more extensive training than usual. We are talking about fairly large enterprises, for which changes are fundamental. At the same time, small companies that do not need so radically restructure accounting and internal structure, can enter international markets earlier. Relatively small companies usually easier and faster switching to full-scale use of International Standards than bigger one.

Recently, many companies in Ukraine are switching to international financial reporting standards. However, most of them just on the way to understand pretty complicated International standards. Unlike to Ukrainian national accounting standards, which are very limited for management decisions, International Financial Reporting Standards (IFRS) designed to reflect real and objective information on the current financial position of the company. It should also be noted that the current standards in Ukraine are often changed and various changes are made by government. Such often changes are not good for company and are not predictable for investors. At the same time, international standards hardly changed, supplemented with explanations and only minor adjustments aimed at reducing the risk of biased reflection of financial information. Thus the application of such standards is better for Ukrainian enterprises, primarily to improve investment attractiveness.

In Ukraine was established the legal framework for companies wishing to implement international standards, only in 2011. For summary see the table below¹.

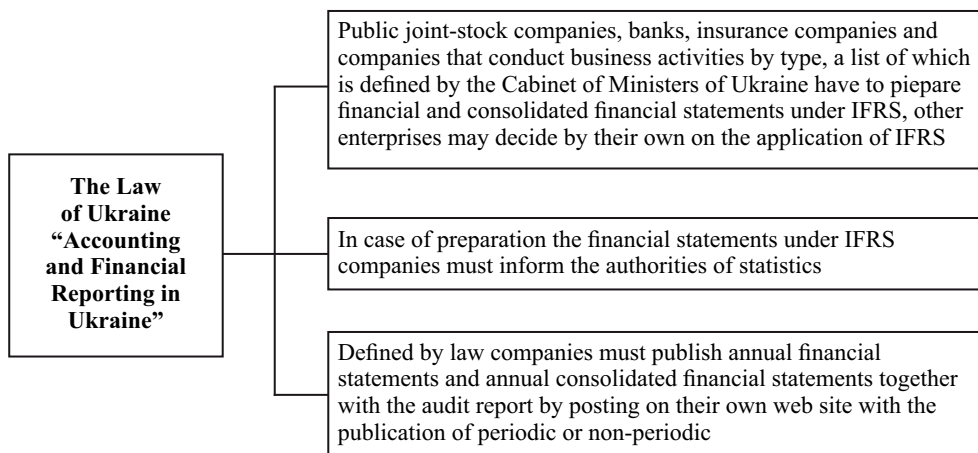


Fig. 1. Regulatory framework to apply IFRS in Ukraine

¹ Закон про бухгалтерський облік та фінансову звітність в Україні 1999 (Верховна Рада України). Офіційний сайт Верховної Ради України. <<http://zakon4.rada.gov.ua/laws/show/996-14>> (2015, лютий, 06).

Among the law specified entities that should carry the financial statements under international standards are the following – public joint stock companies, enterprises - issuers of mortgage bonds, mortgage certificates, bonds and certificates of real estate funds and professional participants of the stock market, banks, insurance companies and other financial institutions.

For other companies accounting according to international standards is not mandatory and is the choice of management. For companies that intend to enter the international capital markets one of the most important steps is to prepare financial statements according to international standards with the aim of further disclosure to potential investors.

There are several ways of how the company in Ukraine may implement International financial reporting standards.

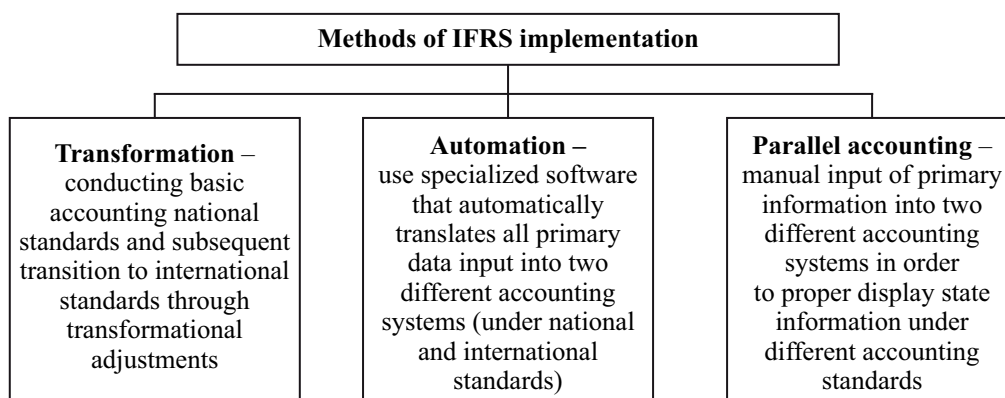


Fig. 2. Ways of transformation to IFRS

Each of the above described methods of transfer accounting to international standards may be used depending on the need and requirements of the company's management.

In modern financial literature there are mentioned number of advantages and disadvantages of going public by the company. Raising funds through open access to capital markets requires plenty of preparations, time and professionalism from management. On the other hand, company itself has to be ready for both organizational and financial transformation. One of the key points of transformation is changes in the form of company's ownership from privately owned to Joint Stock Company. Preparing company to these changes required from management a lot of professional skepticism, knowledge and analytical skills. In general the management of the company can raise quite significant amounts through initial public offerings, however there are number of risks which may lead to unsuccessful offering. Most of risks and market reaction may not be predicted before the first entering. The process of IPO depends on many external factors that are very difficult to forecast. Among these factors are the followings – market conditions, subjectivity of investors, operating conditions and business environment in those countries where company performs most of its operations, and many others, on which the management of the company has no influence.

For Ukrainian companies one of the main indicators of readiness to go public is willingness of the company's management to become fully transparent and disclose its financial performance. However, taking into account all disadvantages and challenges Initial public offering remains one of the perspective ways to raise significant amount of financial resources. Below are the general advantages and disadvantages for companies to go public.

Process of first entering the international capital market is multilateral and involved number of different third parties and professionals from several financial sectors. For successful issue of shares the company needs to attract few investment companies that will accompany and create the necessary conditions for the share issue process. One of the main steps is to find lead-manager which will coordinate the whole process of financial and organizational transformation, to meet the requirements imposed by international exchanges. In common lead-manager is one of the investments companies which has already performed few IPO's and has have enough experience to support company during the process of share issuance. It also searches for the best Marketplace to enter and minimum number of investors which are willing to purchase company's stock.

Other important member is underwriter - investment bank, which purchases most of the issue with a view to resale them to investors. Underwriter guarantees that the company's shares will be purchased and minimize the risk of low demand in the first days of issuance.

Tab. 1.

Advantages and disadvantages of IPO for Ukrainian companies

Benefits	Shortcomings
Opportunity to attract more funding at a lower cost compared to other sources of financing (bank loans, leasing, borrowings etc.).	Significant cost of initial public offering (immediate listing price, commission agents and other charges and fees).
Effective control over the operations of the company as there are new supervisory bodies in the company; annual international audit of financial statements.	Increasing pressure on the company's management; strict terms of financial reporting, which must comply to international standards.
Increase liquidity through diversification of ownership.	Increased risk of lawsuits from shareholders.
Access to the secondary market, and ability to re-issuance of shares (secondary placement (SPO)).	Increase in requirements for professional management.
Improve the company's reputation.	Complexity of the corporate structure of the company.

Among other parties involved into the process are consultants which will help management to reorganize the company and implement international standards and prepare financial statements according to IFRS or other generally accepted accounting principles that must be audited by recognized accounting firm. Regardless of the size and stage of development, the company at the beginning of the implementation of IFRS should decide on a plan and clearly distinguish all stages of the process - to start with the transformation of the existing reporting according to international standards or to establish a full new accounting based on selected international standards.

During the process of transformation from national accounting standards to international management of Ukrainian companies should focus on most challenging issues and standards which significantly vary from IFRS. Generally management miss a lot of important information that is not as important to national accounting standards. Among them are

- the stages of construction and production processes;
- cost of marketing activities and correct allocation of such expenses to captions of profit and loss accounts;
- correct accounting of sales / procurement, especially deduction of discounts and other expenses which reduce revenues;
- disclosure of purchase commitments;
- information on related to business operational risks;
- disclosure of bad debt and ability to create respective provision.

The method of transformation of financial statements compared with the transition of reporting to international standards has both advantages and disadvantages. Among the main advantages is ease of use. It requires less financial resources as well as professional staff. At the same time this method also has significant shortcomings. Typically, the transformation is done on a quarterly or annual basis. Accordingly, obtaining information at intermediate stages is not possible.

Transformation of financial statements typically associated with the use of spreadsheets for transformation. In this transformation table (so called working financials) information obtained under national standards is transferred to international standards by applying number of transformation adjustments. In general this table is done manually by responsible financial reporter which leads to increase in risk of errors. On the other hand, if the company maintains detailed management accounting and there is no need to provide international reporting of financial statements on monthly or quarterly basis, then the transformation of financial statements is one of the best practices to switch from national to international standards. Although it seems less technical and correct, than implementing parallel accounting, this method can be used as an intermediate step for large businesses or become a permanent practice for small companies.

For Ukrainian companies conducting at least annual financial statements under international standards is a significant step towards transparent and efficient economy.

Another method of international standards implementation is accounting automation. All primary information is automatically recorded into two different accounting systems based on national and international standards and perform all necessary adjustments. It requires special software and individual settings for each company, which initially requires significant investments, however in long run, may decrease expenses for financial reporting team. Further annual support is cheap and includes updates and control of automated inputs. This method is usually chosen by international company with subsidiaries business in Ukraine.

The automated method can be considered in two ways:

1) From the start of the subsidiary operating in Ukraine sets certain standards of accounting, including the choice of accounting system;

2) For smaller companies and subsidiaries with a small number of transactions, on a local level transformation is performed and is then entered into general reporting data base on the group level.

It should be emphasized that the method of accounting mostly depends on business needs. In order to choose the method of reporting under the international standards, management of Ukrainian companies should determine main criteria and aims. The main are as follows – who is the final consumer of financial information, reporting frequency, need of intermediate control and reporting, etc. Also, management needs to pay attention to a number of other factors that can influence the choice of a particular method to switch from national to international standards.

There is also a method of parallel accounting. The method is based on manual accounting of one transaction in two different systems at the same time. Such scheme has both pros and cons. On one hand it requires number of accountants which will be responsible for different accounting systems and will control accuracy of all primary information. This will lead in increase in annual expenses on personnel. On the other hand this method allows displaying real-time operations in parallel in different systems at any point of time.

Today in Ukraine government is trying to bring the national standards of accounting closer to the international standards. National accounting standards in Ukraine were developed based on IFRS principals, however there are still number of omissions and misstatement which may lead to not correct disclosure of financial statements and mislead investors. On the other hand applying National accounting standard correctly may help management to decrease spending on transformation to International accounting standards. In Ukrainian practice, problems generally do not arise from differences between national and international standards; they arise mostly due to management inability to comply with professional and ethical principles which laid down in the basis of international standards.

Among the main causes of complexity to move to international standards are given below:

– differences between traditional attitude to the reporting and accounting according to national and international standards;

– inadequacy and low requirements of Ukrainian legislation to the quality of accounting;

– low requirements of business owners to the quality of accounting.

Today in Ukraine is rather low official responsibility for false reporting that causes superficial attitude to disclose all transactions in financial statements. The realities of the modern economy Ukraine is such that most of the operations are in the shade and have no true reflection in the financial statements and are not controlled by government. In such situation it is almost impossible to correctly switch to international standards. Transformation will include number of significant errors and inaccuracies in financial information disclosed. In such cases investor will not be interested to bring money to companies due to disability to assess level of risks it overtakes by investing in Ukrainian companies. Current situation with closeness of business has negative impact on the investment attractiveness of Ukraine in general and investor confidence in the Ukrainian companies.

One of the most significant barriers of doing business in Ukraine is the lack of professional ethics of management and owners. For this reason, the introduction of international standards globally for all companies is difficult and may take plenty of time. On the other hand the implementation of international standards will have a positive effect not only for the company but also for the country as a whole.