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Project management and presentation of information in financial statements – company performance measurement or project performance measurement

Abstract

Realization of projects is such form of operation which in the recent years – in the age of globalization of economy and growing competition – has become more and more significant, both in Poland and worldwide. The value and the number of projects realized are gradually growing and include not only the branches traditionally related to such form of operation (e.g. construction and IT industry) but in practice all fields of our life. A necessary element that determines the success of project realization is timely information which also needs to be reliable and useful. The source of such information is the accounting system composed of two subsystems: financial accounting (focused on the external recipient of the information) and management accounting (providing information to internal recipients).

One of the basic determinants of creating information for external recipients (such as investors, banks, insurance companies, treasury administration organs etc.) is comparability. Keeping it influences the quality of information regarding project activity taken from financial reports created according to the selected regulations of accounting (e.g. IAS/IFRS, US GAAP and the PL GAAP).

The aim of the article is to draw the attention to the problems related to the presentation of the operational result in case of companies realizing projects contained in a financial report. The article is of discursive nature since the issues that it deals with usually depend on what given solution is selected by

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a unit in question. Moreover, some of the areas are subject to detailed regulations of the balance law (both domestically – the Act on Accounting and PL GAAP No. 3, and internationally – IAS/IFRS). However, their application may lead to 'blurring' a realistic and true picture of the capital and financial situation of a company realizing long-term projects.

1. Introduction

Business activity carried out in the form of projects, especially long-term projects, is becoming increasingly popular in recent years. A project can be defined as a set of coordinated activities with fixed execution time, discrete in nature, realized in an integrated and unique way to achive the strategic and operational objectives using the available (limited) resources, and requiring innovativeness and interdisciplinarity of the persons executing the project[1]. An essential element determining successful project execution is timely, reliable and relevant information. Such information is generated by the accounting system, which is made up of two sub-systems: financial accounting (oriented to external users of information) and management accounting (oriented to the needs of internal users of information). Due to the specific character of project management accounting system is the principal element of project management, information systems, because it provides information for both internal users and financial reporting purposes.

The management accounting system provides information of any type and format that its users may require, in contrast to financial reporting, where information must conform to specific rules and requirements arising from professional standards and legal regulations. This is mainly due to the fact that information which it generates is mostly intended for internal users, so there is no need for comparability with other entities. Comparability of data is a prerequisite in generating information for external users (such as investors, banks, insures, revenue authorities, etc.), who rely on financial statements prepared in accordance with selected regulatory systems (e.g. IAS/IFRS, US GAPP, Polish accounting low).

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[1] Literature studies show that there are many different definitions of project. The definition in this paper attempts to combine those project characteristics which, in the author's opinion, are most important from the viewpoint of generating information for management purposep. Other definitions can be found, among others, en example in Oberlander G. D., *Project Management for Engineering and Construction,* McGraw-Hill, Boston 2000, p. 4.

This paper aims to highlight problems in accounting for and reporting of the performance of companies that conduct activity in the form of long-term contracts. It is a discussion paper, as the issues that it addresses are largely determined by the entity's choice of a specific solution. Moreover, some of the areas are subject to specific regulations in both the Accounting Act and IAS/IFRS, but their application may obscure the true and fair view of the financial position and results of a company engaged in long-term projects.

2. The specific nature of project-based activity in the context of accounting system

The accelerating globalization of the economy is leading, on the one hand, to intensified competition, and one the other, to free movement of capital, necessary to achieve the synergy effect. Growing competition and free flow of capital result in intensive growth in different parts of world, which is mainly manifested in development of new technologies and increased investments. Among major driving forces of the economy are new technologies, primarily developed for military purposes to be subsequently adapted for civilian uses. An example is the Internet, originally created in the US military sector, which next spread to cover the entire world in every sphere of life. Hence the development strategies of individual states and supranational organizations such as EU include support for new technologies development among key priorities for the nearest future. Project-based activity is preferable in this context, because new technologies are mostly created as a result of execution of specific projects.

Moreover, completion of certain new technology projects may give rise to a number of new undertakings of this type. (For example, "Project Manhattan" resulted in the discovery of nuclear technology, which in turn stimulated the launch of numerous projects on the practical applications of this technology, both in the military and civilian context). Present-day business model is increasingly transforming from the traditional, mass production-oriented model to execution of single, customized orders, i.c. projects. The companies which mainly specialize in mass or large-batch production run some of its operations in the form of projects – for example, designing a new model of a car in a motor company. These and other reasons determine a great demand for managerial information necessary for strategic and operational management.

On the other hand, free movement of capital is possible owing to free flow of financial information. This, in turn, means the necessity to harmonize the rules for presenting this information, i.e. the principles of external financial statements preparation. Harmonization of accounting will enable investors,

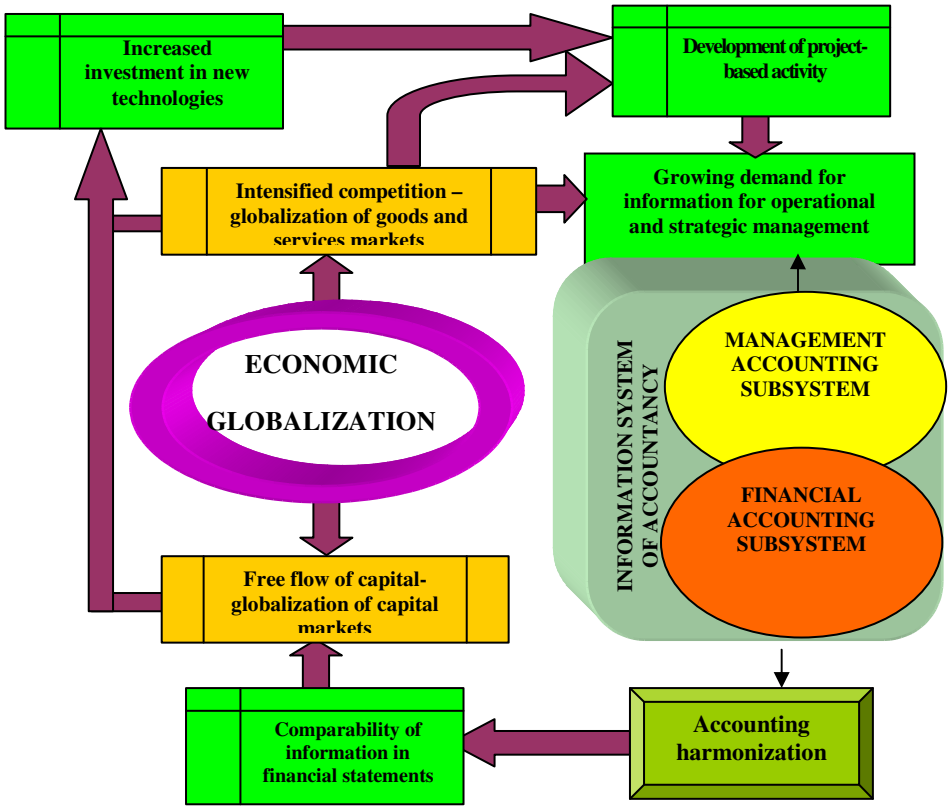
financial analysts, banks, investment funds and other financial institutions to assess the financial position and performance of companies at the global scale, which will diminish investment risk.

Considering the economic globalization and resultant information needs, growing competition and free movement of capital, the following conclusions can be formulated:

1. Economic growth is possible owing to taking advantage of the synergy effect, i.e. phenomenon in which two or more discrete influences or agents acting together create an effect greater than that predicted by knowing only the separate effects of the individual agents,
2. New technologies are the driving force of the world economy,
3. Dynamic growth of investments across the world is the response to the demand for the new technologies,
4. Economic globalization necessitates the development of project activity, which is the most effective mode of carrying out investments and creating new technologies,
5. Project management generates strong demand for information for project stakeholders – both internal and external,
6. Project management information system should be based on an appropriate accounting system adapted to the specific needs of this type of activity,
7. Information essential to management, both strategic and operational, are supplied by the subsystem of management accounting oriented to project management,
8. Free movement of capital requires free flow of information, which in turn necessitates harmonization of the preparation of financial statements, which constitute an element of the financial accounting subsystem.

These conclusions provide a basis for analysis of the impact of globalization on project-oriented accounting information system, which is illustrated in Figure 1.

Figure 1. The impact of globalization on project-oriented accounting information system



Source: author's elaboration.

Before 2002 long-term projects in Poland were mainly associated with the construction industry – a branch with the longest tradition of this type of business activity. The accounting system then in use was lacking special tools for measuring project cost, revenue and results. Accounting information system was largely oriented to measurement in one reporting period – typically the calendar year. Moreover, measurement was focused on one of three stages in project life cycle – the execution phase.

In 2002, revised accounting law came into effect in Poland and long-term projects came to be treated like elsewhere in the world – as contracts for construction of any asset (not only a house, but also an information system, quality management system etc.). The scale of projects realized in Poland is increasing – large – scale projects are often carried out in cooperation with local or foreign partners, which presents new challenges to companies operating in

a market economy environment. Accounting, being closely connected with business practice, must apply the basic principles so us to give a true and fair view of a company's financial position and performance. Information provided by the accounting system should be suited to the specific nature of this mode of carrying out business activity. It is very important that the information should be generated in two perspectives: ex post and ex ante, but interrelated closely so as to form one integrated information system.

3. Accounting regulations applicable to long-term projects

Project type activity is usually characterized by long duration of project execution. Completion of a project often falls into a different accounting period than its beginning. Therefore the primary issue in accounting for long-term contracts is the allocation of project revenue and costs to the accounting periods in which project work is performed.

International accounting regulations relating to long-term projects include International *Accounting Standards* (IAS) also referred to as *International Financial Reporting Standard* (IFRS)[2]. The specific standards applicable to the activity in question are: *IAS 11 Construction Contracts, IAS 18 Revenues, IAS 12 Income taxes and, to a lesser extent, the Framework for the Preparation and Presentation of Financial Statements* and *IAS 1 Presentation of Financial Statements*.

The objective of general purpose financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of the stewardship of management or the accountability of management for the resources entrusted to it[3] (MSSF 2005, p.36).

Thus formulated objective indicates that according to IAS – financial statements, similarly to internal reports generated by management accounting, perform information (or decision support making) and control functions.

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[2] The change of the name was due to the fact In 2001 the International Accounting Standards Board (IASB) was formed to replace the International Accounting Standards Committee (IASC), and it was decided that all standards issued by IASC should be called IAS, while the standards issued by IASB would be called IFRS (for As the standards relating to long-term projects were issued by IASC, they are IAP.

[3] International Standards of Finance Reporting (IFRS) 2004, p.710.

In order for a construction company to prepare financial statements that are reliable and relevant, it is necessary to have a well developed accounting system integrating two areas: financial accounting and management accounting.

To meet the objective of fair presentation, financial statements of an entity must be prepared in accordance with basic accounting principles and must meet principal qualitative characteristics[4]. In the long-term projects context particularly important is the accrual principle[5]. It determines the way in which entities engaged in project work should determine relevant revenue and costs, i.e. prescribes the way of allocating appropriate revenues and costs to the period for which financial statements are prepared.

The rules for determination of uncompleted long-term projects are set out in *IAS 11 Construction* contracts. The term "construction" used in the standard title is misleading, as it refers not only to construction sensu stricto, but also to other long-term projects such as design and implementation of an integrated information system. Another standard applicable to long-term contracts is IAS 18 Revenues, prescribing general rules for recognition of revenues in financial statements.

As a result of application of specific principles of long-term projects valuation, temporary differences arise between the value of assets and liabilities as recorded in the accounts and their tax value. In consequence some entities must recognize deferred tax assets or liabilities. The rules for their determination are set out in IAS 12 – Income taxes.

Polish accounting law, in force since 1995, was amended in 13.11.2000, with effect from 01.01.2002, to incorporate many of the provisions of IAS, including those relating to long-term projects. In addition, Polish Accounting Standards Committee issued in September 2006 *PL GAAP no. 3 "Uncompleted Construction Contracts"* applicable to entities performing long-term projects, especially in the construction industry.

4. Selected dilemmas in presentation of the performance of entities engaged in long-term projects

The main dilemma facing the management of an entity doing long-term projects is to decide what is more important: presentation of the results of the

[4] See International Standards of Finance Reporting (IFRS) 2004, MSR par. 13, p. 712.

[5] The accrual basis is defined among others In IFRS 2004, p. 61.

entity as a whole or presentation of the performance of individual projects. The answer seems simple – after all financial statements relate to the entity as a whole, not to its elements. However, nothing that relates to long-term projects is simple. Accounting is "the language of business", and the main form of doing business by the companies in question is execution of long-term projects.

Dilemma 1: Choice of the way of presenting financial costs of project activity

Let us consider the following situation. Cost of interest at the end of the accounting year was 1 000 000 PLN. The company has two options[6] as regards presentation disclosure of the cost of interest, as illustrated in Figure 2:

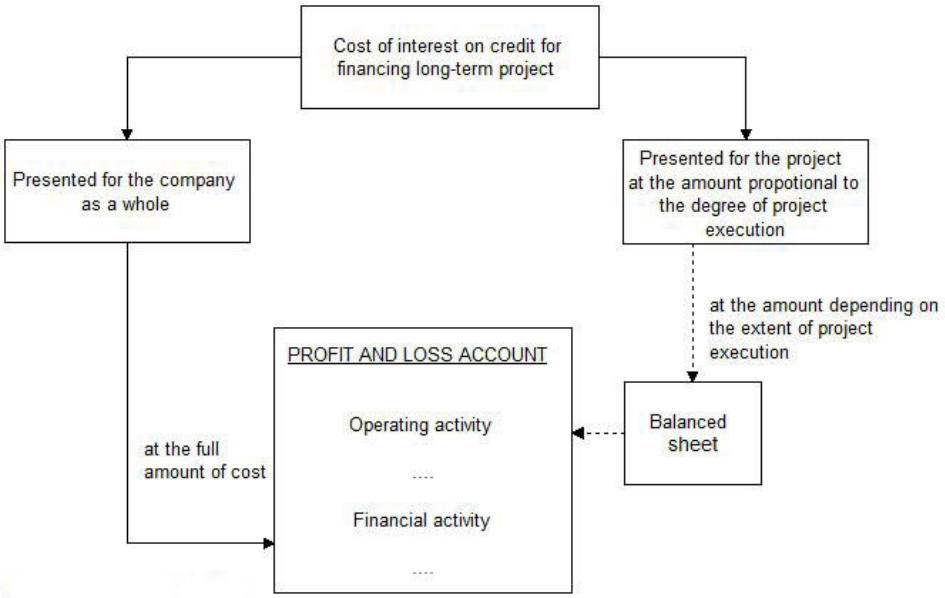
a) For the entity as a whole - as financial costs of the period, i.e. in the profit and loss account as financial activity at the full amount of 1 000 000 PLN,

b) For the long-term project - as operating costs, therefore in the profit and loss account in the amount depending on the extent of project execution, i.e. other than 1 000 000 PLN[7].

[6] In subsequent considerations no account is taken of specific accounting regulations addressing this issue The aim of this paper is to entourage discussion on different solutions, which might lead In the future to change In accounting regulations.

[7] If cost of credit was a cost item of long-term projects – which is allowed in certain cases by national and international regulations – it would affect the result of the period in the same way as all other costs of the project, i.e. proportionally to progress on the project. This means that it would be recognized not at the amount of actual cost but at the estimated amount, which is equal to actual cost only in special situations.

Figure 2. Presentation of financial costs of project activity



Source: author's elaboration.

This is a simple example of the dilemmas facing management of entities executing long-term projects. It also shows how important in such companies is accounting policy, which should specify the chosen method of presenting the results of activity. If there is no detailed information explaining this question, the entity can manipulate data in financial statements, with significantly different results. The very fact of moving cost (regardless of the change in its amount) from operating activity to financial activity makes it possible to change EBIT or EBITDA[8], basic indicators of the performance of publicly traded companies.

In the author's opinion, there is no definitive answer to this question, as everything depends on the economic situation and ethics of the preparer of financial statements. However, the general rule should be as follows: if financial costs relate directly to a particular long-term project, they should constitute an element of its budget, and therefore an element of the project costs. In other

[8] These indicators show the company's results at the operating level, without taking into account the financial activity, so moving costs from ordinary operating activity to financial activity can "improve" EBIT and EBITDA.

cases financial costs should not be presented as an element of ordinary operating activity, but as costs of financial activity[9].

Dilemma 2: Choice of the way of presenting costs of provisions for warranty repairs

According to the approach now dominant in management accounting, long-term project costs comprise the costs of three stages of product life cycle: planning, execution and post-completion, in accordance with the principles of accounting for project life cycle. Under this approach, costs of provisions for possible warranty repairs should be an element of long-term project costs. However, this is contrary to art. 35d of Polish Accounting Act, which provides that provisions are changed to other operating costs, financial costs or extraordinary losses[10].

This approach results from the application of the prudence principle, which is of primary importance in accounting[11]. The opponents of such a solution argue that adding estimated costs of repairs under warranty makes it impossible to establish actual costs of the project, because they will be overstated. The proponents emphasize that this solution is in accordance with the matching principle. It reduces the problem at issue to the question: which of the basic accounting principles is more important: prudence or matching of costs and revenues.

The author of this paper is of the opinion that charging provisions for warranty repairs to other operating costs is wrong[12] for the following reasons:

1) The primary function of accounting is representation, in terms of numbers, of an entity's business activity,
2) Accounting has recently been evolving in the direction of the Anglo-Saxon model, which places less emphasis on the principle of prudence in the presentation of an entity's results in financial statements,
3) Charging provisions for warranty repairs to other operating costs obscures the cost-effect relationship between costs and revenues. Project execution belongs to an entity is ordinary activity, which generates revenues and incurs costs; presentation in the profit and loss account of results of

[9] This opinion is in line with IAS 11 and PL GAAP no. 3, but both these standards use wording that suggests optional choice (see IAS 11, para.16). The author regards this as a requirement not allowing an alternative approach.

[10] See Accounting Act art. 35d item 2.

[11] See Accounting Act art.7.

[12] This opinion is in line with IAS 11 and PL GAAP no. 3.

ordinary, activity reduces costs to the amount of costs incurred, without taking account of estimated costs to be incurred in the future,

4) From the viewpoint of project profitability assessment leaving out the estimated costs of warranty repairs distorts actual profitability and may lead to wrong assessment of the activity.

Dilemma 3: Choice of the way of accounting for subsidiary income

Costs and revenues are usually accounted for in open formation which means that they are recorded separately, without offsetting, However, there are exceptions to each rule, which is exemplified by the accounting treatment of so called subsidiary income[13]. Under both national[14] and international regulations, subsidiary revenues are set against related costs, diminishing them accordingly. Thus, under this approach, subsidiary revenues are treated as decreases in project costs, and not as project revenues or other operating revenues (e.g. from sale of fixed assets).

In the author's opinion this is not the right solution as it is contrary to one of the fundamental principles in recording economic events – the open formation principle. Each exception may cause informational chaos, as financial statements users may have problems in interpreting the information that they provide. This opinion is a subjective judgment, not in line with IAS 11 and PL GAAP no. 3[15].

Dilemma 4: Choice of the way of accounting for retained amounts

Retained amounts are part of the receivables conditional upon performance of the contract, to be received by the contractor upon satisfying the contract provisions (e.g. upon termination of warranty) or elimination of identified defects[16].

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[13] Examples of subsidiary revenues are revenues from sale of surplus materials or sale of equipment purchased for project execution after its completion.

[14] In the case of national regulations there is a problem – accounting law does not prescribe the treatment of ancillary revenues from long-term projects. In art. 10 section 3 it states that unregulated questions an entity is allowed (but not required) to apply, among others, national accounting standards – in this case PL GAAP no. 3 " Uncompleted construction contracts", which regulates this question in the same way as IAS 11 (see PL GAAP no. 3 item VI.5).

[15] The author of this paper is also co-author of draft PL GAAP no. 3 " Uncompleted construction contracts", where he proposed a different solution to conform to global standards (IAS 11), which was approved by the Polish Accounting Standards Committee. However, IAS 11 is an "old" standard (last amendment over 10 year ago) to be revised in the near future, most likely after completion of work on amendment of IAS 18 Revenues. Opinions and proposals such as those in this paper may then be taken into account and contribute to changes in regulations.

[16] See PL GAAP no. 3 " Uncompleted construction contracts" item II.1.

Under national and international accounting regulations[17] retained amounts are not an item of contract revenues. It also follows from the general definition of revenue, where one of the conditions for recognition is that it is probable that future economic benefits associated with the transaction will flow to the entity[18].

The problem in question is a good example of how important is the interpretation of existing regulations by preparers of financial statements.

A common practice in construction companies in Poland is so called guaranty deposit. It is an instrument for reducing investor's risk arising from dishonest or negligent performance of the construction contract (not meeting the quality standards). Guaranty deposit usually consists in retaining a part of the agreed payment[19] for an agreed period (normally from half a year to several years) as security for covering the costs of potential warranty repairs. This means that a company executing a long-term project (e.g. construction of a road) receives upon project completion only a part of the agreed payment, the remaining part being deferred and encumbered with realization risk.

When interpreting accounting regulations in a very one-sided and, according to the author, definitely incorrect way, each guaranty deposit should be treated as a retained amount and therefore be excluded from the revenues of a long-term project. Considering that the amount of guaranty deposit is mostly almost the same as the profit that a construction company makes on a long-term project, it would mean that for most projects the financial result would be 0. Coupled with the earlier described requirement to change costs of provisions for warranty obligations to project costs, we have a situation that might be called the ultimate, double application of the prudence principle. On the one hand we decrease project revenues by the amounts retained for warranty repairs, and on the other we increase the cost of this project by creating a provision for the same

[17] As In case of ancillary revenues, the Accounting Act does not address the issue of retained amounts. PL GAAP no. 3 states that they are not an element of long-term project revenues. IAS 11 does not especially regulate this issue, but analysis of the definition of revenues in IAS 18 and provisions of IAS 11 indicates that positions of PL GAAP no. 3 and IAS 11 are the same in this respect.

[18] See IAS 18 Revenues, par. 20.

[19] There are two practices in regard to guaranty deposit:

An invoice is made for the entire agreed amount, including the guaranty deposit, the term of payment for the latter being much longer (e.g. a construction contract is for 1 000 EUR, 100 EUR being the deposit). The invoice is for 1 000 EUR, 900 EUR is paid upon project completion and 100 EUR – upon termination of warranty (e.g. after 1 year),

The invoice is made out for 900 EUR, with payment upon completion of work, and 100 EUR deposit is invoiced and paid upon expiry of warranty (e.g. after 1 year).

warranty repairs. This decreases substantially the reported profit and confuses the users of financial statements.

In order to establish the rule of conduct in such cases, it is necessary to refer to the above mentioned condition of revenue recognition – likelihood of its realization. If guaranty deposits are standard practice in the case of companies doing long-term projects and, as the company's history shows, their recovery is practically certain, then in the author's opinion, they cannot be regarded as retained amounts. If, however, the guaranty deposit is treated by an entity as a way to avoid responsibility for the costs of repairs under warranty, than its amount should be excluded from long-term project's revenues.

5.Conclusion

The problems involved in presentation of the results of companies engaged in the execution of long-term projects are exemplified in the paper by selected dilemmas facing the management of such companies. Since long-term projects are an increasingly widespread mode of carrying out business activity, both in Poland and across the world, it is high time to start discussion on these issues. Although some of the problems may seem to be resolved by current regulations, it is important to note that IAS 11, which constitutes a basis for accounting regulations, both national and international[20], was approved in 1978 and last amended in 1993[21]. Since that time the character of business activity has changed significantly. And, since accounting is the language of business, and business has changed, perhaps it is time to make adjustments in this language.

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[20] Both the Accounting Act and PL GAAP no. 3 " Uncompleted construction contracts" are conformable with IAS 11.

[21] Excluding a small change to par.45 in 1999 due to IAS 11 adaptation to revised IAS 10.

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Streszczenie

ZARZADZANIE PROJEKTAMI A PREZENTACJA INFORMACJI W SPRAWOZDANIU FINANSOWYM - POMIAR WYNIKU DZIAŁALNOŚCI FIRM CZY POMIAR WYNIKU PROJEKTÓW – ARTYKUŁ DYSKUSYJNY

Realizacja projektów to forma działalności, która w ostatnich latach, w dobie globalizacji gospodarki i narastającej konkurencji, zyskuje coraz większe znaczenie, zarówno w Polsce, jak i na świecie. Wartość i ilość realizowanych projektów nieustannie rośnie, obejmując już nie tylko branże tradycyjnie związane z taką formą działalności (np. branża budowlana, branża informatyczna), ale praktycznie każdą dziedzinę naszego życia. Niezbędnym elementem determinującym sukces realizacji projektu jest dostarczona na czas szybka, rzetelna i użyteczna informacja. Źródłem tej informacji jest system rachunkowości, który składa się z dwóch podsystemów: rachunkowości finansowej (ukierunkowanej na zewnętrznego odbiorcę informacji) i rachunkowości zarządczej (dającej informacje potrzebne odbiorcom wewnętrznym).

Jednym z podstawowych determinantów tworzenia informacji dla odbiorców zewnętrznych (takich jak inwestorzy, banki, ubezpieczyciele, organy administracji skarbowej, itd.) jest porównywalność. Jej zachowanie wpływa na jakość informacji o działalności projektowej, uzyskiwanej ze sprawozdań finansowych, tworzonych zgodnie z wybranymi regulacjami rachunkowości (np. MSR/MSSF, US GAAP, polska Ustawa o rachunkowości).

Celem artykułu jest wskazanie dylematów związanych z prezentacją w sprawozdaniu finansowym wyniku działalności firm realizujących projekty długoterminowe. Artykuł ma charakter dyskusyjny, gdyż poruszane w nim kwestie

pozostają zazwyczaj w gestii wyboru określonego rozwiązania przez jednostkę. Ponadto niektóre z obszarów podlegają szczegółowym regulacjom prawa bilansowego (zarówno w wymiarze krajowym - Ustawa o rachunkowości i KSR 3, jak i międzynarodowym - MSR/MSSF), jednak ich stosowanie może powodować "zamazanie" wiernego i rzetelnego obrazu sytuacji majątkowej i finansowej przedsiębiorstwa realizującego projekty długoterminowe.