# Interim Financial Reporting in the Perspective of harmonization of the Romanian Accountancy with the International Financial Reporting Standards

Bunea-Bontas, Cristina Aurora
Lucian Blaga University of Sibiu

July 2007

**Interim Financial Reporting in the Perspective of harmonization of the Romanian Accountancy with the International Financial Reporting Standards**

***Cristina Bunea-Bontaş, Lecturer Ph.D***
***"Constantin Brancoveanu" University, Pitesti, Romania***
***The Faculty of Management Marketing of Economic Business, Braila***
***telephone number 004 0745 523471***
***e-mail: bontasc@yahoo.com***

Abstract

The main objective of the interim financial reporting is to present, timely and regularly, information concerning the enterprise's capacity to generate earnings and cash flows and its financial position and liquidity. International Accounting Standard 34 "Interim Financial Reporting" concerns the financial statements for an interim period. According to IAS 34, the interim financial report includes a complete or condensed set of financial statements, elaborated for a shorter period than a full financial year. The accounting policies for recognition and measurement should be applied in the same way as they are applied in the annual financial statements. However, the preparation of the interim reports requires a greater use of estimation methods; the measurement procedures should be designed to ensure the correctness of all the resulting information provided to the users.

Key words: interim financial reporting, interim report, interim period, recognition, measurement

JEL classification: $M_{41}$

The interim financial reporting consists in presenting financial information for a period shorter than an enterprise's full financial year, through a complete or condensed set of financial statement. When making the interim financial reporting one has to follow the International Accounting Standard IAS 34 - Interim financial reporting.

Generally speaking, there are two conceptually different views regarding interim accounting reports and the annual report: the discrete view and the integral view.

Those who share the discrete view believe that each interim period should be treated as a separate accounting period in the same manner as the annual period. Thus, the same principles used to report deferrals, accruals and estimated items in the annual report would also be employed in preparing interim reports. In accordance with the discrete approach, there generally would be no allocation to other interim periods of expenses incurred in one interim period.

Those who share the integral view believe that each interim period is an integral part of the annual accounting period. Under this perspective, deferrals, accruals and estimates reported in each interim period reflect the accountant's belief of what is likely to transpire relative to the results of operations for the entire year. Essentially, interim-period allocations are components of interim accounting reports prepared by the integral approach.

Thus, in the case of the discrete view, the annual operating expenses are recognized during the interim period the moment they are produced, without taking into account the number of the interim periods considered. In the case of integral view, the annual operating expenses are estimated and previously allocated to the interim period on the base of the predictions connected to the level of the annual activities.

While comparatively analyzing the two views, one can notice that those who adopt the integral view claim that, in the case of the results reported for each period, it is necessary to have a unique recognition of the expenses in order to avoid the creation of some misleading oscillations; on the other hand, those who follow the discrete view claim that the harmonization of the interim results with estimating purposes may have unwilling effects, that may hide some evolving tendencies or turning points.

Some specialists think that the distinction between the discrete basis and the integral basis is arbitrary, considering that between the interim periods and a full financial year there is the same relationship as between the fiscal year and the longer periods from the life cycle of an enterprise and, also, that financial interim reports are based on estimates and deferrals. In a real sense, annual financial reports are also interim reports prepared on a discrete basis. After all, the going concern assumption underlying normal financial statements assume reporting entities have indefinite lives. So, the division of this indefinite life into annual intervals constitutes arbitrary division that has evolved into a generally accepted practice for two reasons. First, the annual intervals was deemed sufficiently long for many of the uncertainties (arising from random as well as seasonal factors) to have averaged out such that the accumulated results could be used to both assess past performance and to predict the future results for the same interval. Second, on cost-benefit grounds, the annual interval was seen as an ideal interval over which complete financial statements could be developed and audited at reasonable cost.

The IASB approach is a balanced one, following a combination of discrete and integral direction. In many cases IAS 34 supports the discrete approach (the accounting treatment of the income tax, of the salary taxes of the employer), but, some other times, supports the integral approach (the application of the same accounting policy as in the case of the financial annual situations, excepting the changes of accounting policy after the estimation of the most recent annual financial situation). Unlike IASB, FASB (the American normalization organism), through APB Opinion Number 28, entirely chose the integral view, each interim period being viewed as integral part of the annual period.

From the point of view of the content of the interim financial reporting, the enterprise may choose the report through a complete set of financial statements or through a condensed set of such statements.

If an enterprise publishes a complete set of financial statements in its interim financial report, the form and content of the statements has to be conforming to the requirements of IAS 1 – Presentation of Financial Statement for a complete set of financial statements. If the enterprise publishes a set of condensed financial statements in its interim financial report, the condensed statements has to include, at a minimum, each of the headings and subtotals that were included in its most recent annual financial statement and selected explanatory notes.

The minimum components of an interim financial report are:

(a) condensed balance sheet;

(b) condensed income statement;

(c) condensed statement showing either (i) all changes in equity or (ii) changes in equity other than those arising from capital transactions with owners and distributions to owners;

(d) condensed cash flow statement;

(e) selected explanatory notes.

The interim financial report is intended to provide an update on the latest complete set of annual financial statements. It should include additional line items or notes in case that their omission would make the condensed interim financial statements misleading. For example, the explanatory notes should include, among other, the following information:

- the nature and amount of items affecting assets, liabilities, equity, net income or cash flows that are unusual because of their nature, size or incidence;
- explanatory comments about the seasonality or cyclicality of interim operations;
- issuances, repurchases and repayments of debt and equity securities;
- dividends paid separately for ordinary shares and other shares;
- segment revenue and segment result for business segments or geographical segments;
- material events subsequent to the end of the interim period that have not been reflected in the interim financial statements.

In order to decide how to recognize, measure, classify or disclose the additional information in financial interim report materiality should be assessed. In making assessments of materiality, it should be recognized that interim measurements may rely on estimates to a greater extent than the measurements of annual financial data.

Regarding materiality, an important issue is referring to the disclosure of an item which is material for an interim period but is unlikely to be material for the full year. For example, an entity is publicly traded and publishes quarterly financial information in accordance with IAS 34. During the first quarter it incurred significant restructuring costs that were material in terms of interim financial result. The restructuring costs are unlikely to be material based on projected year-end result. The solution is that if the entity is presenting expenses by nature, the restructuring costs may be presented as separate line item in the interim income statement but, at a minimum, the restructuring costs should be separately disclosed in the explanatory notes. If the entity is presenting expenses by function, the restructuring costs should be separately disclosed only in the notes to the interim report. Besides, the interim report should disclose other important information as the nature of the restructuring costs and an indication of whether additional costs of this nature are expected later in the year and the expected amount of the future costs.

According to IAS 34, enterprises are not required to publish interim financial reports. However, governments, securities regulators, stock exchanges and accountancy bodies often require enterprises whose debt or equity securities are publicly traded to publish interim financial reports which present, timely, information about the enterprise´s performances. The motive is that reliable interim financial reporting improves the ability of investors, creditors and others to understand an enterprise's capacity to generate earnings and cash flows and its financial condition and liquidity.

With the purpose of informing, the interim reports may be made either for three months periods (financial quarterly reports) or for six months periods (half-yearly financial reports).

Considering that comparative reporting is more useful than disclosing information for a single period, interim report should include:

(a) balance sheet as of the end of the current interim period and a comparative balance sheet as of the end of the immediately preceding financial year;

(b) income statements for the current interim period and cumulatively for the current financial year to date, with comparative income statements for the comparable interim periods (current and year-to-date) of the immediately preceding financial year;

(c) statement showing changes in equity cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year;

(d) cash flow statement cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

Recognition and measurements for the interim reporting purposes should be based on the same accounting policies as are applied in the enterprise's annual financial statement, except for the accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. Respecting the discrete basis, the requirements of the Standard induce the impression that for the interim reporting purposes, the measurements are made as every interim period is independent. But the Standard also specifies that the frequency of an enterprise's reporting (annual, half-yearly or quarterly) should not affect the measurement of its annual results, which is according to the integral view. This is an example for the well-balanced orientation of IAS 34.

A characteristic situation is that of an enterprise which earns seasonally, cyclically or occasionally revenues within the financial year. These revenues should not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the financial year. For example, an entity engaged in retailing does not divide forecasted revenue by two to arrive at its half-year revenue figures. Instead, it reports its actual result for six-month period. If the retailer wishes to demonstrate the cyclicality of its revenues, it may include, as additional information, revenue for the 12 months ending on the interim reporting date and comparative information for corresponding previous 12-month period.

The rule which is applied to revenues is applied to costs, too. Costs that are incurred unevenly during an enterprise's financial year should be anticipated or deferred for interim reporting purposes if it is also appropriate to anticipate or defer that type of cost at the end of the financial year. Besides, the Standard specifies that a cost that does not meet the definition of an asset at the end of the interim period is not deferred on the balance sheet either to await future information as to whether it has met the definition of an asset or to smooth earnings over interim periods within a financial year. For example, an entity reports quarterly. In the first quarter of the financial year, the entity introduces new models of its products that will be sold throughout the year. At that time, it incurs a substantial cost for a major advertising campaign that will benefit sales throughout the year. The question is if it is appropriate to spread the advertising cost over the benefit period – all four quarters of the year – or the entire cost should be recognized as an expense in the first quarter. The solution is that the entire cost is an expense in the first quarter. All expenditure on advertising and promotional activities should be recognized as an expense when incurred. Explanatory note disclosure may be required.

But there are circumstances in which the enterprise should anticipate the expenses or deferred the costs for the interim reporting purposes. For example, an entity incurs certain costs unevenly throughout the financial year. Staff bonuses are paid at the year-end, based on the annual sales result against budget. The sales for the first quarter exceeded the first quarter budget. However, first quarter sales typically only represent 15% of annual sales. Management is planning to recognize a portion of the bonus in the first quarter. The solution is that management should recognize the bonus in the first quarter financial report, on the basis that it expects to exceed the full-year sales target. There is therefore a present obligation which should be recognized. A provision of 15% of the annual bonus should de provided.

IAS 34 brings about a series of changes of the general criteria of recognition and evaluation. On one hand, some of these stress the fact that the measuring and estimating techniques applied for interim reports may have some limits and on the other hand, there is the necessity of different interpretations of the definitions for the elements in the interim situations compared to the ones used in the annual report.

The specific criteria for recognition and evaluation are explained separately on the base of the elements of the financial situations structures they refer to. Some of these are presented below, together with examples.

*A provision* is recognized when an enterprise has no realistic alternative but to make a transfer of economic benefits as a result of an event that has created a legal or constructive obligation. The standard requires that an enterprise apply the same criteria for recognizing and measuring a provision at an interim date as it would at the end of its financial year. The amount of the obligation is adjusted upward or downward with a corresponding loss or gain recognized in the income statement. For example, an entity sells vacuum cleaners on which it provides a standard warranty of one-year for parts and labour. Entity's experience is that 5% of vacuum cleaners sold will be the subject of warranty claims. That is why the entity provides a provision of 2,500 in the first quarter. It discovered a fault with the cleaner in the second quarter and has revised its estimate of warranty claims from 5% to 8%. Entity sales are 50,000 in each quarter. The solution is that management should calculate the second quarter warranty cost on the basis of year-to-end sales and the new estimate of warranty claims of 8%:

| | |
|---|---|
| Sales ($1^{st}$ + $2^{nd}$ quarter) | 100,000 |
| Warranty cost (8%) | 8,000 |
| - warranty cost recognized in the $1^{st}$ quarter | 2,500 |
| - change recognized in the $2^{nd}$ quarter | 5,500 |

The determination of the warranty cost for the $2^{nd}$ quarter using sales for the quarter is not appropriate and would have resulted in an understatement of the warranty provision.

*Interim period income tax expense* is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period. For example, an entity which reports quarterly earns 15,000 pre-tax profits in the first quarter but expects to incur losses of 5,000 in each of the three remaining quarters (thus having zero income for the year). The estimated average annual income tax rate is 16%.

Table 1. The amount of income tax expense that is reported in each quarter

| Tax expense | Quarter | | | | Annual |
|---|---|---|---|---|---|
| | $1^{st}$ | $2^{nd}$ | $3^{rd}$ | $4^{th}$ | |
| | 2,400 | (800) | (800) | (800) | 0 |

*Volume rebates or discounts and other contractual changes in the prices* of raw materials, labour or other purchased goods and services are anticipated in interim periods, by both the payer and the recipient, if it is probable that they have been earned or will take effect. For example, an entity publishes quarterly financial information in accordance with IAS 34. It offers stepped rebates on sales based on the following volume:

| | |
|---|---|
| up to 50,000 units | no discount |
| 50,000 – 100,000 units | 5% discount on cumulative sales for the year |
| over 100,000 units | 10% discount on cumulative sales for the year |

All rebates are paid to the customer after the end of the financial year.

At $31^{st}$ of March a customer purchased 40,000 units. That customer has a history of purchasing over 100,000 units each year, spread evenly during the year. The solution is that management should recognize volume rebates of 10% in the first quarter interim report as it expects the customer to purchase over 100,000 units this financial year and the discount is applied to the cumulative sales made to that customer for the year. So, there is a present obligation which should be recognized.

*Depreciation and amortization* for an interim period are based only on assets owned during that period. It does not take into account asset acquisition or disposition planned for later in the financial year.

This practice may attract some problems that other elements of income and expenses don't meet. This happens when the stipulations referring to taxing or the conventions of the financial reporting allow or impose using the special formula of allocation for the acquisition year (or of taking out of administration) of the fixed assets. In such cases the amortization will be different from the one estimated only on the period of the year when the asset was in function. For example, let's suppose that, through convention, the half-year amortization in the acquisition year of the asset, disregarding the number of months where the asset was used. Further, we may assume that a certain asset is bought at the beginning of the fourth quarter. According to IAS 34, no expense regarding the due amortization of the respective asset will be recorded in the first three quarters even if it was common knowledge that the asset starts functioning during the fourth quarter. Still, this would mean that the half-year amortization (two quarters) should be recorded entirely during the fourth quarter, fact that would bring about a distortion of the due results of the final period. IAS 34 approaches this problem, mentioning that an adjustment has to be made in the final interim period, so that the sum of the interim amortization equalizes the annual amortization.

*Inventories* are measured for interim financial reporting by the same principles as at financial year end. Inventories pose particular problems at any financial reporting date because of the need to determine inventory quantities, costs and net realizable values. The net realizable value is determined by reference to selling prices and related costs to complete and dispose at interim dates. For example, an entity prepares the 2$^{nd}$ quarter interim report. Due to the loss of the major customer's business in the first quarter, the entity wrote down the goods normally sold to that customer held in stock from 10,000 to 3,000. In the second quarter, the entity gained a new customer for these goods which remain in stock at the end of the 2$^{nd}$ quarter. The value of the goods was reinstated to 10,000, as there was no impairment loss. So, management recognized the reversal of write-down of 7,000 in the second quarter interim report.

*Foreign currency translation gains and losses* are measured for interim financial reporting by the same principles as at financial year end. For example, an enterprise that presents half-yearly interim financial statements, exported at the beginning of the financial exercise of 10,000, the rate exchange of 3.50. In 30$^{th}$ of June the extern debt wasn't recovered and the rate exchange was that of 3.40. The enterprise's management has to recognize the difference of the rate exchange due to the lost debt at the date of 30$^{th}$ of June. This is recognized in the income and loss account as a financial expense of 1,000.

In Romania, the accounting norms elaborated for preparing and presenting the interim financial report, respectively the Order of the Public Finance Minister no. 1752/2005 regarding the Accounting stipulations according to the European Regulations don't give any details regarding the interim financial reporting. But for the entities that had an activity, there is the compulsoriness of presenting the interim financial report at the 30$^{th}$ of June according to the methodological emitted by the Public Finance Minister. The component of the half-yearly financial reporting is presented in the table bellow.

Table 2. The component of the interim financial reporting at the 30$^{th}$ of June in Romania

| | Current year (N) | Comparative year (N-1) |
|---|---|---|
| Condensed balance sheet | 30$^{th}$ of June N | 31$^{st}$ of December N-1 |
| Profit and loss account | 30$^{th}$ of June N | 30$^{th}$ of June N-1 |
| Informative data (remaining payments, medium number of employees, interests and dues payments, postponed payment obligations, innovation expenses) | 30$^{th}$ of June N | - |

In the case of the half-yearly reporting there must be given a special importance to the determination of the gross profit and of the income tax expense:

- the accounting treatment of the engaged expenses and of the generated incomes;
- the estimation and the accounting treatment of the fixed assets amortization;
- the estimation and the accounting of the deductible provisions from the taxing point of view;
- the accounting treatment of the payment expenses, respectively of the expenses for which no employment and payment documents have been made or whose discount period is longer than a month (as the expenses regarding the holiday or debts pays);
- the accounting treatment of the receiving incomes, respectively of the incomes for which no invoicing and receiving documents have been made yet or whose discount period is longer than a month;
- the delimitation of the expenses and the incomes in advance.

Drawing a conclusion, the interim financial statements may offer to the users significant information referring to the directions of the business growth and moreover, information referring to the seasonal character of some activities. Due to this fact, the objectives of the interim financial report are the same as those of the annual financial statements. Accordingly, the users expect that the interim report should offer data on the financial position, the performance and modifications in the financial position of an enterprise, being useful in making an economic decision.

## Bibliography


Badea, Florentina; Popa, Adriana F. – "Using estimations in interim measurement", in "Administration and Accounting of an Enterprise" Magazine, no. 11-12/2006;

Bartsch, A. J. Robert – "Interim Financial Reporting under SAS 96 (Statement of Accounting Standards)", The CPA Journal Online, 1989, www.nysscpa.org/cpajournal;

Feleagă, Niculae; Malciu, Liliana – "Accounting policies and options (Fair Accounting versus Bad Accounting)", Economic Publishing, Bucharest, 2002;

Mensah, M. Yaw, Wernwe, Robert – "The Capital Market Implications of the Frequency of Interim Financial Reporting: An International Analysis", 2006, http://business.rutgers.edu

Răileanu, Vasile (coordinator) – "Guide for understanding and applying IAS 34 – Interim financial reporting", CECCAR Publishing, Bucharest, 2004;

Ristea, Mihai; Dumitru, Corina-Graziella – "Elaborated accounting", University Publishing, Bucharest, 2003;

Siegel, Joel G.; Levine, Marc; Qureshi, Anique; Shim, Jae K. – "GAAP 2001 – A Handbook of Policies and Procedures", Prentice Hall, New Jersey, 2001;

*** Deloitte "Interim Financial Reporting – A Guide to IAS 34", 2006, www.iasplus.com;

*** PricewaterhouseCoopers "Applying IFRS - Solutions", 2006, www.pwc.com;

*** "International Financial Reporting Standards (IFRS) including the International Accounting Standards (IAS) and their Interpretations at the 1st of January 2005", CECCAR Publishing, Bucharest, 2005.