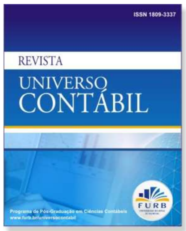

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THE ADOPTION OF THE INTERNATIONAL FINANCIAL REPORTING STANDARDS IN PORTUGAL: CAN EXPECTED COSTS BE REDUCED?[1]

A ADOÇÃO DO PADRÃO INTERNACIONAL DE RELATÓRIOS FINANCEIROS EM PORTUGAL: PODEM OS CUSTOS ESPERADOS SER REDUZIDOS?

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ABSTRACT

In this paper we use a cost-benefit framework to discuss some of the expected effects related to the Portuguese adoption of the International Financial Reporting Standards (IFRS). Given the circumstances underlying this implementation, we anticipate that the overall net result following an analysis of costs and benefits will be negative. Therefore, we also examine what seems to be the causal factor behind this outcome and a potential way of reducing the net cost of adopting the IFRS. The costs are related to the professional updating of accounting skills of those directly or indirectly involved in the accounting process. A part of these costs will be incremental and permanent over time mainly due to the fact that two accounting

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systems will be kept in place. The adoption of a single accounting system, that based on the IFRS, would appear to be a possible solution to reduce such costs.

Keywords: Accounting normalisation. Accounting reporting. International standards. IFRS.

RESUMO

Neste artigo foi usado uma estrutura de custo-benefício para discutir alguns dos efeitos esperados relacionados com a adoção das padrões internacionais de contabilidade (IRFS) em Portugal. Dadas as circunstâncias subjacentes a esta implementação, pode-se prever que o resultado geral após a análise de custos e benefícios será negativo. Portanto, é também examinado o que parece ser o fator causal deste resultado e uma maneira potencial de reduzir o custo líquido de se adotar os IFRS. Os custos estão relacionados com a atualização das habilidades em contabilidade dos profissionais envolvidos direta ou indiretamente no processo contábil. Uma parte destes custos será gradual e permanente ao longo do tempo, principalmente devido ao fato de que dois sistemas de contabilidade serão mantidos. A adoção de um único sistema de contabilidade, baseado nos IFRS, parece ser uma solução possível para reduzir esses custos.

Palavras-chave: Normatização contábil. Relatórios contábeis. Padrões internacionais. IFRS.

1 INTRODUCTION

In this paper we use a cost-benefit framework to discuss some of the expected effects related to the Portuguese adoption of the International Financial Reporting Standards (IFRS). Portugal is characterised by an entrepreneurial structure based on very small firms, and by its narrow capital market of around sixty listed companies - this number refers only to companies with their equity listed in the main market. This environment may help to explain the national reaction to the European Parliament and Commission decision to step up accounting normalisation in Europe through the adoption of the IFRS (Regulation COD/2002/1606). In Portugal, this decision has been given a decidedly minimalist interpretation, in that only listed companies that disclose consolidated financial statements are required to adopt the new accounting rules. In other words, only a very small group of Portuguese companies will be directly affected.

The Decree-Law n. 35/2005, 17th of February, allows other (listed and non-listed) companies to adopt IFRS standards given that they have their accounts audited (art. 12º). However, for fiscal effects, all companies are obliged to keep a parallel accounting based on the national accounting plan (art. 14º).

The potential beneficiaries of this adoption, expected to originate more accurate accounting information, will tend to be the small number of capital market investors and, in particular, a very small group of international institutional investors that trade in about half a dozen Portuguese companies. From the companies' perspective, it may be argued that the expected higher quality of financial information underlying the application of IFRS will eventually result in a lower cost of capital, and may attract more international investors. Companies listed in more than one national market will also benefit from the adoption of the IFRS by cutting the costs involved in the preparation and disclosure of financial information.

The costs of adopting the IFRS are real and expected to be significant. They are likely to have a greater effect on a few groups of professionals that are directly or indirectly related to the accounting process, such as accountants, auditors, market analysts, accounting teachers and governmental tax controllers. These professionals will face the burden of extra costs in two phases: firstly, those entailed in initially mastering the new IFRS environment, affecting them before and during the adoption phase; secondly, future costs that will arise in relation to keeping track of two accounting systems, the IFRS system and the (revised) national system that will continue to be applied to all companies.

Given the circumstances underlying the adoption of the IFRS, we anticipate that the overall net result following an analysis of costs and benefits is negative. We therefore also examine what seems to be the causal factor behind this outcome and a potential way of reducing the net cost of adopting the new accounting standards.

There was not yet a thorough (economic) discussion on the effects of the adoption of the IFRS in Portugal. Given the specific characteristics of the country we think this paper brings a contribution to a better understanding of the whole adoption process and highlights the care that must be taken when importing accounting models designed for different realities. Nevertheless, the paper shall only be seen as a first step in a deeper discussion that has to be done in Portugal around the IFRS subject.

The paper is structured as follows. In Section 2 we provide an overview of the current Portuguese accounting environment. Section 3 discusses potential costs underlying the adoption of the IFRS, followed by a review of its potential benefits in Section 4. In section 5 we make an overall assessment of costs and benefits and briefly discuss a potential way of reducing the net costs expected from the introduction of the IFRS. Finally, in Section 6 we draw a brief conclusion.

2 AN OVERVIEW OF THE PORTUGUESE ACCOUNTING ENVIRONMENT

2.1 The Accounting Environment Strict Sensu

Within the framework put forward by Ball et al. (2000) to classify countries according to their accounting systems, Portugal can be labelled as a code-law country. This is somewhat to be expected when one considers that the Portuguese accounting system, first implemented in 1978, was based on the French system. The General Accepted Accounting Rules (GAAP) have two main sources: sector specific accounting plans (AP), which detail the accounting procedures to be used in companies' operations within a specific sector; and directrizes (DIR), accounting rules with mandatory power issued by the Comissão de Normalização Contabilística (CNC). CNC is the Portuguese Accounting Standards Board established by law and aims to pursue the internal normalisation and the international harmonisation of the Portuguese GAAP.

The AP fully reflect the principles of the 4th and 7th Directives of the European Commission, while the DIR tend to follow international standards on accounting issues not yet reflected in the AP. The DIR are thus used as a kind of regular update of the AP. Moreover, for the companies not obliged to follow the IFRS, these standards are a subsidiary source of accounting rules in the absence of a national one. The case of the accounting treatment for derivative financial products, with the exception of futures contracts, is probably the most notorious situation of an operation that is not dealt with either by AP or DIR. However, only very few companies, mainly financial institutions, use this subsidiary source of accounting regulation in their reporting.

As a law based system, the level of flexibility on accounting choices allowed by the AP is relatively low. A very detailed regulation tends to reduce companies' discretionary behaviour, this being a noteworthy difference between the current Portuguese accounting system and that underlying the IFRS. This aspect is often used as ammunition by those in opposition to the adoption of the IFRS, in an attempt to spread anxiety about the greater flexibility underlying the IFRS, and on how this flexibility may lead to creative accounting practices and even accounting frauds. Beyond the detail of the accounting rules, the tax system also tends, albeit indirectly, to be a constraint on companies' flexibility in interpreting and choosing accounting rules.

2.2 The Impact of the Tax System on Accounting Flexibility

The Portuguese accounting and tax systems are closely linked. Annual financial statements are legally defined as the basic source of information for tax purposes. Companies have to fill in a tax form to estimate the annual amount of taxes due, which is essentially a summary of the information reported in financial statements adjusted according to tax law. The nature of these adjustments constrains the use of different accounting treatments for financial reporting and tax purposes.

To illustrate this point, let us examine the way depreciation charges are dealt with under the tax system. The maximum tax-deductible rates companies may adopt, according to industry and type of assets, is established by law. If a company decides to use a rate lower than that permitted by law in its annual statements, it is not allowed to adjust the depreciation charge in the tax form. Moreover, it is not allowed to consider the difference between the legal maximum amount of depreciation and the actual amount entered as a tax deductible cost for future periods.

This difference is thus a lost depreciation for tax purposes. If the company uses higher depreciation rates than the tax-accepted ones, it has to adjust (deduct) the extra amount in its tax form, but it is allowed to consider that extra (adjusted) amount as a tax cost in a future period if the accounting reflects the adjustment. However, the AP do not have guidelines on how to reflect this adjustment in the accounting. Similar types of legal tax constraints exist for other accounting operations, such as the creation of provisions/adjustments for expected losses.

The obvious effect of these tax constraints is that companies adopt accounting policies that minimise their tax payments – as one would rationally expect – and make financial statements to present a tax view rather than a true and fair view. Thus, the tax system (indirectly) causes companies to lose flexibility in their choice of accounting policies, and pushes them towards tax driven solutions.

There is no official justification for this close relation between the accounting and tax systems in Portugal. It appears to be the result of historical and cost saving factors, namely that it is the easiest way for tax authorities to control companies' tax payments. In a country where, historically, company tax evasion is huge, and where only a relatively small number of companies pay taxes, this reason may be considered plausible. However, given the current level of tax evasion, the conclusion may be drawn that such a solution is highly ineffective in dealing with this problem.

The adoption of the IFRS is widely defended on the grounds that it will improve the quality of companies' reporting. Nevertheless, if the Portuguese tax system does not sever its relation with the accounting system, the argument that better quality accounting information will result seems to be invalid as a justification for the Portuguese case. In effect, no matter what set of accounting standards are used, financial statements will continue to present a tax view of companies. To date, with almost a year passed since the IFRS adoption deadline, (IFRS adoption is compulsory since January 2005) there is still no sign as to whether the Government, through the Tax Administration, has decided to change the situation and sever the relation in order to make companies' accounting choices more independent from the tax system.

The Decree-Law n. 35/2005, 17th of February, seems not allow any illusion on this subject. For fiscal effects, all companies, including those adopting the IFRS, are obliged to keep a parallel accounting based on the AP (art. 14º). The close relationship between the accounting and tax systems may not affect all companies in the same way. The overall effect will tend to be sector specific, and depends partly on companies' business and capital structures.

2.3 Companies Obliged to Adopt the IFRS

The CNC decided that the IFRS would be implemented in Portugal with differentiated levels of complexity according to company type. Firstly, listed companies must adopt the new accounting environment and the conceptual structure of IFRS in their consolidated statements since January 2005. Secondly, for all other companies not included in this first level, the current accounting environment, in particular the AP, will be revised to absorb part of the IFRS requirements, while keeping it simpler than the original standards.

Till now there is not yet a sign on when this revised set of accounting rules will be available. We think the update of the AP may be done following the expected adoption by the European Commission of the international accounting standards for small businesses, under development by International Accounting Standard Board (IASB).

As a result a second division accounting environment will be created, a soft version of the IFRS that will probably not differ greatly from the current Portuguese GAAP. Till then, this second division corresponds to the current AP environment. According to Sousa (2003), the reason for keeping two differentiated levels of normalisation is due to the fact that the IFRS are too complex and demanding and thus not appropriate to be imposed on medium and small companies.

Under these circumstances, and given that only a handful of companies have their equity listed, the first division will comprise around one hundred companies and all others will be included in the second division. The number of companies in the first division may be higher if there are volunteer adopters (Decree-Law n. 35/2005, art. 12º). Moreover, since there is no sign that the entrepreneurial structure will change radically in the foreseeable future and allow the aggregation of most companies into the first division, a dual accounting system must be maintained that will increase the costs to all those involved in the accounting process.

3 EXPECTED COSTS OF IFRS ADOPTION

The adoption of the IFRS is not costless. We expect the (economic) costs to the various professional groups involved in the accounting process to be significant. For accountants, auditors, financial analysts, general investors, governmental tax controllers, and accounting teachers, amongst others, the main cost is related to initially mastering the new accounting standards. Compared with the national accounting framework, the IFRS are much more complex and, although some professionals may already have some knowledge of IFRS usage, for most it will be a new and costly issue.

For these groups, two main types of costs are likely to be incurred. Firstly, the time spent attending the necessary training courses for a better and faster update on the IFRS represents a significant opportunity cost, since time is an extremely valuable resource for most professionals. Secondly, the monetary cost of these courses, either paid by companies as part of their contribution to staff training, or by the professionals themselves.

Both these types of costs tend to occur before and during the adoption of the IFRS. However, overall costs must also include those that will be incurred following the full adoption of the new standards. For example, accounting teachers will require more teaching time in order to be able to acquaint their students with two different accounting systems. This will be a permanent cost for universities and other teaching institutions, although we anticipate that teachers will bear most of this cost through an increased (unpaid) workload.

For companies, that currently have to report using both first and second division accounting systems, there may be permanent extra costs related to the hiring of more professionals to handle heavier accounting duties.

Last but not least, for all the professional groups mentioned there is a permanent (opportunity) cost entailed in having to keep up to date in two accounting systems, rather than in one as at present. For professionals with bargaining power, these costs will tend to be reflected in the price of their services. For all others, there will always be at least a non refundable opportunity cost.

Thus, we summarise these costs (C) for the economy as a whole in the following way:

$$C = f(training,\ tracking,\ teaching)$$

It would appear obvious that these permanent costs are essentially incremental costs that are caused by the parallel existence of two accounting systems. Thus, the cost of adopting the IFRS and in particular of maintaining two parallel accounting systems is not a one-off lump sum, but rather a permanent and highly significant cost for a large group of accounting-related professionals and companies.

4 EXPECTED BENEFITS OF IFRS ADOPTION

It may be supposed that the adoption of the IFRS will lead to an increased level of economic activity brought about by the updating of training and educational processes involved in its introduction, which will be reflected in the GDP. This is undoubtedly a benefit. However, the benefits that are relevant to the present discussion are those that relate directly to the reasons behind the compulsory implementation of the IFRS, i.e. those related to the higher quality of company financial information and to the impact it has on capital markets.

The literature shows that if accounting information is useful, it has an impact on company valuation in capital markets (e.g. BALL and BROWN, 1968; BEAVER, 1989), and that information quality affects the allocation of economic resources (e.g. CHAMBERS, 1999). It is at this (utility) level that the benefits of IFRS adoption must be examined. The higher degree of accounting disclosure underlying the new (international) standards, and the higher flexibility they allow, seem to justify the assumption that IFRS adoption increases information quality and thus has a positive impact on the efficiency of resources allocation. We are assuming that the expected higher volatility of income under the IFRS will not affect an efficient resource allocation and thus do not translate into a cost for investors.

A further benefit will come from the international acceptance of IFRS, allowing cross-listed companies to save resources on the preparation and disclosure of accounting information. These are the main benefits we may attribute to the introduction of the new accounting regulation. However, in the light of the information presented in Section 2 on the number of companies that are obliged to adopt the IFRS, and the narrowness of the Portuguese capital market, we estimate that this benefit will be relatively small.

It may also be supposed that the use of international standards could help foreign investors to discover Portuguese companies, by making their financial statements more transparent and information easier to use. As the Lisbon Stock Exchange (Euronext Lisbon) is a member of the pan-European Euronext trading platform, this benefit may be a real one. However, only less than 20 Portuguese companies are currently traded at a pan-European level.

This will also be a concrete benefit. Yet the small size of most Portuguese companies, including those that are listed, does not support expectations of significant benefits. The fact that Portuguese investors may also benefit from their increased ability to understand and use the information on foreign companies adopting the IFRS does not appear to be a significant benefit. One may say that increased quality in accounting information benefits all citizens. Theoretically it is true. However, given the divorce between the common citizen and capital markets, we think the number of those directly affected is not too large.

Thus, the expected benefits from the increased quality of financial information underlying IFRS adoption are quite limited. Moreover, so far in this section we have implicitly assumed that the adoption will sever the current ties between the accounting and tax systems. It is not the case. As mentioned above, the Decree-Law n. 35/2005, 17th February, on imposing to all companies following the IFRS the obligation of keeping also accounting under the AP, indirectly pushes companies to adopt fiscal solution in their reporting. Therefore, we may not exclude that the tendency for companies' financial information to present a tax view will continue and IFRS adopters may not actually disclose information of higher quality.

The expected benefits (B) from the adoption of the IFRS can thus be summarised in the following way:

$$B = g\,(\textit{information quality disclosure, cross listing, international investors})$$

Hence, even in the best-case scenario, the expected benefits arising from IFRS adoption would appear to be relatively small compared to the underlying costs discussed in the previous section. This means that the expected net cost (NC) is negative

$$NC = B - C < 0$$

However, even if we would think that NC is positive, the costs of IFRS adoption are too high and should be reduced.

5 CAN THE NET COST OF IFRS ADOPTION BE REDUCED?

From the cost-benefit analysis undertaken so far in this paper, specifically in the two previous sections, it would seem obvious that the expected costs of IFRS adoption will tend to be much greater than the benefits, i.e.

$$NC < 0$$

However, although a straight economic analysis suggests that that it does not make sense IFRS adoption, we cannot discuss it in such a way. Portugal is a member of the European Union (EU), and as such, this is not a reasonable argument, even though it may be supposed that Portugal will bear a cost imposed by a change that the European Commission expects to bring benefits to the EU taken as a whole. Not all EU decisions can be assessed in strict economic terms. Nevertheless, we believe that the structural characteristics of the Portuguese entrepreneurial structure should have motivated negotiators to demand financial help to bear the inherent costs, at least in the first years of the adoption period. Unfortunately, this opportunity has been lost. The important issue now is to examine the possibilities of making the impact of IFRS adoption less costly in the future.

We have posed the question of whether the net effect underlying IFRS adoption can be reduced. It must not be forgotten that a large part of the costs discussed in Section 3 were incremental and arise from the fact that two accounting systems – what we have called first and second division systems – were to be maintained in the future. We may conclude therefore that if it were possible to keep only one system, that based on the IFRS, these costs could be expected to drop significantly.

We are aware that the full adoption of IFRS would be an overwhelming burden for small companies, and also that they regard bookkeeping as an activity imposed by law that is useful only for tax purposes. Unfortunately, these companies do not see accounting and its information output as a basic corporate management tool. Why not then simply free these companies from the obligation of having a formal accounting, and tax them on an annual lump sum regardless the amount of business they make, or on a given percentage of their annual sales volume?

A decision of this sort is not original in itself, but could produce the advantage of reducing IFRS adoption costs. The current special of corporate tax advance, that implies that companies have to pay in advance a percentage of their last period revenue, can be seen as a tool of this kind. The idea is simple and intuitive. Freeing small (and small-medium) companies from accounting duties would make it possible to impose the full adoption of IFRS on all remaining companies in the short term, and have only one accounting system in place.

This solution is flexible enough to allow for a milder version with three classes of companies while still operating under a single accounting framework. The first class of companies would fully apply the IFRS. The second one, made up of medium size companies would apply the IFRS but with fewer constraining disclosure requirements. The third, a residual group of small companies, would be free from accounting duties. This solution has the advantage of allowing all the benefits of IFRS adoption and also enables the main goal of reducing the underlying costs of adoption to be achieved.

However, this measure involves a tough political decision, and as a result we doubt that the Portuguese Government would be open to its consideration. The reasons for our doubts are threefold. Firstly, company law is the main accounting enforcement mechanism for establishing most of the basic obligations to disclose accounting information. The same code of law also plays a crucial role in setting up the rights and obligations inherent to the shareholder structure of every single type of company. Within this framework, accounting is vital as a control mechanism for the purposes of the law and the protection of shareholders and corporate partners. To free small companies from accounting obligations would imply the need to revise company law.

Secondly, the (high) level of company tax evasion in the Portuguese economy could potentially increase, although this is by no means certain. In all likelihood the Portuguese Government, currently struggling to control the public budget deficit and tax evasion, would shy away from a measure that may carry a certain risk of increasing the problems in these two sensitive areas of economic policy.

Finally, the public budget is not expected to be significantly affected by the costs mentioned in Section 3. These will essentially affect professional groups involved in the accounting process and companies, and as such, do not exert a great deal of pressure on the Government in its decision regarding the implementation of a single accounting system in the country.

In sum, although the costs of IFRS adoption could be substantially reduced, the current public budget situation and the fear of an increase in tax evasion make it seem unlikely that the Portuguese Government will take positive measures on this issue.

6 CONCLUSIONS

In this paper we have briefly discussed within a cost-benefit framework the expected effects underlying the adoption of the IFRS in Portugal. The costs are related to the professional updating of accounting skills of those directly or indirectly involved in the accounting process. A part of these costs will be incremental and permanent over time due mainly to the fact that two accounting systems will be kept in place. In view of the small number of companies that will be obliged to adopt the IFRS, and the narrowness of the

Portuguese capital market, the benefits of the adoption are expected to be small and significantly lower than its costs.

The adoption of a single accounting system, that based on the IFRS, would appear to be a possible solution to reduce such costs. We have discussed this solution and are aware that it would imply a political decision to free small (and small-medium) companies from their obligation to maintain a formal accounting. However, the need to revise company law, the current difficulties facing the Portuguese Government in dealing with the public budget deficit and extensive company tax evasion may represent serious obstacles to taking such a decision. Therefore, although a way of reducing the cost of IFRS adoption has been identified, it does not seem to be politically feasible in the near future.

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