Problematic Aspects of Financial Reporting in Latvia

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Abstract. The article outlines the changes of accounting policy in financial reporting having occurred in Latvia within the past decade. This period is significant, since the Latvian system of financial accounting and reporting was integrated into the European accounting system. The legal regulation of accounting has been developed and improved in the mentioned period. The article focuses on the legal and regulatory enactments defining significant changes in Latvian system of financial accounting, and development tendencies for the regulation of accounting in Latvia within the recent years. The research hypothesis: adjustment of the regulatory enactments on accounting assumes their harmonisation with the requirements of international standards.
Key words: accounting policy, significant information, financial reporting, standards, the development of financial accounting in Latvia.
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Introduction

Market relations imply an appropriate economic area, which encompasses a wide range of different objects and subjects, and where each of them independently, without any mediation, decides on the mutually beneficial economic relations with business partners. This informational connection is provided by financial reporting, which is a link between an enterprise and the society, and one of the tools for its management. Data of the financial statements are interesting for a wide range of individuals and legal entities, which are connected with the activity of reporting enterprise. Financial reporting is a means of interaction between an enterprise and the market. For better efficiency, the market as external user shall have appropriate information on the activities of a business entity. Information may be insufficient or excessive for the user; thus, urging for the introduction of the notion "material information".

Reforming of accounting implies its progressive and harmonious development consistent with the acknowledged principles, assumptions and rules, which are formulated in the International Financial Reporting Standards. Considerable changes have occurred in this direction within the past decade; hence, Latvian Accounting Standards (LAS) becoming the initial basis for the changes (Jesemcika A., 2008). The course of reforms is supported by the Cabinet Regulations No. 427 of 5 August 2003. The Cabinet Regulations No. 488 of 21 June 2011 prescribe the procedure for outlining events after the balance sheet date, change of the accounting policy, and changes of accounting calculations and adjustment of errors in the financial statements.

The usefulness of accounting and the information of financial reporting are achieved by the direct use of the LAS. The IFRS have served as the basis for developing of Latvian financial accounting and reporting system. Therefore, issues on the practical application of the LAS No. 4 "Change of Accounting Policy, Changes of Accounting Calculations and Errors over Previous Reporting Periods" (hereinafter – standard) in financial accounting for making scientifically reasonable economic decisions in strategy of the development of enterprises' activity are especially important for Latvian enterprises (Latvijas gramatvedibas standarti, 2005). The standard is adopted by the decision of the Accounting Board on 9 February 2005. Article 15.2 of the law "On Accounting" determines the meaning of Latvian accounting standards in the preparation of financial statements as common and reusable guidance for recognition, estimation of items in financial statements, and provision of their explanation.

Here, one should note the practical importance of Principle 4 of the LAS principle on the definition of criteria of choice and changes in the accounting policy. Currently, the standard is the cornerstone of the whole reporting preparation system.

The aim of the research – to ascertain the tendencies of changes having occurred in the system of financial accounting and reporting in Latvia within the past decade.

Tasks of the research – to study the criteria of choice and changes in the accounting policy as well as accounting and representation of the changes of the accounting policy in financial statements and changes in accounting calculations.

Methods of the research. Legal and regulatory enactments were analysed for the research purpose. The method of analysis and synthesis, a logically constructive method, and a monographic method were used in the research.

Research results and discussion

Analysis

Reforming of accounting in Latvia, its adaptation to the market demands and international standards will require clarification of the existing provisions of accounting both in the title and the content and more precise classification. In international practice, the mentioned provisions are known as the principles of accounting, and so they are disclosed in international and Latvian accounting standards (Resina G., 2008).

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The presence of single principles of accounting is explained by the very purpose of financial accounting in the market economy, which is intended to generate complete and authentic data on the property and financial situation of enterprises, act as a method of communication among entrepreneurs, and to be a part of the general government system forming macroeconomic and microeconomic indicators. The accounting policy of an enterprise should meet the requirements of completeness, accuracy, priority of materiality over form, continuity, and rationality (Starptautiskie finansu parskatu…, 2008).

Latvian accounting system does not contradict the world acknowledged approaches to the accounting. The presence of fundamental principles of accounting (assumptions, requirements, and provisions) suggests its unconditional performance (Gada parskatu likums, 1992; Konsolideto gada parskatu…, 2006). Essentially, they are explained by the very purpose of accounting in the market economy, which forms complete and authentic data on the property and financial situation of enterprises. Notions of "assumption" and "requirement" are also the provisions of accounting.

The accounting policy is changed only if:

— there is a need for any explanation;
— financial statements result in containing reliable and more relevant information on the influence of operations, other events or conditions influencing the financial situation of the enterprise, its financial results of activity, and,
— the cash flow.

The users of financial statements shall have the opportunity to compare financial reports of an enterprise for several reporting periods to determine the tendencies of financial situation, operational, and cash flow results. The approved accounting policy shall be applied consistently from period to period to provide comparability of reporting. Therefore, the same accounting policy, excluding the abovementioned cases, is usually applied in financial statements.

The accounting policy is not changed if it is:

— approved for operations, other events, and services, which essentially differ from the earlier operations, events, and services;
— applied to such operations, other events, or services, which did not happen earlier or were insignificant.

The management of an enterprise may apply the accounting policy, which is approved by the new documents issued by other standard-setting authorities. Enterprises may voluntarily make a decision to change their accounting policy based on the later-made changes in the mentioned documents.

The change of accounting policy with the retroactive effect means that the enterprise corrects the balance of each equity item, which has been influenced in all the previous reporting periods. The enterprise also adjusts other comparative indicators for all the reporting periods as if the new accounting policy has always been applied. Application of the new accounting policy retrospectively means the comparison of information of the previous reporting periods as long as it is practically possible. Exceptions are allowed in case it is practically impossible to determine the influence of this accounting policy on each previous reporting period or its general influence (Latvijas gramatvedibas standarti, 2005).

It is not practically possible to apply the accounting policy with retrospective effect in a certain previous period if it is impossible to determine its general influence on the rest of balance sheet items at the end and the beginning of the reporting period. The sum of adjustments, which relates to the periods prior to the specified ones in the report, is attributed to the balance of each equity item at the beginning of the oldest specified period. Usually, the adjustment is attributed to the retained earnings but it may also be attributed to another equity item. Any other information on the previous reporting periods, for example, disclosure of financial data, is also being adjusted as long as it is practically possible.

In case of practical impossibility to determine the influence of accounting policy on comparative indicators for one or few previous specified periods, the enterprise applies the new accounting policy for the book value of assets and liabilities at the beginning of the period, starting from the oldest period it is practically possible. In case of the reporting period, the remaining equity items of this period influenced at the beginning of the period are respectively adjusted. Hence, in such situation, the enterprise adjusts comparative information prospectively; starting from the date such adjustment is practically possible.

The change of accounting policy is allowed also if its perspective application is impossible in none of the previous periods. The enterprise indicates in the notes to the financial statements the sum of adjustments occurred due to the application of requirements prescribed by the new external regulatory enactments and Latvian Accounting Standards. The sum is attributed to periods before the specified period, as long as it is practically possible to determine it.

The annual report ensures the evaluation of the financial results of business, the state of settlements with the budget, creditors, lenders of money, and the economic conjuncture (Zarina V., 2004). The violation of individual accounting principles and requirements without sufficient reasons may distort the property and financial situation of an enterprise and its business results. On certain conditions, it may be interpreted as incorrect accounting.

However, it does not mean that the enterprise in any case has no right to neglect the mentioned assumptions. In reality, especially on conditions of the economic crisis, there may be cases when the enterprise has to neglect some assumptions. For example, the assumption of going concern business is not applicable in the accounting policy in case of liquidation of an enterprise. These situations are exceptions from the general rule (Gada parskatu likums, 1992; Konsolideto gada parskatu…, 2006).

The choice of accounting methods may be linked with the choice of preference for one or another requirement. For example, completeness of the accounting of economic activity may not completely meet the requirement of rationality and vice versa. In this situation, the enterprise management has to evaluate the influence level of chosen method on the usefulness of financial information, and to decide on the requirement to be preferred. Hence, the establishment of accounting policy is the process of balance achievement between the mentioned principles and requirements.

The Annual Accounts Law specifies general requirements for the preparation of financial statements and content of financial statements, provides the

Table 1

Criteria for setting the principle of materiality

No.	Criteria	Indicators of financial statements, LVL	Materiality, %
1.	Earnings before taxes	0 – 1 000 000 1 000 000 – 3 000 000 3 000 000 - … … …	10 7 5
2.	Net turnover	… … … . - 3 000 000 3 000 000 - … … …	1 0.5
3.	Total assets	… … … . – 1 000 000 1 000 000 – 10 000 000 10 000 000 - … … …	2 1 0.5

Source: author's construction based on legal enactments of the Republic of Latvia

Table 2

The example outlining the influence of application of the new accounting policy with retroactive effect

No.		Sum of influence		
		Balance sheet	**Profit or loss account**	**Statement of changes in equity**
	Influence on the previous reporting period			
1.	Increase in interest payments and decrease in the value of objects under construction	(x)		
2.	Reduction of corporate income tax payments and related liabilities	x		
3.	Reduction of net profit		(x)	
4.	Adjusted balance on 31 December of the previous reporting period			(x)
	Influence on the periods from two to more previous years			
1.	Increase in interest payments and decrease in the value of objects under construction	(x)		
2.	Reduction of corporate income tax payments and related liabilities	x		
3.	Reduction of net profit		(x)	
4.	Adjusted balance on 31 December 20XX			(x)
5.	Net influence of change of the accounting policy on 31 December of the previous period		(x)	(x)

Source: author's construction based on legal enactments of the Republic of Latvia

characteristics of statements, the procedure for their submission, terms for storage, and the responsibility (Gada parskatu likums, 1992). The principle of materiality prescribes the disclosure of all the material information related to the basic indicators of the enterprise in accounting and financial reporting. It is recommended to set the materiality in the accounting policy of an enterprise expressing its size as a share (Table 1).

Errors may appear in the recognition, estimation, statement, or indication of items in the financial statements. Financial statements are considered not prepared consistent with the external regulatory enactments and Latvian Accounting Standards if they contain material errors or deliberate trivial errors made to create a definite opinion on the financial situation, business results, and cash flow of the enterprise. Errors of the reporting period disclosed in the period or at the end of the period are adjusted before the approval of financial statements for publication (Butinjec F., 2008). However, sometimes material errors are not disclosed till the next periods; and then the adjustment of these errors is indicated in the notes to the financial statements of the appropriate next reporting period.

Cases of unidentified or incorrectly identified information are material if they individually or commonly may affect the business decisions of users made on the basis of the financial statements. The materiality depends on the amount of unidentified or incorrectly identified information and the estimation of the essence in the context of specific circumstances. The amount or the essence, or both of them may be the decisive factor.

If the accounting policy has been changed in the annual report, then it is necessary to adjust the respective indicator of the previous period's item. Each case containing incomparable data or adjustments in data of the previous reporting periods is disclosed in the notes to the annual report.

The author provides an example of changes in the accounting policy and impact of changes on the financial statements. In the reporting period, the enterprise has voluntarily changed the accounting policy regarding the capitalisation of payments on loans. Before the reporting period inclusively, the historic value of objects under construction increases in payments on loans used for formation of fixed assets. From the reporting period, these payments include the business results of the reporting period – the profit or loss account. The accounting policy is changed to ensure more transparent financing consistent with the needs of the main funding entities of the enterprise. The application of the new accounting policy with retroactive effect has the following influence:

The accounting policy has been changed with respect to the capitalisation of loan expenses and other expenses. The new accounting policy implies that the initial costs of objects under construction include the direct costs incurred in respect of the constructed object before its commissioning, excluding payments on loans that are included in the profit or loss account of the period they have incurred. Thus, it was required to adjust the financial statements retrospectively.

Problems

In Latvia, the "liquidation value" is not being applied in the development process of accounting policy and calculating the depreciation of fixed assets (Starptautiskie gramatvedibas standarti, 2008; Zarina V., 2004). The depreciation of fixed assets is admissible up to a hundred percent. Expenses related to the liquidation of fixed assets are not being considered in the calculation. Therefore, the residual value of fixed assets equals zero after the end of their useful life determined by each entrepreneur independently. Frequently, such fixed assets are still being used in business activity without their revaluation at fair value. According to the materiality principle, enterprises shall determine the liquidation value, for example, 5-7% of the initial costs of fixed assets. This will help avoid errors in the accounting of fixed assets with zero value.

Issues related to the application of fair value in accounting and reporting, are not completely studied and methodologically developed in Latvia (Kuzmina I., 2006). Hence, assets in the balance sheet are reflected by different evaluations:

— foreign currency is disclosed by the real value (according to the exchange rate of the Bank of Latvia);
— fixed assets - mostly by the revaluated value (applying very average coefficients), which frequently does not correspond to the actual value of concrete objects;
— accounts receivable and accounts payable - usually by the historic value;
— material reserves – by mixed value, i.e. one part is reflected by the historic value and the other part - by the possible sales value;
— finished goods, in cases when the account "production output" is used in the accounting policy - by the standard (planned) cost etc.

The author believes that such a mix of different evaluations of assets and liabilities in the balance sheet as one of the basic forms of financial statements evidences not only the absence of a single concept in financial reporting but also forces the users of financial statements encounter unreasonable difficulties. In addition, the balance sheet as the main source of information thereto, greatly decreases in its value, since it contains only approximate to reality evaluations of the enterprise's resources and not the real ones.

Accountants do not apply the principle of fair value due to the following reasons:

— they are afraid to exceed their competence and to break the law;
— determination of "fair" value is perceived as the function of an evaluator and not of an accountant;
— the sphere of the fair value is quite new for the legal system of Latvia.

The accounting by fair value and the disclosure of information on fair value are the different ways of disclosure of information on fair value, which have different consequences both from the point of view of reflection of financial data in the financial statements and the analysis of these data by the users of financial statements.

The disclosure of assets by fair value leads to the changes not only in the balance sheet data, but also in financial results of the enterprise's business that are included in the profit or loss account and in the statement of changes on equity. At the same time, the disclosure of information on fair value provides the user with additional data that could be used for the analysis of the enterprise activity without changing of the reporting data. Evaluation of fixed assets by their fair value would allow enterprises disclosing their potential and future opportunities in the reporting as well as providing the opportunity to evaluate business activity of the enterprise. Therefore, the author primarily focuses on the reforming of financial accounting, since currently, the problem of investment attraction for the sectors of economics remains topical and acute.

The following question immediately arises with respect to changes of the accounting policy: for how many years is it necessary to recalculate the reporting data if an enterprise is operating, for example, 20 years. From a purely theoretical point of view, the answer is obvious – for the entire 20 years. However, the opportunity to apply this approach in practice is doubtful and the opinions on this fundamental recalculation will hardly cover its costs.

Conclusions, proposals, recommendations

1. The paper analyses the criteria of choice and change of the accounting policy in the financial reporting of Latvia. Significant changes in this sphere have occurred within the past decade, Latvian Accounting Standards (LAS) becoming their initial basis. This sphere is regulated by the Cabinet Regulations No. 427 of 5 August 2003 and No. 488 of 21 June 2011.
2. Accounting policies should not be applied when their influence is insignificant. However, even insignificant deviations from the standard, which are committed to present a certain opinion on the financial situation shall not be allowed or ignored.
3. The biggest problem of the standard No. 4 is the retrospective recalculation of indicators for the past years related to the change of the accounting policy or to the detection of serious misstatements related to the previous reporting periods, and the provision of comparability.

4. Issues related to the application of fair value in accounting and reporting are not completely studied and methodologically developed in Latvia.
5. Latvian Accounting Standards, particularly LAS No. 4, are an important step in the reforming of financial accounting, since currently, the problem of investment attraction for the sectors of economics remains topical and acute.

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