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The International Financial Reporting Standards (IFRS) Mean to Businesses and Investors in Uzbekistan

Khalilov Bahromjon Bahodirovich [1]

Abstract: This article presents the importance, development and conditions of creation of International Financial Reporting Standarts, which is developing all over the world. The accounting profession is very conservative, and therefore its representatives are wary of such new products and quite rightly want to first get a thorough analysis of the effectiveness of IFRS, their functionality and reliability, and only then make a decision on the possibility of their use for investors. It must be said that in Western countries, IFRS has already become widespread, becoming a familiar way for businesses to organize the accounting system.

Keywords: business, costs, financial, investors.

On February 24, 2020, The President of Uzbekistan announced a roadmap for a complete change in U.S. accounting standards. If the roadmap is adopted, Uzbekistan companies will have to change from the country's existing accounting rulebook to International Financial Reporting Standards (IFRS) in 2021. Under the Presidental Rule, some very large firms (most likely multinationals) may adopt the new standards as early as 2020. While in recent weeks market turmoil has grabbed headlines, the underlying change in accounting rules could have a deeper and longer lasting impact. If the change goes well, it could usher in easier access to capital for Uzbekistan and foreign firms, lower the costs for Uzbekistan firms operating overseas, and simplify accounting for companies worldwide.

Critics of the switch point to weaknesses in the international standards; for example, they do not provide detailed enough guidance to companies, they may allow managers more potential to manipulate earnings, and they may increase costs and create confusion for businesses. This article examines whether the changeover is likely to happen, and if so, what it will mean to Uzbekistan and foreign firms.

International Financial Reporting Standards (IFRS) were developed by the International Accounting Standards Committee (IASC) and its successor organization, the International Accounting Standards Board (IASB). Because of the standards' identification with these bodies, IFRS is sometimes referred to as IAS GAAP. A note about terminology: Generally Accepted Accounting Principles (GAAP), either U.S. or IAS, are a set of documents that specify the accounting principles and guidelines that companies use to prepare their financial statements, which are the main way companies communicate with their investors and other stakeholders. GAAP documents give guidance on what component statements should be shown within the published financial statements, how the figures in the financial statements should be calculated, and what notes and additional details should be included.

Although it seems like a major step to replace one set of accounting principles with another, it should be noted that any GAAP is a constantly evolving set of principles. Over the last 20 years, U.S. GAAP has seen complete rewrites in the accounting for mergers and acquisitions and in the accounting for derivatives and hedges, as well as major changes in 28 other areas. For investors, the new standards will require an adjustment in how they interpret earnings numbers. For government, it will require ceding some regulatory power to an international body. The gain will be improved access to international capital; however, this is no benefit to the many smaller firms uninterested in international capital, which, in any case, is a difficult benefit to quantify. Adopting IFRS will also require

[1] Asia International University, Bukhara Lecturer of Department of "Economics"

businesses to conduct a one-off reworking of accounting records (at an administrative cost), and it may increase corporate tax payments, due to the "last in, first out" (LIFO) conformity rule, which will be discussed below. Companies with multinational operations will benefit by saving on the ongoing costs of annually converting their foreign reports to U.S. GAAP, but purely domestic companies will have no such countervailing benefit. IFRS is characterized as more "principles based" than U.S. GAAP, which is seen as largely "rule based." However, it should be noted that any GAAP is, by definition, a set of principles. U.S. GAAP gives substantial discretion to managers in determining the assumptions behind their accounting statements, even on such basic items as depreciation timescale and inventory costing methods, decisions that can influence annual income by hundreds of millions of dollars for large firms.

The age of U.S. GAAP (resulting in a larger body of policy than that of the younger international accounting standards organizations) and the voracious appetite of U.S. accounting practitioners for official guidance and clarifications of standards (principally as an insulation against liability in the highly litigious United States) are responsible for much of the rule-based characteristics of U.S. GAAP. If IFRS is adopted in America, the demand for guidance will likely not abate. As companies seek guidance on specific situations, standard-setters may feel pressured to expand the IFRS rulebook, thus eroding its principles-based nature. It may also create additional demand for accountants and accounting experts. Although there is much discretion in U.S. GAAP and IFRS, there are some marked distinctions that will force different treatments on U.S. companies, or make new methods available to U.S. firms. Some of these changes are discussed below note that this is intended to be a representative sample of differences rather than an exhaustive list of the differences between the two sets of standards. Citigroup reports there are as many as 426 total differences, but in many areas there is little divergence. For example, the issue of the marking to market of financial assets (especially hard to value assets such as mortgage backed securities) is one area that has attracted attention in the current credit crisis, but the IFRS standard (IAS 39) is similar to the U.S. GAAP standard (contained in FAS 157, FAS 133, and others). (Incidentally, both standards are being relaxed or "reinterpreted" see Clarifications on Fair Value Accounting and EU Relents on Some Mark-to-Market Accounting.) The most frequently discussed difference between IFRS and U.S. GAAP is in the treatment of inventory costing. U.S. GAAP allows the LIFO assumption, which expenses the most recently purchased inventory (last in) as a cost of goods sold expense first (first out), to be used for inventory costing. As prices tend to rise in most industries, this practice results in a high cost of goods sold expense, thereby depressing profits. Nonetheless, most U.S. companies use the LIFO method because it conveys tax advantages, and due to a unique "conformity rule" if the company uses LIFO in tax accounting, it must also use the harsh method in financial accounting. Under IFRS, LIFO is not allowed at all. Unless the SEC seeks an exception for U.S. firms something which the U.S. Financial Accounting Standards Board has advised against or unless the U.S. Internal Revenue Service scraps the conformity rule, U.S. companies will be forced to discontinue LIFO. While the result will be increased net income, it will ultimately be a disadvantage to stockholders because companies will be charged more corporate taxes. This tax penalty could be in the hundreds of millions of dollars for some large industrial firms and is seen as a major impediment to IFRS adoption. IFRS gives management more discretion in the area of asset valuation as a whole discretion that is also likely to increase company income. In the area of research and development costs and the related area of homegrown intangible assets valuation, IFRS is more generous than U.S. GAAP. IFRS allows development costs, but not basic research costs, to be included in the company's assets and, therefore, not expensed against income. U.S. GAAP insists that all research and development costs are expensed, except in extremely limited industry-specific circumstances.

Additionally, under U.S. GAAP, writing assets down due to "impairment" (i.e., permanent decreases in value), is a one-way process. Once written down, there is no way that an asset can be written back up, even if economic or industry circumstances improve. IFRS, on the other hand, does allow write-ups, and allows them to benefit income. Moreover, under U.S. GAAP, an acquired asset can never be increased in value as a result of market appreciation. In contrast, based on a long-lived but rarely used UK GAAP convention, IFRS allows assets to be written up in line with market values, as long as the

revaluation is carried out with regular frequency. However, the increase in book value does not represent an increase in net income. With IFRS, there is also flexibility in many areas of standard setting, whereby more than one accounting treatment is allowed, although usually, only one treatment is described as the preferred or "benchmark" treatment. In many areas, IFRS is less conservative than U.S. GAAP, meaning that it allows an increase in the risk of overstating income in a company's financial statements. IFRS also allows more flexibility than U.S. GAAP, and since bonus and stock option schemes usually give managers incentives to increase income, this flexibility likely will be used to increase income more often than it will be used to decrease income. It is important to note that income is always an estimate, based on management judgments such as the useful life of long-term assets, the expected losses from bad debts, the expected costs of warranties, and the diminution of large assets such as the value of equipment and the value of accounting goodwill. It can be argued that the income estimate under U.S. GAAP has no more intrinsic validity than the estimate under IFRS. However, setting aside the question of intrinsic validity, it is fairly clear that switching from U.S. GAAP to IFRS will lead to many companies reporting higher income numbers, even while holding cash flows constant. European companies quoted on U.S. markets provide a natural laboratory since they were required to report in both U.S. GAAP and IFRS until very recently. Citigroup London analyzed 73 of the largest European companies quoted in the U.S. and found that 82 percent of the firms reported higher income under IFRS than under U.S. GAAP. Looking at these findings, the adoption of IFRS would seem like great news for investors. But this is not the case. Remember, these European companies were reporting two different income figures based on the *same* financial year, that is, based on the same economic activity and cash flows. The question of which income number is the "true" estimate of underlying profit is irrelevant to some extent. Investors used to analyzing U.S. GAAP income will have to adjust and discount IFRS figures: one additional dollar of IFRS profit indicates slightly lesser incremental economic health and, if the underlying assumptions of accounting are accepted, slightly lesser ability to pay down debt and pay dividends in the future than one dollar of income calculated under U.S. GAAP.

Apart from magnitude, the second useful facet of income numbers is change. Earnings volatility, often minimized by earnings management techniques that are legally dubious, is an important signal to investors of a company's underlying health. Annual income numbers should reflect the economic performance of the company in that particular year. The pre-IFRS GAAP of many European countries often allowed companies wide latitude to manage earnings and show a smooth pattern of earnings change from year to year that hid changes in company performance investors may have wanted disclosed. Although IFRS has substantially changed those practices, more latitude remains than under U.S. GAAP. This has a deleterious effect on how useful IFRS reports are to shareholders. Research shows that European companies' IFRS reports, although more informative than pre-IFRS GAAP reports, are less informative than U.S. GAAP reports for the same firms, because IFRS reports show smoother earnings, show less correlation between reported earnings and cash flow, show less timely loss recognition, and crucially, show less association between reported earnings and firms' stock prices. Perhaps rumors of U.S. GAAP's death have been exaggerated. But it is worth noting that 20 years ago, a unification of U.S. standards and Western Europe's tax-based, low-information-content financial statements would not have been considered. In fact, the actions of a small coterie of accounting regulators effectively exported the "Anglo Saxon" concept of an economic-performance-based, decision-relevant, dual-books accounting system to the world. The IASB now has just under 100 member countries, but management has been tightly concentrated. Between 1973 and 2010, seven of the 12 IAS chairmen came from just three countries (three from the UK, two from America, and two from Australia) and, since 2010, UK-based IASB Chairman David Tweedie has served uninterrupted. The important executive position of secretary/secretary general has been even more tightly controlled with all but one of the secretaries coming from the UK, America, or Australia. Accountants from these three countries do not agree on everything, but there is enormous common ground amongst practitioners and academics on what the aims of a financial accounting system should be. That common ground may be summed up as follows:

- A financial accounting system should aim to provide information on how well the company is doing (economic performance) and help investors in their resource allocation decisions (decision relevance).
- If the tax authorities or governments require information for their legal or revenue-raising purposes, this should be accomplished by a separate system (dual books).

These concepts are central to IFRS, but they were not generally accepted by all countries until quite recently. The United States will grapple with substantial change if it adopts IFRS, but for many IASB member countries, including Japan, Germany, and France, the past few decades have already brought changes beyond recognition to their accounting standards, changes that bring them much closer to U.S. GAAP. It would be a pity if the Uzbekistan backed out of the convergence process after being intimately involved in the process over the last 30 years. For Uzbekistan firms seeking foreign capital and Uzbekistan firms operating overseas, convergence is a promising prospect. Many IASB member countries have undoubtedly favored convergence based on the prospect of gaining access to large Uzbekistan capital markets a carrot that has been implicitly dangled in front of them based on U.S. involvement in the process over the years. Even in the markets' current weakened state, convergence remains a substantial benefit to foreign firms.

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