

## **Differences in Calculation of Depreciation under International Financial Reporting Standard and Russian Accounting Standard and Effects of Those Differences on Finance Result of Western European Company Operating in Russia**

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**Abstract:** The influences of changes of the price limit of allocation of the tangible assets to fixed assets or inventory on the tax base and cost of production under International Financial Reporting Standard (IFRS) were researched on the example of Western Company operating in Russia. The impact of changes of price limit of fixed assets on tax amount, profit and prime costs is shown in the article. Consequently the possible mechanism of managing performance indicators and pricing strategy of the company laid down by IFRS was discovered. Comparison of financial indicators under Russian Accounting Standard (RAS) and IFRS was made, quantitative qualitative difference between those indicators was shown and its interpretation was given. It is considered highly important to use both International and Russian accounting standards at the adaptation stage to IFRS in Russia.

**Key words:** Different Accounting Systems in a Country • Changes of Price Limit • Management of Financial Performance

### **INTRODUCTION**

There has been an ongoing reformation of the Russian accounting system in accordance with market economy and requirements established by international accounting and finance practice [1]. Internal economic processes are taking place in Russia amid rapid integration in international accounting systems and intensifying economic activity with EU (Europe Union). As a result there occurred an objective necessity to adjust Russian accounting system. One of the driving forces of accounting reform is new stage of development of market relations which appeared with the creation of companies of different form of ownership, reconstruction of organizational structures, increase of risk of economic activity, the development of the stock market and increase of role of financial institutions [2]. Comparability of accounting systems is the priority condition pushing towards convergence of Russian and international accounting systems as it promotes stronger cooperation and attraction of foreign investments to Russia.

Let's consider the following example of fixed assets reporting in two companies, tentatively named XYZ Limited which is a subsidiary of ABC Corporation.

Despite of the conventionality of the names, these companies have been really present in Russia for several years.

XYZ Limited is a part of ABC Corporation Group. ABC Corporation offers media products to its customers through direct sales. As XYZ Ltd. has more than 30 million customers, it could be said it is one of the largest international companies engaged in retail media products. It operates in 22 countries, has 600 bookstores and sells 180 million publications a year.

XYZ Limited was established by Western investors; however it is operating in Russia. This implies that the company has to keep records in accordance with international standards to report to its investors [3]. At the same time XYZ must keep records under Russian accounting standards to report to Russian tax authorities. The company has two accounting systems and that is what of our interest.

**Methodology: Reporting System Differences:** All standards regulating financial reporting of XYZ Limited are in IAS/IFRS Manual of Corporate Financial Reporting. The manual consists of 6 chapters that provide general

information on accounting principles, explanation of principles of accounting for assets, liabilities, income, financial and managerial reporting.

The activity of XYZ Limited is based on international accounting standards, at the same time the company has its own specialties in (management of) accounting policies. Namely there exists an obvious preservation of national (Russian) differences in financial reporting despite the integration of the world markets. (This makes us think that in Russia, with its conservative mechanisms of adaptation, integration processes are fraught with "longevity" of certain forms of purely national characteristics of accounting) [3].

XYZ Limited records its assets at its initial historical cost minus accumulated depreciation and losses from impairment, i.e., at book value. In accordance with the financial policy of the company, XYZ Limited annual depreciation on fixed assets differs from the depreciation allowed by the tax authorities. This leads to the difference between the carrying value of the account and its tax base, as a result the company creates a deferred tax. When making comparison between Russian and Western way of depreciation calculations, it should be noted that the residual value of fixed assets calculated in accordance with Russian standards was higher than residual value calculated on the basis of International standards.

This difference primarily occurred because of the dissimilarity in value of price limit of a fixed asset. In accordance with PBU 6/01 (Russian accounting standard which regulates accounting for tangible assets) assets within the price limit set by the organization, but not more than 40 000 (rubles (1334\$) per unit should be reflected in the inventory (according assets with the value higher than 40 000 rubles are fixed assets) [2]. The accounting policy of the researched company sets this limit to 20 000 rubles (667\$). IAS 16 does not establish restriction on price criteria to recognize fixed asset items. According to the accounting policy of XYZ Limited asset is recognized as fixed starting from the amount of 60\$, anything less is recognized as inventory and is not depreciated [3].

**Impact on Financial Statements:** Consequently the following situation occurred: as the price limit of a fixed asset in accounting policy of the company is in accordance with the Russian PBU 6/01 (667\$), it exceeded the limit according to Western accounting standards (60\$), so the amount of accumulated depreciation under IFRS exceeded depreciation calculated according to Russian standards on 116 834 RUB (3 895 \$) [4]. The difference in the calculation of depreciation deductions had a direct impact on the calculation of the residual value of the assets.

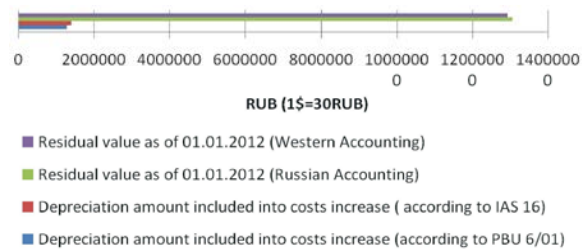


Fig. 1: Interdependence between depreciation charges and residual value of fixed assets

The residual value of fixed assets according to Russian standards exceeded the residual value of International standards on 116 834 RUB (3 895 \$), exactly the difference between calculations of depreciation.

The difference in depreciation calculations had a direct impact on difference in value of prime costs of products of XYZ Limited. Since depreciation based on IFRS was higher than based on RAS (Russian Accounting Standards), prime costs calculated under IFRS were higher in the resulting difference in depreciation. Hence, there is a situation where same company has a different finance result when using different accounting standards. Increase in costs has a reverse effect on the amount of profit received by the company. Consequently XYZ's profit calculated under IFRS was lower than the profit calculated in accordance with RAS. Based on this fact the size difference of tax base for income tax calculated according to IFRS and according to RAS is obvious.

This conclusion is correct if not to take into account such an important factor (that increases prime costs of the produced goods) as the value of inventory. Having counted cost of inventory, the following result was obtained on the analyzed company: according to RAS total value of inventory was 560 151 RUB (18 672 \$). Comparing cost savings in the amount of 116 834 RUB (3 895 \$) under RAS and over-expenditure because of inventory reclassification 560 151 RUB (18 672 \$), it becomes clear that the difference in value limit on recognition of fixed assets under RAS and IFRS (60\$~1 800 RUB) has a direct affect on costs.

Thus, the greater the value limit, the higher are the costs. In our case there is 11 times difference in fixed asset value which resulted in approximately 11 times difference in costs.

Therefore the change in value of fixed asset (and inventory) price limit affects the amount of costs and expenses, there is a direct relationship. So by reducing the amount of the price limit to a certain point, the firm may well reduce the prime cost of produced goods. However we should not forget that when reducing the value of

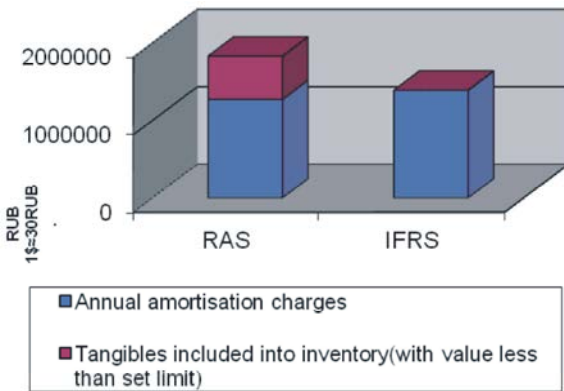


Fig. 2: General Costs of Depreciation charges and material costs according to IFRS and RAS

the limit we should constantly calculate the amount of depreciation charges because of the inventory reclassification. The company itself should determine the optimum value of the cost limit which would correspond to the least amount of expenses [4].

**Financial Performance Management Using Differences between RAS and IFRS:** According to IAS 16 (p.45,2) land is the only type of fixed assets item which is not a subject to depreciation. According to paragraph 17 of PBU 6/01 assets consumer properties of which do not change over time are not depreciated (land, environmental facilities). In addition, paragraph 17 states that fixed assets of non for profit organizations are not subject to depreciation [5].

Thus, Russian accounting standards establish a much broader list of fixed assets that are not subjects to depreciation. So the before mentioned fact also forms differences in the size of the tax base of income tax.

After comparing IAS 16 with PBU 6/01 we can conclude that there are both big differences and similarities between these two standards.

First, regarding the main criteria of fixed asset recognition, in general they are the same for IFRS and RAS except the price criteria, which is established in PBY 6/01 but not present in IAS 16. Price criteria are not definitive criteria of fixed assets in IAS 16. Instead every company has a right to set its own limit above which expenses are capitalized and below which are charged to operating expenses. However this limit is set to 20 000 RUB (~667\$) in PBU 6/01. This difference in international and Russian law affects not only the criteria and the ability to recognize tangible assets as fixed assets, but also difference in the production expenses. The fact is that the different value of the price limit for fixed assets items has a direct affect on depreciation expenses that reduce taxable income of the company [6].

Depending on what goals the company is pursuing, its line of business it can set and adjust the value of the cost limit. For example, if the company will increase the value of limit of fixed assets recognition than under IFRS it can decrease depreciation expenses and as a result prime cost of goods produced or it can decrease the limit and consequently increase depreciation expenses and decrease taxable income [7].

Thus, under IFRS the company has an opportunity to regulate its tactics and strategies by using fixed asset recognition policy as an instrument to control its expenses. According to cost-is-no-object approach of pricing which contrary to many opinions has not lost its significance, by regulating the amount of depreciation and amortization expenses can make the company's business more effective, especially when this business runs in a very price competitive environment, where different methods of price reduction (including dumping) are used.

However, it should be noted that when increasing value of price limit of a fixed asset and decrease depreciation expenses go along with the increase of material costs. This resulted because of the increasing the price limit of fixed assets that caused the amount of inventory to increase which caused the material costs to increase. The companies that set price limit to the fixed asset items should pay attention to this fact. It is important to evaluate and estimate costs generated by accumulated depreciation and corresponding value of expenses on inventory when setting the price limit of fixed assets. Of all the options available, the company must choose the most appropriate one for meeting its goals and objectives [8].

## CONCLUSION

It should be stressed that at the same company with the same cash flow, same taxes, net income is going to be different under IFRS and RAS. And the difference is going to be material. Moreover, there can be situations when the same company can be profitable under one standard (RAS) but unprofitable under the other (IFRS) [5].

Is it a paradox? Yes and its essence is that there are big differences in reporting systems. It is quite reasonable to think that to overcome this situation the common understanding of accounting indicators should be established as well as common framework for audit inspections and means to monitor the compliance with framework. Of course there are transformation models of one reporting system to another which are supposed to solve this problem (IFRS1 standard).

But anyone acquainted with this standard, can easily imagine the amount of work required to complete it. Moreover not every company can afford it [7].

There is another reason, which caused and likely will lead to such paradoxes. This reason lies in the categories of accounting, which, like the "depreciation" have some internal "unification", "haziness". To make the best use of these categories is beneficial for protecting commercial interests of the company. It should be said that IFRS has more options for that and as American say "challenges" company's management [9].

In conclusion, we would like to say that there exists a need to reform Russian accounting standards in order to adapt to international financial standards; and this reform needs to be carried out with the analysis of experience of international and national standards application [10].

The paper shows how unexpected and deep the differences between accounting systems could be. Those differences could be seen only when two systems are used simultaneously. This simultaneous usage of two systems exposes the fact that there is a line of factors that leads to different finance result. The article exhibits only the tiny part of the differences between two systems; the more detailed analysis is yet to be done.

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