

The method of presentation of income statements used by Chilean corporations and reasons for their choice

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ABSTRACT The opening of the markets has created the new need for accounting to generate comprehensible and comparable information for foreign investors or creditors, which implies a process of harmonization of financial information. In Chile this begins at the entities supervised by the Superintendence of Securities and Insurance, which gradually after 2009 had to adopt the International Financial Reporting Standards (IFRS). Among them, International Accounting Standard 1 (International Accounting Standards Board, IASB, 2006) is of vital importance. In this context, this work shows the results of a research whose objective was to identify the methods of presentation of income statements used by Chilean corporations and the reasons for their choice. For analyzing the information, quantitative and qualitative techniques were used. The main conclusions are that publicly traded corporations in Chile present their income statements in terms of function of the expenses and that there is not a direct relationship between the alternative chosen and the industrial sector that the company belongs to. Some reasons for this choice are reduced employee training, generation of useful information for decision making and, most of all, the similarity between the alternative used and the format already known based on Chilean accounting regulations.

KEYWORDS income statement, function of expenses, nature of expenses, IAS 1, publicly traded corporations.

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El método de presentación del estado de resultados utilizado por las sociedades anónimas chilenas y las motivaciones de su elección

RESUMEN La apertura de los mercados ha creado una nueva necesidad en materia contable: generar información comprensible y comparable a inversionistas o acreedores extranjeros. Esto implica un proceso de armonización de información financiera, el que en Chile inicia con las entidades supervisadas por la Superintendencia de Valores y Seguros, las cuales, de manera gradual a partir del año 2009, debieron adoptar las Normas Internacionales de Información Financiera (NIIF). Entre estas normas, cobra vital importancia la Norma Internacional de Contabilidad n.º 1 (NIC n.º 1) (International Accounting Standards Board, IASB, 2006). En este contexto, el presente trabajo muestra los resultados de una investigación cuyo objetivo fue identificar la alternativa de presentación de estados de resultados utilizada por las sociedades anónimas chilenas, y cuáles fueron las motivaciones para su elección. Para el análisis de la información se utilizaron técnicas cuantitativas y cualitativas. La principal conclusión es que la mayoría de las sociedades anónimas abiertas en Chile presentan sus estados de resultados por función de los gastos, sin que exista una relación directa entre la alternativa escogida y el sector industrial al que esta pertenece. Las motivaciones para esta elección son: el ahorro en capacitación para empleados, la generación de información útil para la toma de decisiones y, mayoritariamente, la similitud de esta alternativa con el formato ya conocido como normativa contable chilena.

PALABRAS CLAVE estado de resultados, función de los gastos, naturaleza de los gastos, NIC n.º 1, sociedades anónimas abiertas.

O método de apresentação do estado de resultados utilizado pelas sociedades anônimas chilenas e as motivações da sua eleição

RESUMO A abertura dos mercados criou uma nova necessidade em matéria contável: gerar informação compreensível e comparável a investidores ou credores estrangeiros. Isto implica um processo de compatibilidade da informação financeira, que inicia no Chile com as entidades supervisionadas pela Superintendência de Valores e Seguros, as quais, de forma gradual a partir do ano de 2009, aprovaram as Normas Internacionais de Informação Financeira (NIIF). Entre estas normas, uma das mais importantes é a Norma Internacional de Contabilidade n.º 1 (NIC n.º 1) (International Accounting Standards Board, IASB, 2006). Neste contexto, o presente trabalho mostra os resultados de uma pesquisa com o objetivo de identificar a alternativa de apresentação de estados de resultados. Para a análise da informação se utilizaram técnicas quantitativas e qualitativas. A conclusão principal é que a maior parte das sociedades anônimas abertas no Chile apresentam os resultados segundo a função de gastos sem a relação direta entre a alternativa escolhida e o setor industrial ao que pertence. As motivações para esta escolha são: a economia na capacitação para empregados, a geração de informação útil para a tomada de decisões e, o mais importante, a semelhança desta alternativa com a já conhecida normativa contável chilena.

PALAVRAS CHAVE Mapa das despesas, função das despesas, natureza das despesas, “NIC no. 1”, sociedades anônimas abertas.

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Introduction

In Chile, the Superintendence of Securities and Insurance (SVS in Spanish) supervises the activities carried out by the companies that participate in the securities and insurance markets. On August 27, 2007 SVS published the IFRS adoption calendar for audited entities. Such calendar stated that publicly traded corporations should gradually conform to those standards from January 1, 2009 to January 1, 2012. Therefore, all the audited entities had to present their financial statements according to this regulation. It is worth mentioning that the income statement is one of the most useful financial statements for managerial decision making because it influences directly investors' decisions as it provides a greater level of detail about the returns obtained by the company.

In terms of the relevance and type of information that can be obtained from this statement, it is important to bear in mind that International Accounting Standard 1 (hereinafter IAS 1) proposes two presentation methods: nature of expenses and function of expenses. Each of them has particular characteristics in terms of scheme and the way financial information is presented. Each entity must choose a method and this decision must be based on a series of criteria. However, according to the literature, the method chosen by each company may influence the investors' decisions, given that the level of detail differs in each of them.

It is therefore interesting to identify the method of presentation of income statements used by publicly traded companies in Chile four years after these accounting standards were required as well as the criteria considered for their choice. The objective of this exploratory research is to determine the method of presentation of income statements used by publicly traded companies in Chile, in order to establish the existing relationship between the industrial sector that they belong to and the method of presentation used, besides identifying the criteria taken into account for the companies' choice.

Literature review

Like all countries, before the appearance of IFRS Chile applied its own accounting standards. Financial statements were prepared based on the guidelines given by two institutions: the Chilean Accounting Association (Colegio de Contadores

de Chile A.G.) and the Superintendence of Securities and Insurance (SVS in Spanish). The Technical Bulletin 1 issued by Chilean Accounting Association (1973) establishes the concept of "financial statements", stating that they are "the means by which quantitative accounting information that has been collected, processed and analyzed is periodically presented to those who use it". It states that the basic financial statements are the balance sheet and the statement of financial position and the income statement (Colegio de Contadores de Chile AG, 1973, p.4). For its part, Newsletter 1501 published by SVS in 2000 determined the rules on form and content of the financial statements issued by the companies registered in the securities registry. It determined that financial statements should be prepared in accordance with the generally accepted accounting principles issued by the Chilean Accounting Association, as long as such principles did not contradict those issued by SVS itself. If that were the case, the principles issued by SVS would prevail. Additionally, the newsletter established a format for presenting the financial statements called uniform codified statistical file (FECU in Spanish), which should contain the company's identification, balance sheet, income statement, cash flow statement and explanatory notes about the financial statements presented (Superintendencia de Valores y Seguros, 2000, p. 1).

García (2003, p.158) points out that all countries are currently required to prepare and present information related to its companies' situation and that there is an internal regulation that has been proposed according to each nation's characteristics with the objective of regulating the content and presentation of financial statements. These are the means of communication between the company and the users of the information. The author indicates that this allows accounting information to be internally understood and compared, but there is a problem when that information is addressed to foreign investors or creditors who are only familiar with their own country's regulations, which may differ from the ones used in the country where the information was originated. This implies redoing the financial statements in order to adapt them to the current regulations of the country of destination. Likewise, García (2003) points out that "these problems, which affect all of multinational companies, have led to the need and viability of having international accounting standards that allow harmonization

of accounting and guide the preparation and presentation of such information". These problems are the basis for the creation of a common standard that establishes the way in which companies must present their financial statements. Amat & Perramon (2005, p.10) point out that "accounting differences among countries produce disbelief in account users", so they argue that international standards improve the quality of accounting information by establishing criteria that must be met to deal with current accounting problems, such as the needs to generate information that can be comparable at an international level and to deliver reliable information, reducing the chances of "creative accounting" or "account massaging" (which is supposedly legal).

The International Accounting Standards Committee (IASC), which originated in 1973, plays an important role in this harmonization process. Its purpose is to formulate a series of accounting standards that can be accepted and applied in different countries in order to favor data harmonization and comparability. This body worked until 2000 on that mission and in April, 2001 the International Accounting Standards Board (IASB) was created in order to replace it. Amat & Perramon (2005, p.9), define IASB as a private entity whose main objective is the issuance of accounting standards that can be used around the world in order to have a single global accounting language.

The conceptual framework issued by IASB in 2010 included, among other aspects, the objective of financial statements, which is "to provide information about the company's financial situation, performance and changes in its financial position. Such information is intended to be useful for a wide range of users when making economic decisions" (IASB, 2010, p.5). This information can be obtained from the balance sheet or statement of financial position and the income statement. In this scenario, Chile decided to adopt these International Financial Reporting Standards as a way to homogenize the information presented by companies, starting with publicly traded corporations, which are supervised by SVS. From 2009, these companies had to present their financial statements comparatively under full IFRS standards. Faced with this situation, SVS issued new instructions on the format for the presentation of financial statements to be issued by the entities it audited. On December 28, 2007, SVS issued Newsletter 427, which stated that the entities that

had to consolidate their financial statements with those of their subsidiaries would only be required to present them in a consolidated manner and not individually. Newsletter 1501 issued in 2000 was modified through Newsletter 1,879 of April 25, 2008. Finally, it adapted the old FECU presentation format to the new standards and called them FECU-IFRS (SVS, 2007, p.3).

The International Accounting Standard on the presentation of financial statements (IAS 1) states that the information must be comparable among financial statements previously issued by the same entity and also among other entities. This standard is applicable to all companies, whether they present consolidated or individual financial statements. Also, it has instructions about the structure of the financial statements and one of them is the income statement.

In this regard, Guzmán, Guzmán & Romero (2005, p.164) postulate that the income statement "offers the possibility of evaluating the profitability obtained by a business in a given period." They also point out that "the income statement must be very detailed in order to obtain useful information for the financial analysis of the company." Besides, Ávila (2007, p.68) indicates that the purpose of the income statement is to "disclose the results obtained by the company in a given period, including all its purchase and sale operations, which can be either profits or losses." In this regard, Horngren, Sundem & Elliot (2000, p.143) state that "investors are generally interested in the company's ability to obtain profits and dividends for much longer and this information can be collected from the income statement", so this document is much more important than the balance sheet.

Paragraph 99 of IAS 1 indicates that an organization's costs and expenses are to be classified in the income statement according to their nature or function within the company. Consequently, two methods of presentation are established: nature of expense and method of expense. In the first method, expenses are grouped in the income statement according to their nature (specific essence, for example, amortization, material purchases, transport costs, employee compensation and advertising costs). They are not redistributed according to their function within the company. Otal & Serrano (2006, p. 335) state: "This method is easy to apply, since it is not necessary to distribute operating expenses among the different functions carried out in the company". In contrast, in the second method expenses are presented according to

their function in the company, such as: sales costs, sales expenses and administrative expenses. In this classification, sales costs are disclosed separately from the other expenses. In addition, when using this method additional information on the nature of the expenses should be disclosed, including depreciation and amortization expenses as well as employee benefit expenses, since this information is useful when it comes to predicting cash flows.

Otal & Serrano (2006, page 327) emphasize that while the function of expenses method “can provide users with more relevant information than the one offered by the nature of expenses method (...)”, it must be taken into account that “the distribution of expenses by function may be arbitrary and it may imply subjective judgments”.

IAS 1 states that the company’s expenses are to be broken down to present them in the income statement through the method that “provides the most reliable and relevant information”. It also points out that the choice between function or nature of expenses depends both on historical factors and the industrial sector that the company belongs to. Furthermore, it establishes that “both methods provide an indication of the expenses that may vary directly or indirectly with the company’s sales or production level”, pointing out that both present useful information for the companies that use them, generally depending on the industrial sector they belong to (IAS, 2006, p.17).

In this regard, Otal & Serrano (2006, p.335) state that breaking down expenses by function has certain advantages: it allows evaluating the evolution of expenses by departments, it avoids losing the analytical view derived from the evolution of expenses by nature and it also provides information about costs.

After reviewing the literature on the adoption of IFRS and the application of IAS 1 in the presentation of income statements, it is possible to notice that very few studies provide a vision of how this topic has been dealt with, the future tendency of the presentation method chosen, the companies’ level of knowledge, analysis or interpretation about this situation or the complexity of defining the progress made, if any, as to how companies have complied with the norm with respect to the presentation of the income statement from the point of view of the advantages and disadvantages of preparing it with one of the methods described by IAS 1.

However, some studies provide certain guidelines that can contribute to define the contribution of the current research to the area studied. The first study that can be mentioned was carried out by Yáñez, Pilar-Cortés, Inostroza-Gonzales (2010, p. 56). It analyzes the effects of the implementation of IFRS with a sample of 16 Chilean non-financial companies listed in the Santiago Stock Exchange in 2008, which adopted international regulations in 2009. In this study, 50% of the companies presented their income statement by using function of expenses, while the other half did so through the nature of expenses method. According to Kvaal & Nobes (2010), the implementation of IFRS in a country does not guarantee uniform criteria, since there are systematic differences in internal accounting policies.

In terms of methods of presentation of financial statements in accordance with international standards, there are some contributions in international literature such as those made by Ding, Jeanjean & Stolowy (2008), who conducted a study of 199 companies listed in France with the objective of determining their reason to choose the method of presentation of their financial statements. The conclusion was that the main motivation is internationalization, which is influenced by several factors such as size, the possibility of being audited internationally and existing accounting regulations, among others. On the other hand, Duque, Muñoz & Osorio (2011, p.24) analyze separately each of the methods established by IFRS, pointing out that the main error of the nature of expenses method is to think that the concepts used in the productive area are similar to the ones used in the administration, sales or logistics areas. They add that another error is that companies “consider that for example all the benefits paid to employees are of the same nature and that they can be grouped for presenting the income statement”. The authors state that this is an error based on the general theory of costs, because according to it “those concepts that are used in the operational area have the ‘nature’ of being associated with the product, while those that are used in the administrative and sales areas have the ‘nature’ of being associated with the period.” In addition, they state that “the objective of this method is to provide detailed information, but it falls short in its aspirations.” The reason for reaching this conclusion is that “it is very difficult to use in companies that keep inventories (manufacturing companies) so its use would be limited to commercial or service

companies.” They conclude that “instead of grouping the concepts according to their nature, this method groups concepts that should be separated by nature”. Regarding the function of expense method, the conclusions are that “compared to the additional information that should be included in this form of income statement, IAS 1 was not specific, since it states that it should include at least the amount for depreciation and amortization expenses and employee benefit expenses.” The article by Duque, Muñoz & Osorio concludes that the international standard tried to include the statement of costs in the income statement presented but this objective was not achieved, so the usefulness of this internal report was affected when presenting the income statement with the use of the nature of expenses method.

Finally, Maines & McDaniel (2000) analyzed how the presentation format of the income statement influences investors’ decisions. They concluded that their decisions are based on psychological patterns and that a higher information level is required to make decisions, given that there is not enough technical knowledge for the analysis of the statements presented.

Methodology

This investigation was carried out both from the quantitative and qualitative research paradigms by conducting a document review, graphic analyses and surveys. In order to determine the population, the study involved 196 corporations that published their financial statements (both consolidated and individual) on the SVS website as of December 31, 2012 using the uniform codified statistics form (FECU-IFRS).

Regarding the quantitative analysis, the population comprised of 196 companies was divided into four groups according to their economic activity: commercial, industrial, services and others. The “others” classification included those companies that presented their consolidated financial statements and that have subsidiaries that develop various economic activities. The subsidiaries’ financial statements presented by their corporations were analyzed together with the explanatory notes included in their annual report, which is made public on the SVS website. Through this mechanism it was possible to analyze the way in which corporations presented their income statements and the industrial sector that they

belonged to, establishing relationships between both variables.

For explanatory research purposes, these companies were further analyzed by applying a survey to determine the reasons for choosing each presentation method. An invitation to participate in the research was sent to the 196 companies, 10 of which expressed their interest in participating in the research. These 10 companies are the population under study. A survey was applied to the people in charge of preparing the financial statements in these companies in order to know their reasons for selecting each method for presenting their income statement.

Results

Out of the total population of corporations that presented their financial statements with the FECU-IFRS format as of December 31, 2012, 155 companies did so on a consolidated basis and 41 on an individual basis, which corresponds to 79% and 21% respectively. Regarding the date of the first issuance of financial statements according to international standards, the following information was obtained from the total of 196 companies: 65% of them (128 companies) presented their financial statements under IFRS for the first time in 2009. 25% of them (49 companies) did so in 2010 and 8% (15 companies) in 2011. The remaining 2% (four companies) presented them for the first time in 2012. With regard to the modality used to present the financial statements when they were first issued under IFRS, it was established that 64% of the population (126 companies) issued their financial statements in full IFRS mode and the remaining 36% did it according to the pro-forma modality.

Regarding the method of presentation of the income statement used, it can be observed that 15%, which corresponds to 29 companies, did so according to the nature of expenses method. The remaining 167 companies used the function of expenses method, which represents 85% of the total. Also, out of the 29 companies that presented their income statements as of December 31, 2012 following the nature of expenses method, there are five private pension fund administrators, five companies from the telecommunications sector, six electricity companies and three companies related to the processing and distribution of drinking water. The remaining ten companies

belong to various sectors, including three agro industrial companies, two investment companies and others. Likewise, two situations that demonstrate a direct relationship between the companies and their method of presentation of income statements can be mentioned. That is the case of Sociedad de Inversiones Tricahue S.A., whose exclusive corporate purpose is "to acquire and sell Empresa Eléctrica Pehuenche S.A shares or those of whoever legally succeeds it." In this case, both companies present their financial statements individually by using the nature of the expenses method to prepare their income statement. Another case that can be highlighted is that of Sociedad Almendral S.A., whose "main asset is its participation in Entel Chile S.A., equaling more than 98% of its investments". In this case, both Entel Chile S.A. and Almendral S.A. present their financial statements as of December 31, 2012 in a consolidated manner and both use the nature of expenses method.

When carrying out the same analysis according to the type of financial statement presented, whether individual or consolidated, it can be observed that the most commonly used method is still the function of expense method, which in the case of the individual financial statements represents an 83% with a total of 34 companies that used this method, while in the consolidated financial statements it represents 86% from a total of 133 companies. When separating the total population according to the economic activity developed by the company, 12 of them belong to the commercial sector, 76 to services, 81 are industrial companies and 27 are classified as others, representing 6%, 39%, 41% and 14% respectively. The most commonly used method of presentation of income statements by group continues to be function of expenses. Nevertheless, in the service companies an increase in the presentation of their income statement by the nature of expenses method can be clearly observed. 25% or 19 of these companies presented their income statement through this method, while in the rest of the groups only one of the commercial companies, six of the industrial companies and three of the "others" group used this method, which represents 8%, 7% and 11% respectively out of the total of companies in these groups.

When analyzing the results according to the type of financial statement presented, whether individual or consolidated, it can be observed that the trend is maintained because the most common

method used by companies is function of expenses, regardless of the type of economic activity developed. The service companies that presented consolidated financial statements stand out, as 14 of them (27%) presented their income statement by using the nature of expenses method, followed by companies in the same sector that presented individual financial statements, with five companies (21%) that used the same method. On the other hand, the industrial and commercial companies that presented their consolidated financial statements were the ones that used this method the least with a total of five companies, which is equivalent to 7% of the industrial companies and a company (8%) in the case of the commercial ones. In the same way, it can be added that out of the companies classified in the "others" category, 10% (three companies) present their financial statements through the nature of expenses method and the remaining 90% continue to do so by using the function of expense method.

Regarding the results of the survey applied to the companies studied, it is important to note that it was answered by officials who held positions directly related to the company's accounting area, such as general accountants, analysts, accounting assistants and heads of the accounting department. All of them participated in the preparation of the financial statements. Regarding seniority, all those responsible for the preparation of financial statements have been in the company for more than five years, which allows the authors to assert that all of them have wide knowledge about the questions answered, given their years of seniority and the functions performed.

On the other hand, an element that is worth considering in the preparation of the financial reports that publicly traded companies must present to SVS is the software used. Regarding this, most of the companies studied stated that before applying IFRS they used certain software to prepare their financial reports. However, after the adoption of IFRS most of these companies had to adapt the accounting software used to issue their reports or acquire new software in order to prepare the financial statements under this new regulation.

In relation to the knowledge of the methods used to present income statements as stated by IAS 1, all the companies stated that they were aware of those methods. Regarding the method of presentation chosen to present the income statement, most mentioned the function of expenses

method. Regarding the reasons for this choice, they mentioned that this method allows them to reduce employee training and generate better quality information for decision making. Also, they stated that this method is very similar to the one already used, according to Chilean regulations. It should also be noted that all companies, regardless of the method chosen to present their income statement, comply with the obligation to disclose in the explanatory notes to the financial statements the nature of the expenses shown in the income statement. Furthermore, regarding the usefulness of the information obtained from such presentation method, the respondents indicated that they used it:

- i) as support for accounting management of both the society and its corporate governance;
- ii) for analysis of the board of directors;
- iii) to comply with the regulations, and
- iv) for financial management.

On the other hand, the companies that chose nature of expenses as the method of presentation of their income statement mentioned that this method was selected because it generates better quality information for decision making and also that the information provided by this method is used as accounting support and for making managerial decisions.

It should be noted that none of the companies studied mentioned explicitly using both methods for the preparation of their income statement.

Finally, regarding the respondents' opinion about the advantages and disadvantages of the implementation of IFRS, they point out that the benefits are:

- i) there was a higher level of analysis and development of the items on the balance sheet and the income statement;
- ii) the real values are obtained in terms of fair value accounting, and
- iii) there is more clarity and comparability of the financial information.

Regarding the disadvantages, the following aspects stand out:

- i) higher costs in terms of purchase or adaptation of the software to report to SVS (XBRL), time required for the preparation of financial statements and increased expenses because of audit and training fees and

- ii) the non-application of monetary correction, which implies a greater difference in the determination of the net taxable income for tax purposes.

Finally, all the respondents agree that the implementation of IFRS has clarified the interpretation of the financial information provided by corporations.

Conclusions

According to the results obtained, it can be observed that publicly traded companies tend to present their financial statements by means of the function of expenses method. Some authors point out that using the nature method is not recommended for manufacturing or service companies that keep inventories, as its construction is very complex. It has also been suggested that it is not useful for making decisions, so it would only be applicable in trading companies. In the case of Chile, it was observed that out of the total population, six manufacturing companies presented their income statement by nature of expenses, including three from the electricity sector (generation) and three from the agro-industrial sector. This situation is particularly interesting, since even maintaining inventory levels and being able to use the function method (which was traditionally used in Chile before the application of IFRS), agro-industrial companies opted for a higher level of disclosure by using the nature of expenses method, which made the authors of this article wonder what the motivations of the companies would be when choosing a method for presenting their income statement.

When observing the results of the explanatory analysis, it was found that the main reason for choosing the function of expenses method of presentation has to do with the fact that the people in charge of the preparation and presentation of the financial statements in corporations believe that this method is similar to the one they used before the adoption of the IFRS norms, which also facilitates adaptation with the company's existing accounting software. Likewise, based on the results of the qualitative analysis, it can be established that the criteria used by publicly traded companies when selecting the presentation method of their income statement are (in order of priority):

optimization of time for the preparation of the financial statement, savings in adaptation costs of the accounting software used and generation of information that is useful for decision making. This would explain why the companies studied mostly use the function of expense method.

The literature indicates that given the characteristics of the financial information used by the nature method, it should be used mainly by service companies. In this sense, it was observed that they tend to prefer presenting their income statement through this method. From the total of companies that used the nature of expenses method, 19 out of 29 (66%) belonged to the service economic sector, mainly the ones involved with sanitary services, electricity distribution companies and pension fund administrators. For example, the five pension funds existing in Chile present their income statement by using the nature of expenses method.

Based on the research and analysis presented above, even though the most frequently used method was always function of expenses, it was found that the reason for this choice mainly considers the corporations' current possibilities of generating information due to the computer systems used, which are not prepared according to the required IFRS parameters. In addition, adapting them would imply a high investment for the reporting entities and this method does not necessarily provide more reliable or relevant information, as mentioned by the literature, it is not particularly useful for investment decisions or for the industrial sector that the company belongs to. It is often performed without a previous study of the budgets that may be affected.

It was also shown that in the opinion of the respondents although the application of international standards helped to clarify the interpretation of financial information, it has meant more costs than benefits for some companies, such as software purchase or adaptation costs in order to report the information to SVS, time involved in the preparation of the financial statements and increased audit and training fees, among others.

Finally, it was seen that three companies which are classified in the "others" sector present their income statements by using the nature of expenses method. Now, if the characteristics of the companies that were classified in this area are analyzed, they are mainly investment and holding companies with diversified areas. Therefore, taking into consideration organizations whose

subsidiaries develop various economic activities, the authors of this document wonder what the most appropriate method for this type of companies would be, considering that they should consolidate their financial statements and maintain the same accounting policies as their parent company.

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