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*Financial reporting in adapting financial systems*

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Warunki transformacji współczesnego systemu finansowego

**Key words:** financial system, financial services market, financial architecture, formalized information, financial reporting

**Słowa kluczowe:** system finansowy, rynek usług finansowych, architektura finansowa, sformalizowana informacja, publiczne sprawozdanie finansowe

## **Introduction**

In modern global financial area, monetary parameters are deeply intertwined and intersected with institutional entities. Liberalization and further globalization of financial systems, facilitating capital mobility leads to the emergence of a number of factors that increase financial and economic risks.

Current market of financial services develops rapidly, constantly complicating its infrastructure. Classic financial instruments are supplemented with the new ones, which systematically provoke the development of debt instruments. Further processes of capital virtualization cause hybridization of financial instruments, the combination of debt assets with investment, which further generates a debt economy area.

The global financial and economic crisis has revealed a number of problematic aspects, has become an indicator for the necessity of changes in the principles and methods of financial system management. Formalized information base, including indices of financial (corporate) reporting should be considered as an important component of these principles and methods. Modern crisis processes influence the change in the architecture of the global financial system, but at present it is impossible to

characterize the objectivity of these declared changes. This leaves a wide scope for analysis and research of the world financial market development. In such circumstances scholars and practitioners lead an active scientific dialogue on the determination of modern vectors of financial services market development [1, 2, 6, 7, 15, 20].

### **1. Financial system: preconditions for modernization and the imperatives of development**

The postulates of classical economics state that the development capabilities of national economies correlate with the degree of development of the financial system. Undoubtedly, the high level of the financial system multiplicatively facilitate acceleration of economic growth rate, accumulation of capital assets, increase of social production. However, acute problems of disproportionate development of the financial and real sectors of the economy arise now. The severity of these problems has received a qualitatively new level of theoretical discussions on the above canonical foundations of economic theory, has given rise to active scientific-practical dialogue concerning the determination of feasible vectors of development of financial services market and the theory of financial intermediation. Based on the above “the consideration of entities and processes of financial and economic character as systems is becoming the rule of modern scientific research” [Lukashenko S.V., 2011, p.8].

The ambiguity of the proposed ways of the global financial system stabilization requires thorough research, and, therefore, as the basis for these studies, by reference to the real financial market conditions, can be considered as mainly theoretical and empirical foundations. In the opinion of many scientists “today the studies of changes that have occurred in the global financial architecture in the post-crisis recovery are currently central” [Glushchenko O.V., 2010, p. 136], in particular, this is the analysis of changes in the financial markets and parameters of a new financial architecture modelling. The basis of the modern financial architecture is integration, and therefore, first of all, it is important to establish how a violation or a gap of integration ties will impact the global financial system, within the framework of what institutional building (institutional architectonics) the formation of a new financial system will be held .

The term “globalization of finance” includes an idea of interrelated, interdependent integrated market with no borders for unregulated capital. Financial globalization precedes financial integration in content, scope of coverage and business segment, but in shape and depth of the financial mechanisms the processes swap over. It can be considered as paradox of the world economy globalization that globalization of finance exists and has proved itself post factum, without being integrated in the direction of convergence. That is why scientists refer “the methods of controls on international capital flow” [Dmitrenko D.M., 2008, p. 116] to the urgent measures for modernization of financial system.

By the level of globalization the financial sector, ahead of the other sectors of the real economy, not only insufficiently accelerates economic development, but also increases the risk of international financial transactions, extends the sphere of influence of local financial cataclysm. Stock crashes, public finances crisis cover entire regions and can grow in the global financial turmoil. As important causes of global financial instability increase scholars consider “institutional failure of the global financial architecture” [Sofischenko I., 2011, p. 140] on the one hand, and on the other – “increasing self-sufficiency and independence of financial sector of the regulatory mechanisms of macro-economic policies of the world impact” [Stolyarchuk Y.M., 2009, p. 43]. Independently defining the parameters of the global financial aggregates, the formed financial system is able to ensure super-profits, causing financial imbalances in global economy, which neither national no regional or global institutional system can withstand.

We consider modern approaches to financial imbalances studies due to fragmentation and isolation of the individual factor causes, etc., that are quite common in of scientific and analytical literature, including upheld views of well-known scientists and practitioners, as those that essentially narrow (veil) the existing problems. Obviously, the most objective modern financial imbalances should be seen through deep transformations in the global economy, primarily related to the rapid growth of the gap between the material content of the global gross product and its value form through the separation of capitalization processes of the company from the real basis of social and economic development. Today, especially acute is the question of theoretical understanding, methodological formalization and justification methods for measuring the totality of information and intellectual capital components of market economy, which fundamentally influence the stock price and investment attractiveness.

## **2. Financial reporting as a tool of financial system**

The systems of accounting and financial reporting are the only models that give estimation of economic unit capital in a formalized way. However, systems of accounting and reporting in the context of the modern standardization do not reflect the current totality of intangible economic resource, which economic entity objectively possesses. The inability to reflect and represent for external users the significant amount of intangible assets of the enterprise it is accented in papers [9, 10, 13, 16, 22].

The existing problems promote the use of weakly-formalized information models (or example, Value Reporting, Enterprise Value Map, Value Explorer, etc.) for the purpose of the financial system. It can be argued that none of the weakly-formalized models is able in practice to objectively identify the capital value characteristics of an economic unit, especially its such important components as the information and intellectual.

At the present time the differences in evaluating the potential of financial and economic stability and development of economic systems of different hierarchical levels have become, to some extent, a regularity. The economic literature provides a number of examples of the gap between the company market and book value. Rating agencies of various types, financial analysts, market institutions, etc establish all kinds of estimates regarding the characteristics of the capital of one or another market economy entity. Many experts hold the view that the important component of analytical assessment fallacy is the low level of basic and aggregate information objectivity, and insufficiency of its formalization.

For the analysis of two main measures of financial system performance (efficiency and stability) a number of “asymmetric information problems” [Mishenin E.V., 2010, p. 11] is pointed out by the scientists. Assessing the causes and consequences of global economic crisis of 2008, Nobel laureate Paul Krugman noted in the September issue of “The New York Times” for 2009 that “in the «Golden years» economists believed that the markets are basically stable in essence, price, shares and other assets were always assessed properly. There was nothing in common models that foreshadowed the possibility of such a collapse, which occurred” [Kurylyak V., 2010, p. 162]. Taking into account the above factors Ukrainian analysts justify the need for “ongoing review of the requirements for the capital minimum of financial institutions on the basis of inclusion in the calculation of all significant risks in accordance with the parameters of the financial system development” [Belinskaya Y.V. and others, 2012].

One of the main factors of the relevance loss of the information in the financial markets is the discrepancy between financial (corporate) reporting and conditions of functioning of post-industrial type economic systems, which compounds the problem of information and analytical gaps of various financial institutions.

In many scientific publications and analytical surveys a number of arguments about inadequate reflection of financial and property position of post-industrial type economic entity in public reporting is adduced, a distorted representation of real productive assets and capital. The inadequacy of the accounting and reporting information causes impossibility to implement on its basis the audit confirmation of financial-economic position of market economy entity, and, as a consequence, the loss of values of the indicators for the shareholders, investors, managers, in the processes of governance and regulation of the economy as a whole.

Objective disclosure of information on the effectiveness of modern economic systems functioning, and the transparency of financial reporting, which, in turn, affects the transparency of corporate governance, play a key role in ensuring the efficiency of the capital markets, lowering of the level of economic and financial risks in the economic environment in general. At the same time, we can uphold the position that on the basis of the commonly accepted modern liberal principles on the global capital and investments markets, even perfect corporate reporting does not provide elimination (minimization) of financial risks on free capital markets. Although, as it is noted

by the leading scientists, “more advanced reporting will allow the market to react more quickly to events, alleviating their consequences” [DiPiazza S., 2003, p. 23].

A solid conclusion is made by Richard Stutely, who has fundamental theoretical knowledge in the field of banking, finance and accounting, priceless practical experience in NatWest, one of the largest banks in the world, an investment analyst and economist at leading investment banks (Shearson Lehman, American Express, Chase Manhattan), professionally Qualified member of the London Stock exchange. In particular, this respected scholar and high practical level financial analyst notes that currently “banking and finance are away from the mundane reality of the surrounding world ... have led to the formation of a thin line that separates estimation and prediction, which is increasingly becoming to resemble a festive divination” [Stutely R., 2006, p. 22, 176].

Robert C. Higgins (University of Washington), analyzing the financial instruments and markets in [Higgins R., 2007, p. 172, 187], argues that in modern financial and economic conditions, despite the fact that non-financial companies for raising funds first of all rely on the capital markets, reliable information about the possibilities of volumes and rates of investment growth for joint-stock capital does not exist.

The priority role of the financial (corporate) reporting as an important formal means of communication becomes apparent in the fact that its main goal is objective representation of economic entity activities on the markets of capital and investment. In modern conditions it is possible to attract the attention of potential investors or creditors only by their objectively informing them about the available potential (assets, equity) and efficiency of its functioning (reporting indicators of activities outcomes). That is why researchers and practitioners of various domains of the economy hold the view of the necessity for adequate reporting format developing, as “the global financial markets need a more reliable structure of the corporate reporting” [Wendy McKenzie, 2006, p. 11].

## Conclusions

The global financial system is on the verge of profound changes and fundamental shifts. It can be argued with a sufficient level of argumentation that in the near future the launch of new trends and the formation of a modernized model of the global financial system will take place. The basic principles of financial globalization modernization should be the development and adoption of international short-term capital movement rules that ensure minimization of losses from targeted speculation. As an important component of these modernizations the development of regulatory instruments that will prevent uncontrolled growth and spread of fictitious capital should also be considered. The significantly higher level of responsibility should also be applicable in those market institutions, which, using weakly-formalized information-analytical models, estimate the total capital expression of modern economic systems.

Financial reporting with audited and formalized indicators on the markets of capital and investment nevertheless should be currently considered as a constraining tool of further capital virtualization and hybridization of financial instruments. Despite this, further format of financial reporting development proper to the characteristics of post-industrial type companies is needed. The content and purpose of such reporting should be viewed through more extensional representation of information and intellectual resources and the objective value of the capital, efficiency of the economic entity according to the criterion of total capital expansion and the level of its reserves and insurance.

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### **Financial reporting in adapting financial systems**

In the article the modern problems of the world financial system functioning are considered. The basic causes of global financial instability are defined, in particular the separation of capitalization processes of the company from the real basis of social and economic development; discrepancy between financial (corporate) reporting and conditions of functioning of economic systems. Emphasis is placed on the necessity of the development of regulatory instruments that will prevent uncontrolled growth and spread of fictitious capital and creating updated format of financial reporting proper to the characteristics of post-industrial type companies.

### **Warunki transformacji współczesnego systemu finansowego**

Artykuł nawiązuje do ujawnionych przez kryzys finansowy problemów wymuszających istotne zmiany zasad i metod sprawozdawczości finansowej. W najbliższej przyszłości wymagana jest modernizacja globalnego systemu finansowego. Podstawą tej modernizacji powinno być opracowanie i przyjęcie międzynarodowych przepisów dotyczących krótkookresowych przepływów kapitału. Ważnym elementem powyższej modernizacji jest rozwój instrumentów regulacyjnych, które mogą uniemożliwić niekontrolowany wzrost i rozprzestrzenianie fikcyjnego kapitału. Sprawozdawczość finansowa na rynkach kapitałowych, oparta na poddanych kontroli i sformalizowanych wskaźnikach, powinna być traktowana jako narzędzie ograniczające dalszą wirtualizację kapitału i hybrydyzację instrumentów finansowych. Autor podkreśla potrzebę doskonalenia finansowego raportowania właściwego dla przedsiębiorstw ery postindustrialnej.