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Title

WHAT PREDICTIVE VALUE FOR FINANCIAL REPORTING ON WINE INVENTORIES?

I want to submit an abstract for:

Conference Presentation

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Keywords

wine inventories - financial reporting - IFRS standards - current assets - fixed assets

Research Question

"Does financial information on wine inventories fulfil the IFRSs defined qualitative characteristics, and more specifically does it allow to achieve the predictive value requirement?"

Methods

Forecasting mechanical model based on accounting data to test whether the classification of the long-term wine stock falls into fixed assets modifies the predictive capacity of the accounting data.

Results

We expect to prove that the prediction depends on the decomposition of wine inventories between fixed assets and fixed assets and provide the best way to record wine inventories.

Abstract

Purpose

This paper examines the relevance of considering wine inventories as current assets. The production cycle in the wine industry is particularly long: it can take several years to produce wine. The wine maturation process give birth to wine inventories, which are reported, in accounting terms, as "inventories" elements corresponding to work-in-progress and finished goods. Such inventories are considered as "current assets", i.e. short-term assets that are used up within one year. As the objective of the financial information, defined by the IFRS standards, is to place a certain importance on the economic reality in accordance with the postulate of "substance over form", we examine the relevance to consider wine inventories as current assets in financial statements while they are present on the

firm often for more than one year. We are particularly interested, in this paper, on the predictive value of the financial information. In that respect, we will investigate the impact of different accounting classification of wine inventories (current assets – short term – VS fixed assets – long term) on the predictive value of financial information.

Literature and research question

For many years now, the use of International Financial Reporting Standards (IFRSs) – defined as global accounting standards – has spread throughout the world. Nowadays, more than 100 countries require or authorize the use of the IFRSs for the individual and/or consolidated financial reporting. The IFRS's conceptual framework defines the objective of financial reporting as: “to provide financial information about the reporting entity that is useful to existing and potential investors [...] in making decisions relating to providing resources to the entity”. (CF. § 1.2, 2018). In order to achieve the usefulness objective, financial information must respect different qualitative characteristics among which two are presented as fundamental, that is relevance and faithful representation:

- A relevant financial information will make a difference in helping the users to come to their decisions, thanks to the predictive or confirmatory value of this information (CF. § 2.6 and 2.7, 2018). Financial reporting has a predictive value if it can be used to predict future outcomes (CF. § 2.8, 2018).
- A faithful representation will be achieved if the substance of the phenomena is faithfully represented (CF. § 2.12, 2018). This faithfulness of the representation is characterized as follows: complete, neutral and free from error. From 2005, the European Union (EU) has made these standards compulsory for public companies publishing consolidated financial statements, but each member state has got the liberty to enlarge the implementation perimeter. Since then, other economically powerful countries adapted their domestic rules to the IFRSs' content, whether by endorsing or converging (e.g. Australia, Canada, China, USA...). As a results, accounting practices corresponding to the IFRSs' requirements are the most widely spread globally and more specifically on financial markets.

However, the adequacy between these accounting standards and the specificities of the wine industry is not always obvious. In Australia, Juchau (1995) explains the need for a revision of the accounting practices to fit the sector requirements and attract investors. In an international study in Europe, Blake et al. (1998) point out the necessity to improve accounting practices to face the consequences of the higher production quality. The issue of value assessment appears central in their approach. Later, Viana and Rodrigues (2006) highlight the need for more flexibility in the accounting treatment for Porto wine production, more precisely regarding its recognition, value measurement and reporting.

The strong interest regarding this topic can be explained by the special features of the wine production process. From grapes harvested to bottles sale, many years may pass. Producing wine is a long term activity. The length of the production cycle leads to report in the balance-sheet as “inventories” elements corresponding to work-in-progress and finished goods that will stand for a period longer than one year (corresponding to an accounting period). However, from an accounting perspective, inventories are classified as current assets, defined as short-term assets that are used up within one year. Blake et al. (1998) claim that we need to adapt the accounting rules for the wine industry in order to provide a “fair and meaningful view” to users of financial statements. With the same objectives, some Australian companies decided to report wine inventories as non-current assets even if they appear to be current assets in terms of the related accounting standard AASB 1040 (Booth and Walker, 2003). The IFRS standards place a certain importance on the economic reality in accordance with the postulate of “substance over form”. However, IAS 2 (the IFRS standard dealing with the accounting of inventories) does not take into account wine inventories distinctive features in terms of registration and valuation. This distortion between what is considered as « inventories » from an accounting point of view and the specificities of the wine industry can threaten the qualitative characteristics of financial information: relevance and faithful representation and by extension, their informative and predictive power. That's why our research question is the following: “Does financial information on wine inventories fulfil the IFRSs defined qualitative characteristics, and more specifically does it allow to achieve the predictive value requirement?”

Methodology and expected results

We based our work on a representative and highly reliable sample. Our sample draws on data from a collaborative project of the Confederation of French Wine Cooperatives (CCVF), the General Association of French Wine Firms (AGEVE), and France Agrimer (i.e., the French Ministry of Agriculture). The collaboration began in 1998 and has been financed by Crédit Agricole SA, the largest agricultural bank in France. It contains French companies (producers, wine merchants, wholesalers and cooperatives) with a turnover of more than €2m. The wholesaler segment is ambiguous since they can buy and sell packaged wines or blend and package bulk wine they bought. Only the latter category fits the “wine trade” definition, as “pure” wholesalers belong to the “distribution sphere.”

Drawing on expert opinion, we determine the main business purpose of each wholesaler and remove those that focus on “distribution” only. Finally, as a consistency check, we compared the sum of exports of the selected 1,000 firms with the French customs wine export statistics. At the end of this process, we obtain a sample of 951 enterprises that includes 365 cooperatives and 586 corporations. We collected financial information from the ALTARES database for the years 2003 to 2014.

From this database, we will distinguish companies that have inventories corresponding to more than one year of production from others. We consider that companies in the wine industry get their supplies once a year. It is obvious for a producer – there is only one harvest per year – and it seems to be the use for a wholesaler who usually buy products once a year. For companies with an inventory that exceeds one year of revenue (estimated at cost of production), we reprocess the data to register the amount of long-term inventory (the difference between the amount of inventory and revenue estimated at cost of production) in fixed assets.

We then define a forecasting mechanical model based on accounting data to test whether the classification of the long-term wine stock falls into fixed assets modifies the predictive capacity of the accounting data.

The model is the following:

Where: t is a time index (accounting period),
 X is the dependant variable (either revenue R or EBIT),
 A represents total asset,
 F represents fixed assets,
 C represents current assets,
 α are the forecast parameters.

We expect the classification to directly impact revenue and earnings before interest and taxes. We can also imagine a mediation effect. That’s why we also build a two-step model

where: R represents revenue,
 $EBIT$ represents earnings before interest and taxes

For each model, two forecasts are made: one with published accounting data and one with reprocessed accounting data (long term inventories classified as fixed assets). Then, we compare the quality of each of the two forecasts by determining the forecast error. In practice, as we have access to 11 years of data, the first 10 are used to define the parameters of the models (coefficients α). We then try to predict revenue or EBIT of the 11th year.

Doing so, we expect two levels of results:

- First, the parameters α and especially their significance will determine if the prediction depends on the decomposition of wine inventories between fixed assets and current assets,
- Second, the comparison between forecast errors from the model with published data and the one with reprocessed data will help us to determine which way to record inventories produces better forecasts.

This research will help us to determine if there is an optimal way to deal with wine inventories in order to provide a relevant and faithful financial information.

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ABSTRACT

Purpose

This paper examines the relevance of considering wine inventories as current assets. The production cycle in the wine industry is particularly long: it can take several years to produce wine. The wine maturation process give birth to wine inventories, which are reported, in accounting terms, as “inventories” elements corresponding to work-in-progress and finished goods. Such inventories are considered as “current assets”, i.e. short-term assets that are used up within one year. As the objective of the financial information, defined by the IFRS standards, is to place a certain importance on the economic reality in accordance with the postulate of “substance over form”, we examine the relevance to consider wine inventories as current assets in financial statements while they are present on the firm often for more than one year. We are particularly interested, in this paper, on the predictive value of the financial information. In that respect, we will investigate the impact of different accounting classification of wine inventories (current assets – short term – VS fixed assets – long term) on the predictive value of financial information.

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The IFRS standards place a certain importance on the economic reality in accordance with the postulate of “substance over form”. However, IAS 2 (the IFRS standard dealing with the accounting of inventories) does not take into account wine inventories distinctive features in terms of registration and valuation. This distortion between what is considered as « inventories » from an accounting point of view and the specificities of the wine industry can threaten the qualitative characteristics of financial information: relevance and faithful representation and by extension, their informative and predictive power. That’s why our research question is the following: “Does financial information on wine inventories fulfil the IFRSs defined qualitative characteristics, and more specifically does it allow to achieve the predictive value requirement?”

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¹ ALTARES is the French distributor of the Dun & Bradstreet database that provides financial information about 2.5 million French companies.

amount of long-term inventory (the difference between the amount of inventory and revenue estimated at cost of production) in fixed assets.

We then define a forecasting mechanical² model based on accounting data to test whether the classification of the long-term wine stock falls into fixed assets modifies the predictive capacity of the accounting data.

The model is the following:

$$X_t = \alpha_1 X_{t-1} + \alpha_2 F_{t-1} + \alpha_3 C_{t-1} + \alpha_4 + \varepsilon_t$$

Where: t is a time index (accounting period),
 X is the dependant variable (either revenue R or EBIT),
 A represents total asset,
 F represents fixed assets,
 C represents current assets,
 α are the forecast parameters.

We expect the classification to directly impact revenue and earnings before interest and taxes. We can also imagine a mediation effect. That's why we also build a two-step model

$$R_t = \alpha_1 R_{t-1} + \alpha_2 I_{t-1} + \alpha_3 C_{t-1} + \alpha_4 + \varepsilon_t$$

$$EBIT_t = \alpha_{11} R_t + \alpha_{12} I_{t-1} + \alpha_{13} C_{t-1} + \alpha_4 + \varepsilon_t'$$

where: R represents revenue,
 $EBIT$ represents earnings before interest and taxes

For each model, two forecasts are made: one with published accounting data and one with reprocessed accounting data (long term inventories classified as fixed assets). Then, we compare the quality of each of the two forecasts by determining the forecast error. In practice, as we have access to 11 years of data, the first 10 are used to define the parameters of the models (coefficients α). We then try to predict revenue or EBIT of the 11th year.

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This research will help us to determine if there is an optimal way to deal with wine inventories in order to provide a relevant and faithful financial information.

² A mechanical model is a model whose result depends solely on the forecasting process implemented and not on the forecaster

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