Does the Adoption of International Financial Reporting Standards Provide Commensurate Benefits to Prospective European Union Countries?

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Abstract

The common set of reporting standards allows for a unified business language when reporting on the financial status of businesses. Standards help to raise the quality of information and the comparability of financial statements. The understanding of financial statements is particularly important for the economies of prospective European Union countries, especially the smaller ones, because their growth is so dependent on the free movement of capital and extensive foreign direct investments. Researchers stress that even though the International Financial Reporting Standards (IFRS) are adopted by most of the developing countries, their business characteristics could limit their ability to accomplish expected benefits. Formal adoption does not necessarily lead towards unimpeded implementation. This chapter presents the perceptions of Macedonian managers about IFRS acceptance. First, we survey, a representative sample of Chief Financial Officers from companies listed on the Macedonian stock exchange, and executives and analysts in investment and pension funds. Next, we compare the findings with the results of the similar survey presented in the Association of Chartered Certified Accountants Reports 2011, on the attitudes of their counterparts in America, Europe, the Middle East and Asia. Finally, we offer recommendations on the further implementation of standards in the prospective European Union countries, which in turn will help their inclusion into the overall economic, social and cultural trends of the Union.

Keywords: Financial reporting, International Financial Reporting Standards, small economies, Global Financial Reporting Standards.

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Introduction

The adoption of international accounting standards for Europe is the most revolutionary development in the field of financial reporting, since the invention of double entry accounting by Luka Pacioli, in 1494. It will enable the same accounting language across Europe and according to Hoogendoorn (2006), it make all financial statements fully comparable, all to the greater benefit of investors. International Financial Reporting Standards (IFRS) are implemented in all countries of the European Economic Area, which is comprised of the EU plus Iceland, Liechtenstein and Norway. They have also been introduced into approximately 120 other countries across the world, and definitely are or will have to be introduced into all the EU candidate countries. Consequently, the EU is currently the main promoter of the unification of accounting standards internationally. One of the major expectations from the Lisbon Treaty, which was signed in 2007 and entered into force in December 2009, was the improved coherence of the EU and its actions. It is expected that the Lisbon Treaty will bring in more checks and balances into the EU system and greater powers for the European Parliament. The need for common and mutually comparative financial reporting between member states was obvious, and the International Financial Reporting Standards have provided a practical set of instruments for achieving these goals.

The acceptance of international accounting standards is particularly important for developing countries and the so-called emerging economies. Their economies are open to the external influence and they are dependent on foreign investment and financing, which means that the introduction of accounting standards in these countries provides the important preconditions for attracting foreign investors. Accounting standards relate to both sides of businesses: they provide financial information for both the executives of the enterprises and for their investors. The existence of implemented Standards facilitates institutional and individual foreign investors significantly. Bearing all that in mind, in 2005, the Republic of Macedonia published the International Standards and made them compulsory for all large businesses listed on the national Stock Exchange, and their annual reports are subject to consolidation, including Macedonian banks and insurance companies (Vasileva 2011). Since 2012, even the micro companies and small businesses have to keep accounting in accordance with the relevant International Standards. According to Vasileva (2011), the introduction of international standards for small entities enables the preparation of good quality financial reports, reduces the number of errors and limits the number of opportunities for fraud in this important segment of the national economy. In addition, these standards will improve the comparability of the financial statements of small businesses, thereby making their access to capital easier and less costly.

Literature Review

In their research on a sample of 1,547 firms from 15 European Union countries, Zeghal et al. (2012) have found that the mandatory adoption of IFRS results in reduced accounting earnings management. A longitudinal study (Li, 2010) of the effects of the mandatory adoption of International Financial Reporting Standards in the European Union on a sample of 1,084 firms, during 1995 - 2006, provided evidence that the cost of equity lowered on average for 0.47 %. According to Ball (2006), enhanced transparency could increase the efficiency of contracting between firms and their managers, reduce agency costs between managers and shareholders, and enhance corporate governance with potential gains for investors arising from managers acting more in the investors' interest. Others indicate that the introduction of IFRS has an influence that is more positive for the debt, rather than for the equity market (Beneish et al., 2012). Brüggemann et al. (2009) report an increase in trading activity on the open market at the Frankfurt Stock Exchange following the adoption of IFRS. There are studies that point out the benefits of the improved comparability of the financial statements, when IFRS are in use, on cross - border investments. For example, Louis and Urcan (2012) provide evidence that IFRS lead to a significant increase in cross-border acquisitions of publicly traded companies. In an analysis of mutual fund holdings, Yu (2010) concludes that the adoption of IFRS increases cross-border holdings by reducing the information processing costs of foreign investors, through improving the comparability of financial information and indirectly by lowering other barriers such as geographic distance.

Flourou and Pope (2011) report increases in ownership and consequently show that IFRS affect the allocation decisions of institutional investors. The other authors suggest that high quality financial statement information assists analysts (Lang and Lundholm 1996). Bae et al. (2008) and research on foreign firms suggests that they benefit when the accounting standards in the various countries they operate in are closer to the international standards. Horton et al. (2012) conclude that IFRS improved the information environment by increasing the quality of information provided and comparability and accuracy in the forecasting of earnings.

On the other hand, there have been research publications which have called for a word of caution when drawing immediate conclusions. DeFond et al. (2011) find that US mutual fund ownership increases for mandatory adopters, but only when the adoption is seen as 'credible'. Daske et al. (2009) indicate that the way standards are implemented is crucial for realising the benefits from the implementation of IFRS. There are many who stress that the benefits of common standards cannot be achieved by standards alone and that, in many countries, the proclaimed adoption of the Standards is merely on paper and has not been put into practice.

Chen at al. (2010) stress that studies on the effect of International Financial Reporting Standards on the quality of accounting often have difficulties in the control of other factors of accounting quality that have not changed. As a result, the observed changes in the quality of accounting could not be entirely attributed to their introduction. Nevertheless, Cheng and his associates compared the accounting quality of publicly listed companies in 15 member states of the EU, before and after the adoption of standards and measured the quality of accounting in terms of five proxies. The results clearly proved that there had been an improvement in the quality of accounting in terms of less managed earnings toward a target, a lower magnitude of absolute discretionary accruals and higher quality in accruals. However, the results also show that the firms were more prone to engage in smoothing out earnings and in recognizing large losses in a less timely manner, after the introduction of Standards. Cheng and his colleagues believe that the better quality of accounting was attributable to the Standards, rather than to changes in managerial incentives, institutional features of capital markets or the favourable environment for business or to any other similar factor, that could also lead to an improved quality in accounting.

The Study

The study we conducted addressed the attitudes of financial managers from a range of industries in the Republic of Macedonia and the analysts and executives on the side of the institutional investors in the country. In addition to our demography and the questions we were interested in, we used questions from the ACCA (2011) questionnaire in order to provide comparability of our results with their survey. Throughout March 2014 we sent out 47 questionnaires, 32 to CFOs of listed companies on the Macedonian stock exchange and 15 to investors. We received 27 replies, fourteen from the CFO community and thirteen from the investors. Bearing in mind that the population of the CFOs is large enough and that the responses collected from the side of the institutional investors practically covered all of them; we can conclude that the results can be treated as a fair representation of the attitudes of both targeted populations.

For a better understanding of the results, we will first present some basic data about the Macedonian economy, its financial sector and the investors' community. The Republic of Macedonia, with 10,500 dollars GDP per capita is a developing country that managed to "achieve sustained economic growth" and thanks to a prudent monetary policy, enjoys a relatively high reputation in international financial circles as recognized by its debt rating against its investment grade. The first investment fund was established in 2007, and is now only eleventh in total and managed by only five private investment companies. The biggest institutional investors on the domestic securities market are the two pension funds with a net asset value of Euro 435,8 million in 2013 (MAPAS, 2014). Macedonia is dependent on close banking and economic links with the developed parts of Europe, and thus it is essential to integrate quickly into the global flows of goods, services and capital.

The structure of the Macedonian business sector is similar to that of the entire EU, in terms that the majority of the business entities are small. Thus, the share of SMEs is 99.8 % of all enterprises, and it is almost identical with the EU average, although in the case of Macedonia there are more micro-enterprises and less small businesses. However, based on the other criteria for the development of the International Monetary Fund, the country has an insufficient variety of exports and lacks any integration of its capital and financial markets with the global markets. The Republic of Macedonia is very much dependent on close banking and economic links with developed parts of Europe, and thus it is essential to integrate rapidly into global flows of goods, services and capital. One of the most important requirements for accomplishing this is the implementation of International Accounting Standards.

In 2005, the Republic of Macedonia published the International Standards and made them compulsory for all large businesses listed on the national Stock Exchange and their annual reports are subject to consolidation, including the banks and insurance companies (Vasileva, 2011). In addition, since 2012 even the micro companies and the small businesses have to keep accounting in accordance with the related International Standards. The adoption of these standards will improve the comparability of the financial statements of small entities by comparison with those from other countries, making any access to loans and to capital from private and institutional investors easier, with less capital costs. According to Vasileva, the introduction of the international standards for small entities enables the preparation of quality financial reports, reduces the number of errors and limits opportunities for fraud in this important segment of the national economy.

Foreign investments in Macedonia are the smallest when compared with other countries of South Eastern Europe. Moreover, they remained modest even after the accounting standards had been implemented. Furthermore, the data for Macedonia does not prove that the comparability of the financial statement with the IFRS significantly attracts cross-border mergers and acquisitions. The trading volume after its overgrowth in 2007 as a result of the global stock exchanges boom, plummeted similarly as in the case of other comparable countries, and this is demonstrated in Table 4.

The difficulties in the process of establishing public accounting services as an independent profession; the still rudimentary licensing process and the lack of spontaneous standards set within the profession calls for state interference in these domains that otherwise should be internally driven within the profession. These facts indicate that, maybe not as pervasive as in some other ex-communist countries in the region, the afore-mentioned formal approach to IFRS standards and the culture might be present at least in some isolated cases, even in the Republic of Macedonia, particularly as a result of it being a relatively underdeveloped financial sector.

The Results of the Research

On the question does the compliance with IFRS outweigh the cost of the implementation, 28.6% of CFOs and 23.1% of investors in Macedonia believe that the answer is ‘yes’, which is less than in the ACCA survey (39% of CFOs and 31% of the Investors). Such results indicate a potentially lower familiarity with IFRS and a greater resistance of Macedonian respondents, financial managers and investors.

In terms of assessing how the international accounting standards affect their business abroad, most respondents in our study (93% of CFOs and 54% of investors) believe that the effects are favourable; none claim that the effects are unfavourable; and the rest claimed that there is no direct effect. On the side of the ACCA these numbers are 52%, 6% and 42% in the case of CFOs and 55%, 9% and 33%, in the case of investors. This result might be explained partly by the fact that our businessmen trade in the region with accounting standards that have not been properly introduced, and that any step forwards in these terms significantly improves their business environment abroad. The percentage of positive answers in the case of investors could be explained similarly by the fact that the financial market even in this region is highly regulated ever since its inception.

Otherwise, 71.4% of Macedonian CFOs think that the impact of the IFRS on a firm's access to capital would have both positive and very positive effects. This number in the ACCA survey is 39%. This very affirmative attitude of our financial managers towards this issue is not quite in line with the low volume of foreign investments and trading in general on the local stock exchange. However, it can be explained, at least partly, by the fact that our companies are focused on bank loans, where the full compliance of the reports presented to the bank is a common requirement. On the other hand Macedonian investors (53.4%) are much closer than their peers in the ACCA study (49%).

It is interesting to note the opinion that Macedonian managers share about international auditing standards. Among the CFOs surveyed in the ACCA study, none of them responded that the International Auditing Standards would influence the quality or the cost of the auditing process in their companies, while in the case of Macedonian managers, this opinion is shared among a high 64.3% with 28.6% of them answering that the benefits would be very substantial. This attitude of the CFOs in the case of Macedonia could be explained, partly, by the very negative experience that they have with low standards of the local providers of auditing services and partly by overoptimistic expectations from the IAS.

Macedonian CFOs are also very optimistic regarding the development of global standards in the area on environmental risk management. About 79% of them believe that this standard will significantly improve this area of corporate social responsibility, and the public image and reputation of their companies. Macedonian investors in 69.2% of cases, think that the impact of global standards in this area will improve the reputation of companies, compared with the 60% who think the same in the ACCA survey.

Macedonian CFOs in 50 % of cases also consider that global standards of reporting integration of the issues of the management of the environmental risks in annual reporting will improve the overall reporting and 21% of them believe that they will improve the decision making. Their colleagues on the side of the investor community, at 85% think similarly and are close to their counterparts in the ACCA who in 77% of the cases answered similarly.

The Survey we performed among the Macedonian professional investors and issuers demonstrates their broadly positive attitude towards the IFRS benefits. They share similar opinions with their counterparties in developed countries as presented in the ACCA Report. This survey emphasises their support for global standards in the domain of financial reporting, auditing and the integration of the financial aspects of operations with how companies manage their own environmental risks. They see clear benefits from the International Standards of Auditing in terms of quality and cost. They, more than their foreign counterparts, believe in the positive impact of IFRS on their businesses and only a few of them do not support any integrated reporting of financial and non-financial information. They are more conservative regarding the cost effectiveness of the introduction of IFRS standards in their accounting systems. However, it is understandable, bearing in mind that our companies are small and that the fixed costs of the process of implementation, software, training and so on, are quite considerable.

Conclusions and Recommendations

The preparation of financial statements in accordance with the international accounting standards represents the main pillar in the standardization of accounting reports. Their application helps bridging the communication barriers in accounting, raising the level of accounting information and opening the way for a freer exchange of information and data on financial markets. The protection of investors, maintaining confidence in the financial markets, strengthening the freedom of movement of capital and helping companies to compete, on an equal footing, for financial resources, are just a few of the overall advantages provided by the use of the International Accounting Standards.

The Republic of Macedonia accepted and published interpretations of the International Financial Reporting Standards, back in 2005. All large or medium-sized companies, all banks or insurers, all entities listed on the Stock Exchange and all others, whose financial statements are subject to consolidation, are obliged to prepare and to submit their financial statements in accordance with the International Accounting Standards. Only the organized fostering of an awareness of the benefits of good financial reporting, may gradually lead to an increased confidence in financial reporting in Macedonia, an improved knowledge of financial reporting and the wider potential base for investments in Macedonia.

Based on the Survey of the perceptions of International Accounting Standards, carried out among managers in the country, several recommendations can be offered: (1) The country should continue with awareness raising activities among all stakeholders about the importance of the improvement of the quality of financial reporting. Financial reporting in accordance with the IFRS should be published in at least one of the world languages which would contribute to better transparency and ultimately drive more foreign portfolio investments into the country. (2) To further strengthen the professional education and the training of current and prospective accountants in issues beyond the technical aspects and involving strategic management and good corporate governance issues. The state might consider matching funds to foster the lifelong training of local accountants, particularly if it would be offered in some auditing and consulting in big four partnerships in countries with developed financial markets, and (3) to explore how the country can help companies and investors to overcome the fixed costs of compliance to the various global standards.

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Tables

Table 1 SME in Macedonia in 2011

Type	Number	Share		Employed	Share	
		MK	EU27		MK	EU27
Micro	71.794	95.4	92. 2	121.998	44.80	29. 7
Small	2.850	3.8	6. 5	55.059	20.20	20. 6
Medium	493	0. 7	1. 1	44.266	16.20	17. 2
SME in total	75.139	99.9	99. 8	221.323	81. 2	67. 5
Large	88	0. 1	0. 2	51.092	18.8	32. 5
TOTAL	75.227	100. 0	100. 0	272.415	100. 0	100. 0

Source: SBA Factsheet 2013 - European Commission

Table 2 FDI Flows in South-East Europe, 2006-2011 (Millions of Dollars)

Country	2006	2007	2008	2009	2010	2011
Serbia	4. 256	3. 439	2,955	1. 959	1. 329	2. 709
Croatia	3. 468	4. 997	6,180	3,355	394	1,494
Albania	324	659	974	996	1. 051	1. 031
Montenegro	622	934	960	1. 527	760	558
BIH	555	1. 819	1. 002	251	230	435
Macedonia	433	693	586	201	211	422
Total	9,658	12,541	12,657	8,289	3. ,74	6,650

Adapted from: UNCTAD, World Investment Report 2012

Table 3 Cross-border M&A in South-East Europe (Millions of dollars)

Country	2005	2006	2007	2008	2009	2010	2011
Serbia	-	582	280	501	10	19	1. 340
Croatia	360	2. 530	674	204	-	201	92
Macedonia	0	280	53	57	-	46	27
Montenegro	-	7	0	-	362	-	-
Albania	7	41	164	3	146	-	-
BIH	21	79	1. 022	2	8	-	-
Total	955	3. 942	2. 192	767	529	266	1. 480

Adapted from the source: UNCTAD, World Investment Report 2012

Table 4 SEE Stock Exchange Trading Volume as Per cent of GDP

Country	1996	2001	2006	2011
Romania	0. 0	0. 6	3. 5	1. 8
Croatia	1. 0	0. 5	3. 7	1. 5
Slovenia	1. 9	3. 9	2. 6	1. 0
Serbia	0. 0	0. 0	4. 6	0. 7
Bulgaria	0. 0	0. 5	4. 5	0. 5
Macedonia	0. 0	1. 4	3. 0	0. 5

Source: World Bank Database

Figures

Chart 1 Does compliance with IFRS outweighs cost of implementation

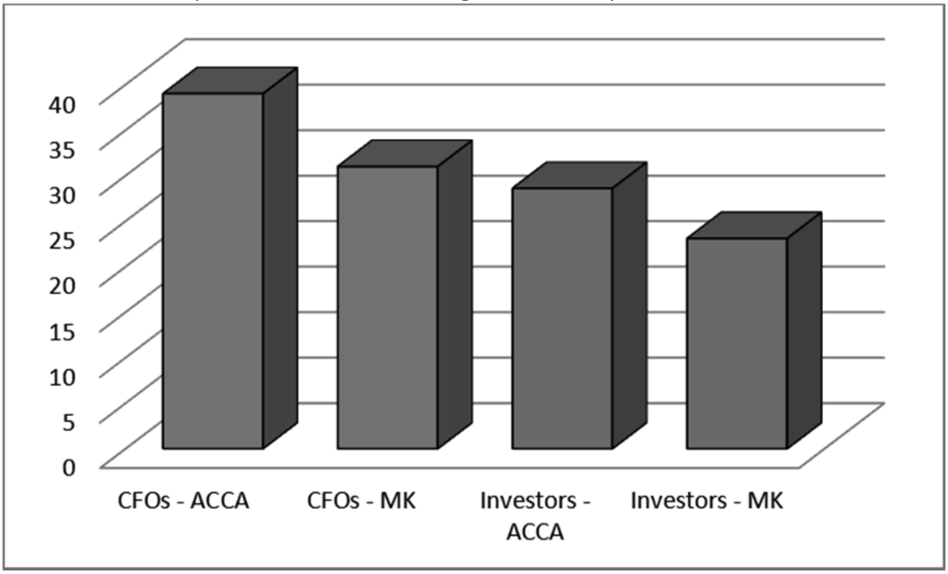

Chart 2 Impact of IFRS on the business activities abroad

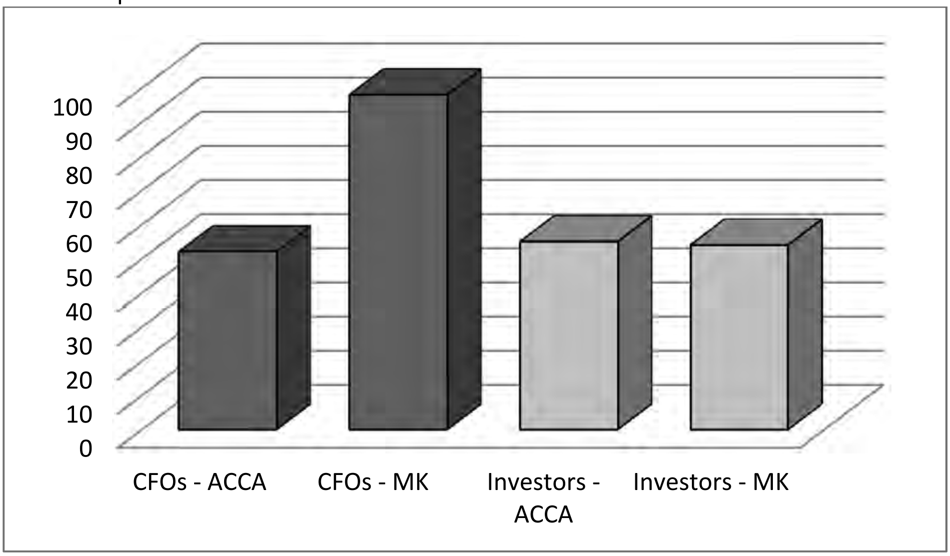

Chart 3 Perception of impact of IFRS on access to capital

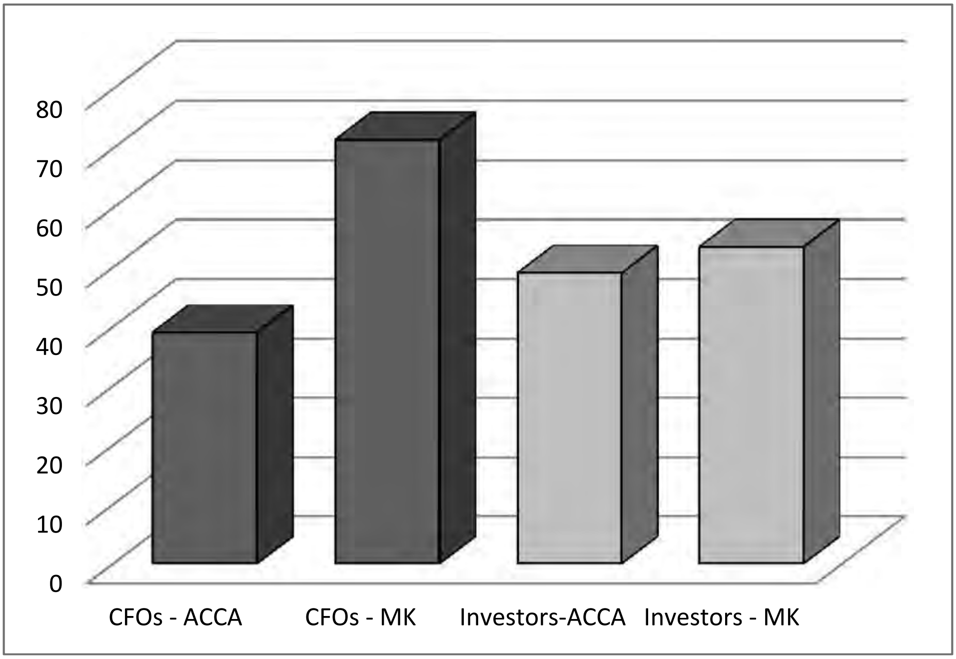

Chart 4 Impact of the global standards in area on environmental risk management

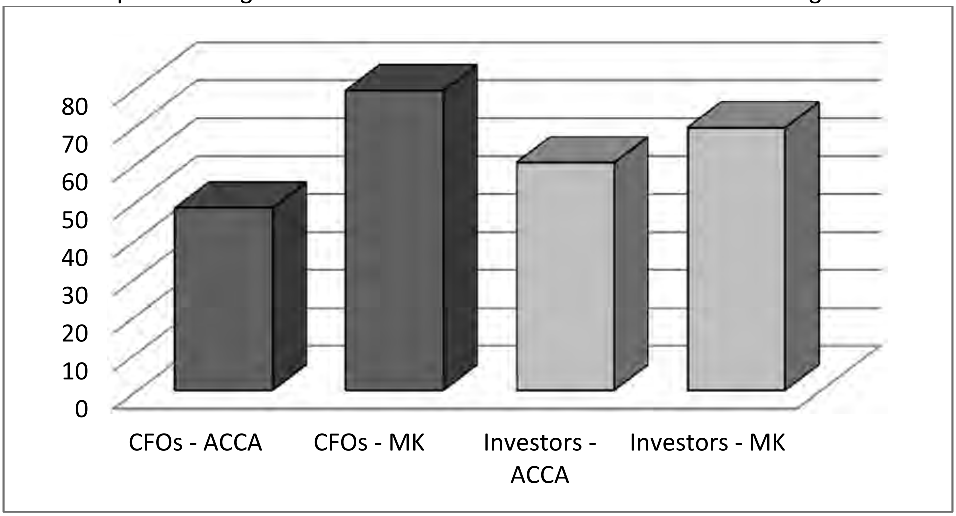

Chart 5 Integrated reports help investors and companies